

UWTSD MBA (2020 intake)
Global Business Challenges
(HKBM7009_HKMA)
(5-1)

Regional Economic Integration and Trade Arrangements

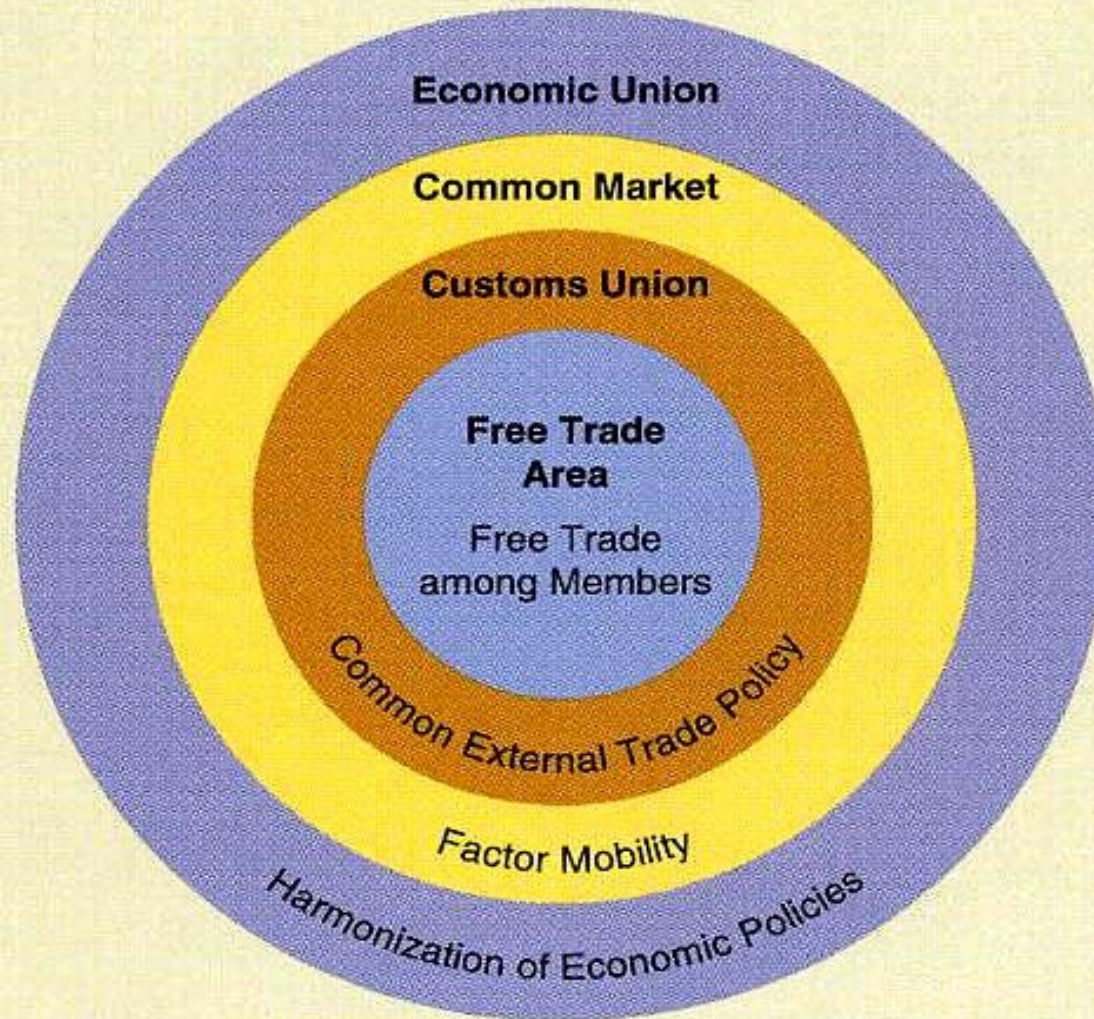
Che Cheong POON
31 January 2021; 10:00 am to 1:00 pm

Lecture Agenda :

