CHAPTER 3

Regional Economic Integration

Chapter Outline

- Introduction
- What Is Regional Economic Integration?
    - Stages of Regional Integration
    - Pros and Cons of Regional Integration
- The Economic Geography of Regional Integration
    - Steps to Regional Integration
        - Start Small
        - Think Global
        - Compensate the Least Fortunate
    - Major Classes and Characteristics of Regional Integration
        - Regional Blocs Close to World Markets
        - Remote Regions with Large Local Markets
        - Remote Regions with Small Local Markets
- Does Regional Integration Confound Global Trade?
- The European Union (EU)
    - Turkey
    - The Euro
- The North American Free Trade Agreement (NAFTA)
- Association of South East Asian Nations (ASEAN)
    - ASEAN Security Community (ASC)
    - ASEAN Economic Community
    - ASEAN Sociocultural Community
    - The Future of ASEAN
- Regional Integration in Latin America

Teaching Objectives

After covering this chapter, the student should be able to:

- Explain regional economic integration, its evolution, and its benefits and costs.
- Identify how economic geography helps explain, promote, and segment regional integration blocs.
- Identify the primary reasons why countries are now seeking to pursue regional integration at the expense of multilateral trade liberalization.
- Explain why the European Union is seen as the most advanced regional integration bloc.
- Describe how NAFTA has affected U.S.–Mexico bilateral trade in goods and services.
- Explain the importance of ASEAN and indicate why Asia may become the most important free trade region for this century.
- Explain why regional integration in Latin America is challenging, and why there is potential for a grouping like MERCOSUR to become more predominant.

COMPREHENSIVE LECTURE OUTLINE

I. Introduction. Regional integration is an ongoing process. Reasons for regional integration are economic, political, or combination of both. Regional integration can bridge barriers between national borders, and increase interdependence within a region and the rest of the world.

CLASS ACTIVITY: *Use the Cultural Perspective case as an opportunity to allow students to explore the impact of the Trans-Pacific Partnership (TPP) Agreement.* **Exhibit 3.1 • Trans-Pacific Partnership Agreement**

II. What Is Regional Economic Integration? Some countries prefer to work closely within a regional setting. Because the future of the Doha Round of trade liberalization is uncertain, there has been a sharp increase in the number of regional trade and integration agreements.

Regional Integration includes a multitude of economic and/or political steps. **Exhibit 3.2 • Form and Stages of Regional Integration.**

- **Stages of Regional Integration** can take several forms, representing varying degrees of integration.
  - Countries that create a **free-trade area** eliminate all barriers to trade among themselves while keeping their external tariffs with non-members.
  - In a **customs union** all free trade member countries will adopt a common external tariff with nonmember countries.
  - Removal of barriers to allow free movement of capital and labor within the customs union leads to a **common market.**
  - Within the common market, the implementation of common social programs and coordinated macroeconomic policies could lead to **economic and monetary union.**
  - Finally, the urge to have common defense and foreign policies may lead to the creation of **political union.**
- **Pros and Cons of Regional Integration** depend upon the level of integration the countries in the group achieve.
  - The benefits of regional integration include:
    - Creating a larger pool of consumers with growing incomes and similar culture and values.
    - Encouraging economies of scale, increasing the region's level of competitiveness, and enhancing growth.
    - Freeing the flow of capital, labor, and technology to the most productive areas of economic activity.
    - Increasing cooperation, peace and security.
    - Encouraging member states to enhance their social welfare.
  - The costs of regional integration include:
    - Undermining the almost global most-favored-nation status rule.
    - Imposing laws and regulations that are not globally uniform.
    - Eliminating jobs and increasing unemployment in protected industries.
    - Losing sovereignty, national independence, and identity.
    - Reducing the powers of the national government.

- Increasing the probability of rising crime associated with ease of cross-border movements.

DISCUSSION STARTER: REALITY CHECK 1.