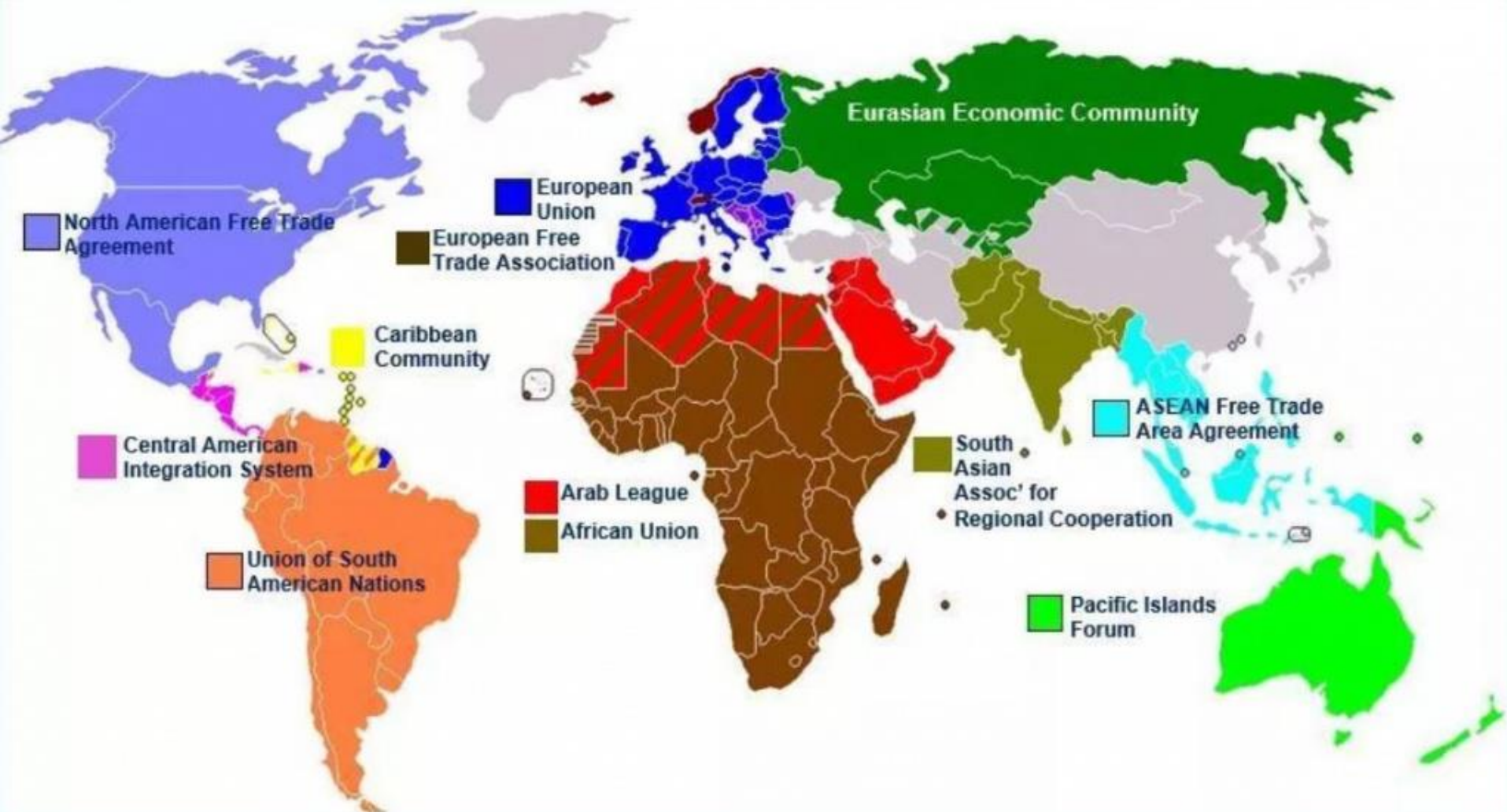
- Some basics
- Theories of regional integration
- Major regional trading groups
- Regional Economic Integration Implications for Global Business

Some Basics

Types of existing trade blocs existing today



Economic Union is an agreement between or among countries that allows products, services, and workers to cross borders freely. The union requires the integration of monetary and fiscal policies, so that member countries coordinate policies, taxation, and government spending related to the agreement. They also use a common currency that comes with fixed exchange rates.



Concept of regional economic integration

Regional economic integration occurs when countries come together to form free trade areas or customs unions, offering members preferential trade access to each others' markets.

Free Trade Area

There are two distinguishing characteristics of a free trade area.

- **The first characteristic** is the liberalization of trade regulation for members.
- **Second**, the removal of trade barriers placed against members. This includes the removal of tariffs, quotas, and various non-tariff barriers, or a pledge to remove such trade barriers by a date certain in the future.

Customs Union

- A customs union adds a **third** characteristic to the two characteristics of a free trade area, namely the imposition of a common tariff on nonmember countries.
- This means that the member countries of a customs union pledge to liberalize trade regulations, remove trade barriers placed against members, in addition to agreeing to impose a common tariff against nonmember countries.
- For example, all members of a customs union might agree to have a ten percent tariff against nonmember countries, while previously each country had different and unique tariff levels.
- Imposition of a common tariff implies a convergence of trade policy across member countries and, through such trade policy convergence, a pooling of national sovereignty.

Common Market (Single market)

- A common market encompasses all characteristic of a free trade area and of a customs union, while adding mobility of factors of production as a **fourth** distinguishing characteristic.
- Included is mobility of capital, labor, and technology.
- Mobility of labor requires that the member countries develop a common visa policy and a common position on residency.
- Additionally, the member countries will develop common policies to harmonize standards, have mutual recognition or acceptance of each other's standards, or agree on minimum standards.

Economic Union

1. An economic union brings a **fifth** distinguishing characteristic to the four characteristics of in the previous slides.
2. That characteristic is to seek economic integration through harmonizing fiscal and monetary policies, creating a common currency, and establishing a super-national governing authority.
3. For example, a super-national governing authority is the European Parliament established by the European Union countries.

Political Union (an ideal state)

- A political union is the ultimate step along the regional economic integration path.
- A political union brings full economic and political unification to members of an economic union.
- The question whether there will be a United States of Europe sometime in the tomorrow's beyond, is an example of a situation of an economic union (i.e., the European Union) maturing toward full economic and political unification (not likely to occur anytime soon).

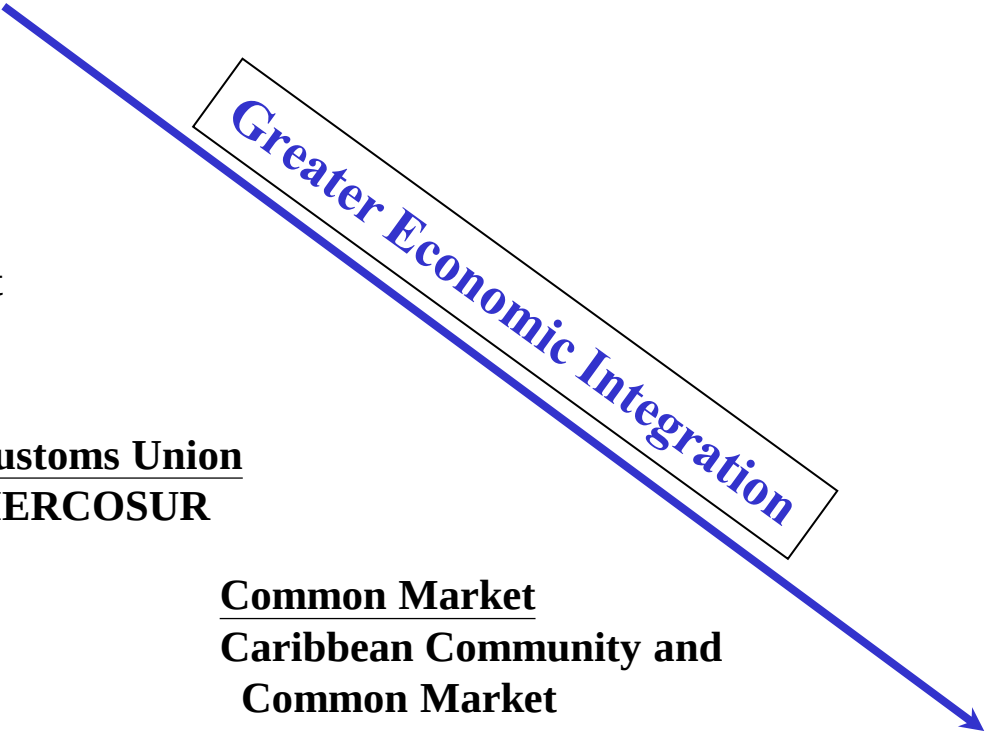
Major regional trading blocs (groups)