Do you believe that increased regional integration will, overall, help or hurt the citizens of your city? Defend your position.

III. The Economic Geography of Regional Integration. The World Bank concludes that positive changes related to market size, location, and openness to trade are essential for successful regional integration. Hence, the policy instruments needed for successful integration include institutions that unify the markets, infrastructure that efficiently connects these markets, and lower economic barriers to facilitate trade.

- **Steps to Regional Integration.** Regional integration is more than just cross-border trade liberalization. The appropriate approach includes the following three fundamentals:
  - **Start Small**. Regional integration should have clear goals and initially address a narrow, well-defined area of cooperation in which the costs and benefits are easily defined.
  - **Think Global.** Regional integration should not create unconnected or isolated countries. Instead, it should help countries gain access to world markets.
  - **Compensate the Least Fortunate.** Regional integration will lead to a concentration of economic activity in fewer places with increased efficiency and competitiveness. It also means that some regions will gain more than others. Explicit compensation programs may be required to ensure access to social services and basic infrastructure in lagging areas.
- **Major Classes and Characteristics of Regional Integration.** In global trade agreements, tariff and non-tariff barriers are reduced or eliminated using MFN rules. Under regional trade agreements, tariff and non-tariff barriers are reduced only among member countries. When the various regional integration blocs are

analyzed from an economic geography perspective, they fall under three general categories:

- **Regional Blocs Close to World Markets**. Market access is essential for economic growth, and proximity to world markets is an asset for just-in-time production, exports of perishable goods, and tradable services. **Exhibit 3.3 • Regions Close to World Markets.**

ECONOMIC PERSPECTIVES: The Ascent of the Maghreb Union. *Use the Economic Perspectives case as an opportunity to discuss the impact of the Maghreb Union on the economies of the five North African countries that are its members and the nearby E.U. countries.*
Suggestion: You could ask students to do this case as individuals or in teams as a class activity. Have the students read the case presented in the text and answer the questions at the end of the case.
Questions:

1. *Name some reasons why the countries of the European Union periphery may be losing their competitiveness against the Maghreb countries. Answer: Wage rates in the Maghreb are less than half those in eastern European Union countries and their 44-hour rather than 35-hour work week makes Maghreb attractive for investors. Additionally, Maghreb countries have a non-unionized labor force, and their workers do not object to overtime work and do not demand a five week annual vacation, like workers in E.U. countries do.*
2. *What are some of the major business reasons why investors find the Maghreb an attractive economic region for future investment? Answer: Maghreb countries are relatively debt free, and they are strategically located along the Mediterranean Sea across from southern Europe.*

- **Remote Regions with Large Local Markets.** Sizeable countries that are far from large world markets can benefit by attracting industrial activities because of their large local market. If the country's infrastructure is well connected to world markets, this advantage is reinforced. **Exhibit 3.4 • Regions with Some Large Local Markets but Located Far from World Markets.**
- **Remote Regions with Small Local Markets.** International integration is most difficult for countries in regions that are divided, far from world

markets, and lack the economic size of a large local economy. Regional integration is paramount for their growth and can be achieved through institutional reform, increasing infrastructure investments to improve market access, and incentives such as preferential access to world markets, liberalized rules of origin, and skills development. **Exhibit 3.5 • Regions with Small Local Markets Located Far from World Markets.**

ETHICAL PERSPECTIVES: The Chinese Syndrome. *Use the Ethical Perspectives case as an opportunity to discuss the socioeconomic impact of economic integration and ethicality of the bilateral deal between China and DR Congo.*

Questions:

1. *Does the DR Congo-China venture make economic integration sense? Explain. Answer: It does make sense. China is attracted to DR Congo due to its massive appetite for mineral resources, while DR Congo despite its size and mineral wealth is lacking in modern infrastructure. The nine billion dollar deal between China's state-owned companies and DR Congo will provide DR Congo with desperately needed infrastructure: roads, railways, hospitals, and universities in exchange for 10 million tons of copper and 400,000 tons of cobalt that will be shipped to China.*
2. *Do you believe that the Chinese are behaving ethically, or are they taking advantage of the DR Congo? Can you identify other strategic choices that DR Congo could use to develop its mineral resources? Answer: The joint venture will be 1/3 DR Congolese and 2/3 Chinese-owned, and will continue exploiting the mine even after a projected 10 years in which Chinese companies are expected to recoup their investment. The deal is criticized because the Chinese are negotiating with African governments in ways that lack transparency and unfairly disadvantage the DR Congo. For example, although the project details are not published, there are indications that Chinese enterprises will be exempt from paying taxes on mining income and customs duties until the infrastructure work is complete. DR Congo needs an open and transparent system of tenders to make sure that the company that will win the bid will provide the best deal for the Congolese economy.*

DISCUSSION STARTER: REALITY CHECK 2.

Identify the regional integration blocs of which your country is a part. Do you think that being part of these regional integration blocs has helped or hurt your personal welfare? How?

IV. Does Regional Integration Confound Global Trade? Groups of countries have formed various kinds of economic cooperation agreements. Economists are concerned that as a result of these negotiations, the prospects of creating a truly open global economic system that benefits all countries may recede.

DISCUSSION STARTER: REALITY CHECK 3.

Are policymakers in your country pushing for more regional integration or global integration? Why? Will that benefit you personally? If so, how?

V. The European Union (EU). The EU, headquartered in Brussels, is the most highly evolved example of regional integration. It is in the fourth stage of the integration process, and is moving toward political union with common defense and foreign policy institutions.

- The origins of the EU can be traced back to the creation of the European Coal and Steel Community (ECSC) in 1952. The objective of ECSC was to encourage member countries to cooperate in steel production, preventing the member countries from warring with each other.
- The second major step was the Treaty of Rome signed in 1957. It established the European Economic Community (EEC) that called for free trade among members as well as a common external tariff for non-members.
- In 1992 the Maastricht Treaty was signed and the EEC became a full economic union or single market with free movement of labor among member countries.
- The EU's enlargement was mostly gradual, reaching 28 member countries by 2013. **Exhibit 3.6 The European Union; Exhibit 3.7 The European Union and the United States: A Comparison.**

▪ **Turkey.** The fate of EU candidate country Turkey is uncertain. Geographically, about 5% of Turkey's land mass is in Europe. Due to its low per-capita income level, significant EU budgetary resources may be needed for Turkey's infrastructure development. Some other issues of concern to existing members are the powerful role of the military within a nascent democracy, a questionable human rights record, and a large and predominantly Muslim population.

▪ **The Euro.** The Eurozone's single currency was introduced on January 1, 1999. Its performance until the start of the European sovereign debt crisis in 2009 was remarkable. The international role of the euro as a foreign exchange reserve currency is gaining ground. After meeting strict fiscal and monetary criteria, 18 of 28 EU countries that formed the Eurozone were allowed to use the euro as their currency. The European Central Bank (ECB), based in Frankfurt, is the apex central bank for the Eurozone countries. It maintains responsibility for the Eurozone's monetary policy--maintaining annual Eurozone inflation at below but close to 2%--and the stability of the euro.

DISCUSSION STARTER: REALITY CHECK 4.

Using end-of-year annual data, identify how the value of the euro has changed (with respect to your national currency) over the past five years. In your opinion, has the euro been stable? Would this be the right time to visit the European Union? Explain.

VI. The North American Free Trade Agreement (NAFTA). NAFTA is a comprehensive free-trade agreement among Canada, the United States, and Mexico. It addresses issues ranging from protection of workers' rights and the environment to phased reduction of tariff and non-tariff barriers by 2009. **Exhibit 3.8 North American Free Trade Agreement**.