**European Free Trade
Association
Central European Free
Trade Agreement
North American Free
Trade Agreement
Association of South East
Asian Nations**

**Customs Union
MERCOSUR**

**Common Market
Caribbean Community and
Common Market
Central American Common
Market**

**Economic Integration
European Union**



Greater Economic Integration

China's FTA network (As at December 2019)

China-Mauritius FTA	China-New Zealand FTA
<u>China-Maldives FTA</u>	China-Chile FTA
China-Georgia FTA	China-Pakistan FTA
China-Australia FTA	China-ASEAN FTA
China-Korea FTA	Mainland and Hong Kong Closer Economic and Partnership Arrangement
China-Switzerland FTA	Mainland and Macao Closer Economic and Partnership Arrangement
China-Iceland FTA	China-ASEAN FTA Upgrade
China-Costa Rica FTA	China-Chile FTA Upgrade
China-Peru FTA	China-Singapore FTA Upgrade
China-Singapore FTA	China-Pakistan FTA second phase Study

Effects of Integration

- Static effects—shifting of resources from inefficient to efficient companies as trade barriers fall
 - Develop when either of two conditions occurs
 - trade creation—comparative advantage is the cause of production shifts which allows consumers access to more goods at lower prices
 - trade diversion—trade shifts to member countries, even if nonmember company is more efficient
- Dynamic effects—overall growth in the market and the impact on a company of expanding production and achieving greater economies of scale
 - Occur when trade barriers fall and the size of the market increases
 - Leads to increased efficiency due to increased competition

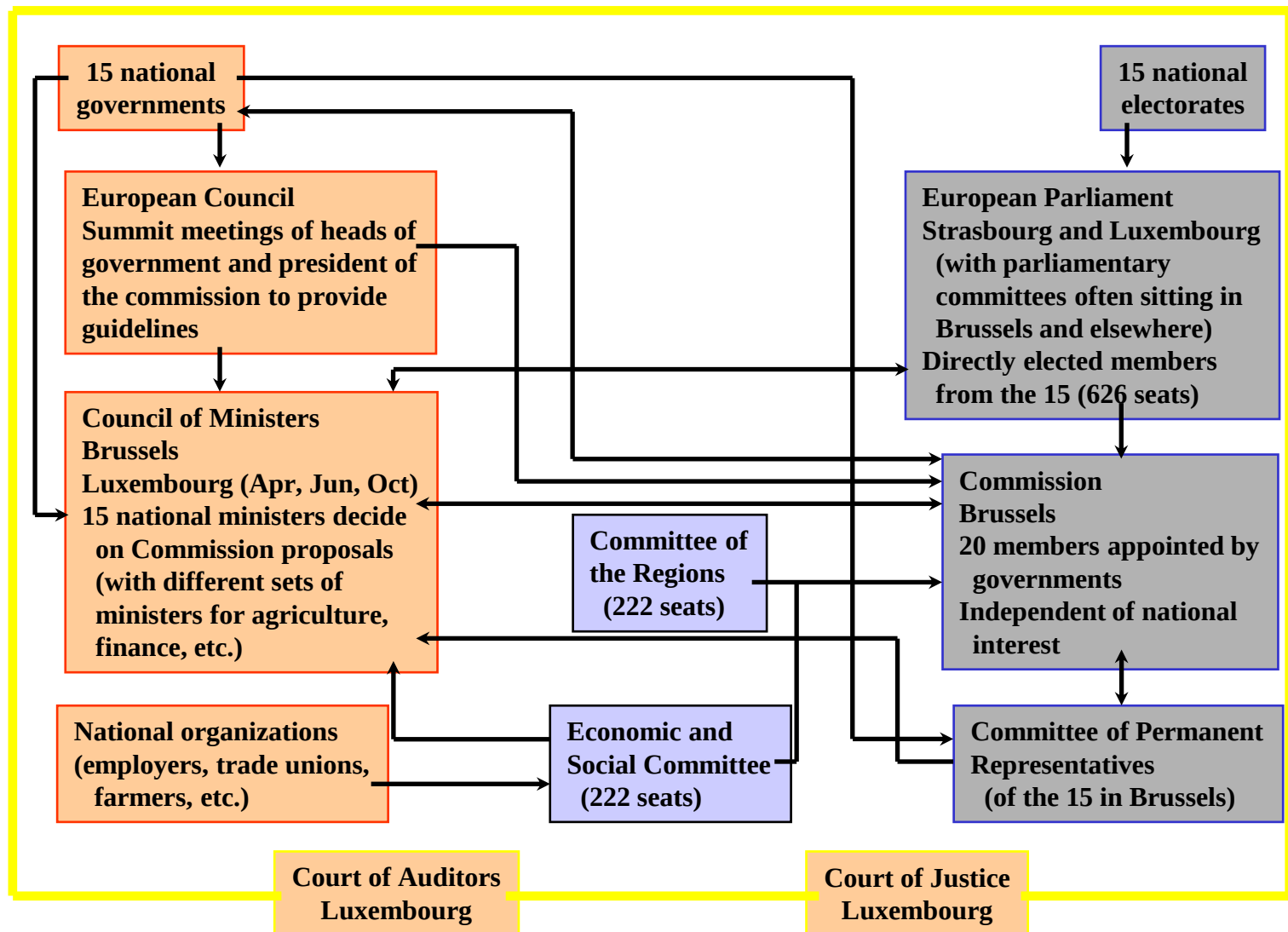
Major Regional Trading Groups

The European Union (EU)

European evolution to integration

- Organization for European Economic Cooperation
 - established to facilitate the implementation of the Marshall Plan after World War II
- European Economic Community (EEC)
 - eliminated internal tariffs
 - established a common external tariff
 - established common agricultural policy
 - expanded membership
- European Parliament
 - directly elected by the people
 - attempted to bring democracy into governance of Europe
- European Monetary System (EMS)
 - established to link individual national currencies

EU Organizational Structure



North American Free Trade Agreement (NAFTA)

- Became law: January 1, 1994
- It is an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America.
- The NAFTA trade bloc is one of the largest trade blocs in the world by gross domestic product.
- The provisions include intellectual property, environment, agriculture, and transportation infrastructure.
- Passage of NAFTA resulted in the elimination or reduction of barriers to trade and investment between the U.S., Canada, and Mexico.
- Impact of the US withdrawal from NAFTA
 - “Ospina (2018) United States Withdrawal from NAFTA: Potential Effects on the Domestic Agriculture Sector and In-Market Consumers”