- NAFTA has three major objectives:
    - Expansion of trade in goods and services
    - Protection of intellectual property rights
    - Creation of institutions to address potential environmental and labor problems
- Until 2004, the United States' top two trade partners were Canada and Mexico. However, since that time, China has surpassed Mexico and has become the United States' second largest trade partner. **Exhibit 3.9 United States: Exports and Imports of Goods to and from Top Ten Trade Partners.**

DISCUSSION STARTER: REALITY CHECK 5.

If you are living in the United States, visit a local chain grocery store like Kroger or Safeway and investigate from where some of those fresh vegetables come. Is NAFTA at work?

VII. Association of South East Asian Nations (ASEAN). ASEAN, headquartered in Jakarta, was established in 1967. ASEAN's current membership stands at 10. **Exhibit 3.10 Association of South East Asian Nations (ASEAN)**. As of 2013, the ASEAN region had a population of

625 million, a land area of 4.4 million square kilometers, and a combined GDP of $2.4 trillion. **Exhibit 3.11 ASEAN Selected Key Economic Indicators**. ASEAN's two main objectives are:

- To accelerate economic growth, social progress, and cultural development
- To promote regional peace and stability through the rule of law

In 2003 ASEAN leaders agreed to establish an ASEAN Community based on three pillars:

- **ASEAN Security Community (ASC).** ASC's objective is to ensure that countries in the region live in peace with one another. Since ASEAN's establishment, tension has never escalated into armed confrontation among ASEAN members.
- **ASEAN Economic Community.** The goal is to create a stable, prosperous, and highly competitive economic region. The ASEAN Economic Community calls for the establishment of a single market, but it does not call for the free movement of labor across member countries.
- **ASEAN Sociocultural Community.** The goal is to ensure that the ASEAN workforce is well prepared to benefit from the economic integration. Programs are being put into place through investments in basic and higher education, training, R&D, and raising the standard of disadvantaged groups and the rural population through better health care and social protection.

The Future of ASEAN. ASEAN's Vision 2020 calls for aggressive outward-looking economic policies. If all goes as planned, ASEAN inspired FTAs will create the world's largest free trade area,comprising much of Asia. A growing ASEAN concern is the economic ascendancy of China.

DISCUSSION STARTER: REALITY CHECK 6.

Identify the ASEAN country that is considered to be the regional hub for multinational corporations operating in Asia. How does that country's per capita income compare with the United States and why?

VIII. Regional Integration in Latin America. The first step toward free trade in Latin America was taken with the signing of the Treaty of Montevideo in 1960, which created the Latin American Free Trade Association (LAFTA).

- In 1969, the Andean Group was created in frustration due to the lack of progress in LAFTA.
- The Treaty of Asuncion, signed in 1991, created the Southern Cone Common Market, or MERCOSUR. **Exhibit 3.12 Regional Integration in Latin America.** The treaty called for progressive tariff reduction, the adoption of sectoral agreements, a common external tariff, and the ultimate creation of a common market. Much remains to materialize in MERCOSUR. The newest member to join Mercosur was Venezuela in July 2012. Guyana and Surinam signed a framework agreement with Mercosur in July 2013 to become associate states.
- Formal discussion to establish a Free Trade Area of the Americas (FTAA) began in 1994 under the Clinton administration, but the outlook remains uncertain.
- The Bush administration began free-trade talks with the five Central American countries and the Dominican Republic. DR-CAFTA became effective in 2005.

DISCUSSION STARTER: REALITY CHECK 7.

Visit your local grocery supermarket and discover from where the various brands of premium coffee beans come. Which trade agreement do you think makes that choice possible?

Assignments

End-of-Chapter Discussion Questions

1. Will countries be better off under a multilateral economic liberalization regime or under a system of regional economic integration? Why? Answer: Overall, a multilateral economic liberalization regime is more desirable, since it creates a discrimination-free environment for all. Yet, because the future of the Doha Round is uncertain, regional economic integration at this point is the most viable strategy.