Regional Economic Groups in Latin America

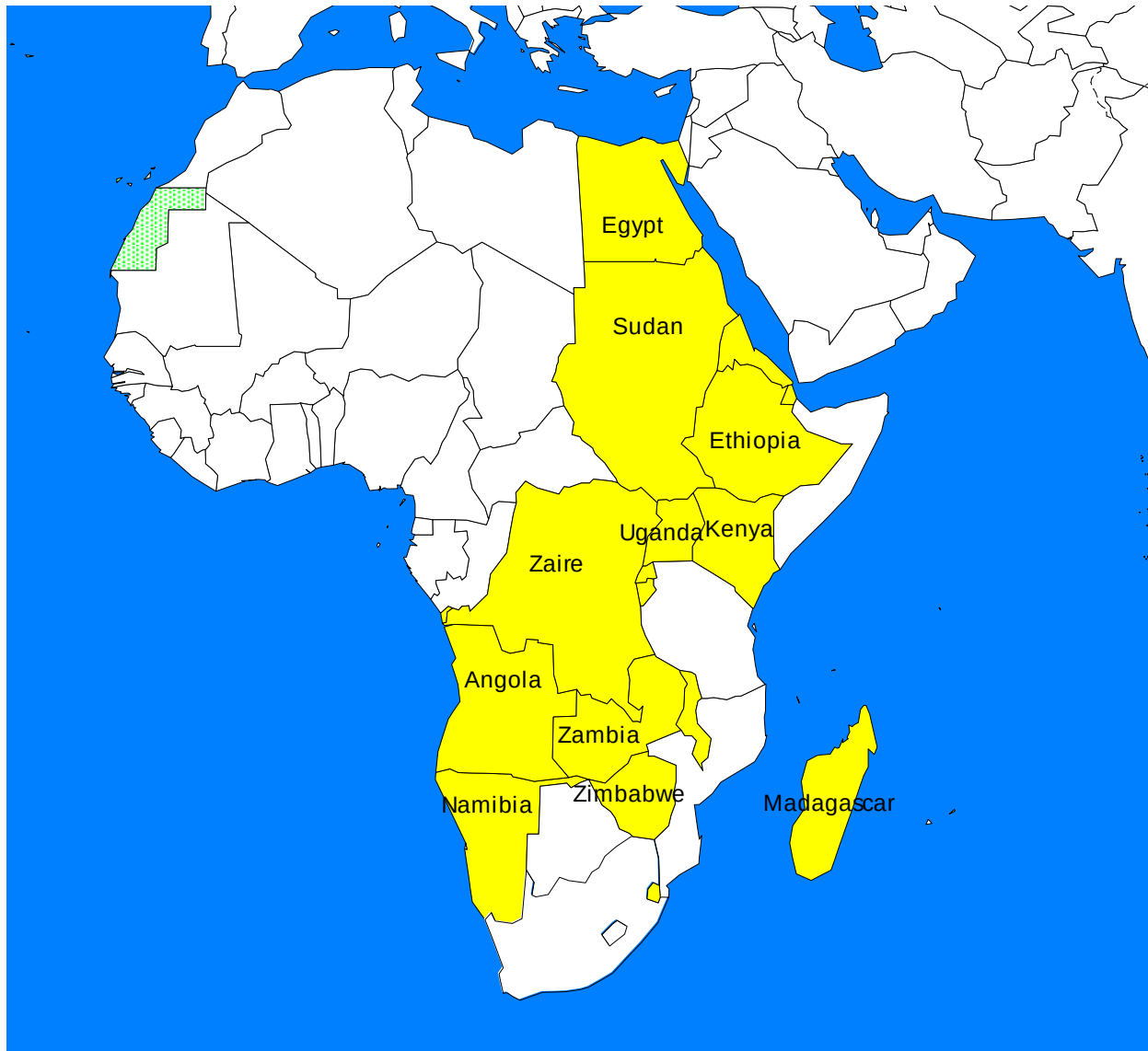
- Caribbean Community and Common Market (CARICOM)
 - It is a regional group of nations that encourage common policy and economic goals
 - It was formed in 1973 and consists of 20 nations, including fifteen full-time members and five associate members.
 - One of CARICOM's current goals is to establish a free-trade zone and single market for increased trade and economic growth in the region.

- Southern Common Market/South American Common Market (MERCOSUR)
 - It is is an economic and political bloc in South America established in 1994 Argentina, Brazil, Paraguay, Uruguay, and Venezuela.
 - Its main objective has been to promote a common space that generates business and investment opportunities through the competitive integration of national economies into the international market.
 - Since its inception, it has been based on the principles of Democracy and Economic Development, which underpins the core values of a human-faced integration. Aligned with these, different agreements have been added in terms of migratory, labour, cultural, and social matters -just to mention a few, which are of utmost importance for its inhabitants.

The Common Market for Eastern and Southern Africa (COMESA)

- The history of COMESA began in December 1994 when it was formed to replace the former Preferential Trade Area (PTA) which had existed from the earlier days of 1981.
- COMESA (as defined by its Treaty) was established ‘as an organization of free independent sovereign states which have agreed to co-operate in developing their natural and human resources for the good of all their people’ and as such it has a wide-ranging series of objectives which necessarily include in its priorities the promotion of peace and security in the region.

COMESA countries



Association of Southeast Asian Nations

- The Association of Southeast Asian Nations, or ASEAN, was established on 8 August 1967 in Bangkok, Thailand, with the signing of the ASEAN Declaration (Bangkok Declaration) by the Founding Fathers of ASEAN, namely Indonesia, Malaysia, Philippines, Singapore and Thailand.
- Brunei Darussalam then joined on 7 January 1984, Viet Nam on 28 July 1995, Lao PDR and Myanmar on 23 July 1997, and Cambodia on 30 April 1999, making up what is today the ten Member States of ASEAN.
- The ASEAN Community is comprised of three pillars, namely the ASEAN Political-Security Community, ASEAN Economic Community and ASEAN Socio-Cultural Community. Each pillar has its own Blueprint, and, together with the Initiative for ASEAN Integration (IAI) Strategic Framework and IAI Work Plan Phase II (2009-2015), they form the Roadmap for an ASEAN Community 2009-2015.