2. How useful is economic geography in explaining the success of regional economic integration blocs? Give examples. Answer: Economic geography studies principles that govern the efficient spatial allocation of economic resources and the resulting consequences. Analysis of market size, location,

and openness to trade helps explain why some markets are developing faster than others.

3. Why are countries pushing to sign regional integration blocs? Answer: Some countries prefer to work more closely within a regional setting. Others realize the complexity of achieving progress in the Doha round of WTO negotiations and rely on regional economic integration instead.

4. Although the European Union is the most advanced form of regional integration, it is currently facing a challenging time. What are some of the major challenges facing the EU? Answer: The EU imposes uniform laws and regulations on its members. At times, they do not take into account national economic, cultural, and social differences. Some EU members are concerned about the power of Brussels and losing sovereignty, national independence, and identity. The EU's eastward enlargement poses some problems due to the lower levels of economic development in some of the newer EU members. A major contradiction of the European Union is the desire of its members to behave as a single country and at the same time have national sovereignty, with each country following its own fiscal policies. The latter has led several countries to run budget deficits and pile up huge public debt that is in direct contradiction of the "convergence criteria" laid out by the ECB to be a part of the Eurozone. The net result has been the sovereign debt crisis and its negative impact on the euro.

5. NAFTA has improved Mexico-U.S. trade and investment, yet bilateral trade between the United States and China is greater than with Mexico. Why is this true? Answer: Although the U.S. remains Mexico's largest trade partner, low-cost manufacturing is diverted to China. Currently, Mexico cannot compete with China because of its higher labor costs. But rising labor costs in China and Mexico's proximity to the U.S. could possibly change the dynamics in the long run.

6. It appears likely that a free trade area in much of Asia is likely by the end of 2020. What are the global implications for such a development? Answer: ASEAN's Vision 2020 calls for aggressive outward-looking economic policies and includes bilateral trade agreements with all major Asian economic powers. If everything goes as planned, ASEAN-inspired FTAs will create the world's largest free trade area, comprising much of Asia.

7. Regional integration in Latin America offers tremendous potential. Yet economic achievements are relatively modest so far. Why? Answer: Although the countries of Latin America have significant natural and human resources, the region has been a patchwork of constantly changing regional trade agreements. Economic and political uncertainties, such as Argentina's debt crisis and shifting political ideology, have undermined implementation of most Latin American trade agreements.

Mini-Case Synopsis and Questions

The rapid enlargement of the EU raises some questions about the reasons for recent expansion and the proper procedure for vetting the new members. Some experts and EU bureaucrats argue that the purpose of enlargement should be political—i.e., to keep Europe safe for democracy, which means that new members should be admitted even without adequate vetting. Critics call for a uniform enforcement of rule of law and tighter, more effective regulation of the financial sector within the EU.

Questions:

1. *Given the security concerns of both the EU and Russia, where should the EU's eastern border end? Do you think the buffer states should become NATO members as well? Why or why not?* The geographical borders of Europe stretch east as far as the Ural Mountains—which is in the middle of the Russian Federation. A case can be made that Russia may consider becoming an EU member. Until then, a buffer state like the Ukraine could become an EU member, but it may not be politically wise on the part of Ukraine to become a NATO member. Including Russia in the EU will reinforce the economic ties between European countries and Russia and will have a positive effect on their political relations, making buffer states unnecessary.

2. *Should non-uniformity policies in the EU (i.e., cherry picking EU policies that members may choose to follow) be tolerated or encouraged? Make your case.* These policies should not be tolerated because they will lead to uneven development of EU members and inconsistencies in their political, economic, and technological environments. At the present level of economic integration, these inconsistencies can lead to serious problems, such as the Greek crisis.

Point/Counterpoint, *Interpreting Global Business News*, and *Portfolio Projects*

Students' answers to these assignments will vary widely. Their writing should reflect an understanding of the chapter's basic concept, thorough research, and logic and critical thinking skills.