ASEAN countries



- As set out in the ASEAN Declaration, the aims and purposes of ASEAN are:
 1. To accelerate the economic growth, social progress and cultural development in the region through joint endeavours in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of Southeast Asian Nations;
 2. To promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries of the region and adherence to the principles of the United Nations Charter;
 3. To promote active collaboration and mutual assistance on matters of common interest in the economic, social, cultural, technical, scientific and administrative fields;
 4. To provide assistance to each other in the form of training and research facilities in the educational, professional, technical and administrative spheres;
 5. To collaborate more effectively for the greater utilisation of their agriculture and industries, the expansion of their trade, including the study of the problems of international commodity trade, the improvement of their transportation and communications facilities and the raising of the living standards of their peoples;
 6. To promote Southeast Asian studies; and
 7. To maintain close and beneficial cooperation with existing international and regional organisations with similar aims and purposes, and explore all avenues for even closer cooperation among themselves.

Asia Pacific Economic Cooperation (APEC)

- The Asia-Pacific Economic Cooperation (APEC) is a regional economic forum established in 1989 to leverage the growing interdependence of the Asia-Pacific. APEC's 21 members aim to create greater prosperity for the people of the region by promoting balanced, inclusive, sustainable, innovative and secure growth and by accelerating regional economic integration.
- APEC ensures that goods, services, investment and people move easily across borders. Members facilitate this trade through faster customs procedures at borders; more favorable business climates behind the border; and aligning regulations and standards across the region. For example, APEC's initiatives to synchronize regulatory systems is a key step to integrating the Asia-Pacific economy. A product can be more easily exported with just one set of common standards across all economies.

- APEC has 21 members. The word 'economies' is used to describe APEC members because the APEC cooperative process is predominantly concerned with trade and economic issues, with members engaging with one another as economic entities.

APEC Members	Date of Joining	APEC Members	Date of Joining
Australia	6-7 Nov 1989	New Zealand	6-7 Nov 1989
Brunei Darussalam	6-7 Nov 1989	Papua New Guinea	17-19 Nov 1993
Canada	6-7 Nov 1989	Peru	14-15 Nov 1998
Chile	11-12 Nov 1994	The Philippines	6-7 Nov 1989
People's Republic of China	12-14 Nov 1991	Russia	14-15 Nov 1998
Hong Kong, China	12-14 Nov 1991	Singapore	6-7 Nov 1989
Indonesia	6-7 Nov 1989	Chinese Taipei	12-14 Nov 1991
Japan	6-7 Nov 1989	Thailand	6-7 Nov 1989
Republic of Korea	6-7 Nov 1989	The United States	6-7 Nov 1989
Malaysia	6-7 Nov 1989	Viet Nam	14-15 Nov 1998
Mexico	17-19 Nov 1993		

Organization of Petroleum Exporting Countries (OPEC)

- Producer cartel that has significant control over output and price. OPEC oil exports are 60 percent of oil traded internationally
- OPEC is a permanent intergovernmental organization of 14 oil-exporting developing nations that coordinates and unifies the petroleum policies of its Member Countries.
- Its mission is to coordinate and unify the petroleum policies of its Member Countries and ensure the stabilization of oil markets in order to secure an efficient, economic and regular supply of petroleum to consumers, a steady income to producers and a fair return on capital for those investing in the petroleum industry.

- The Organization of the Petroleum Exporting Countries (OPEC) was founded in Baghdad, Iraq, with the signing of an agreement in September 1960 by five countries namely Islamic Republic of Iran, Iraq, Kuwait, Saudi Arabia and Venezuela. They were to become the Founder Members of the Organization.
- These countries were later joined by Qatar (1961), Indonesia (1962), Libya (1962), the United Arab Emirates (1967), Algeria (1969), Nigeria (1971), Ecuador (1973), Gabon (1975), Angola (2007), Equatorial Guinea (2017) and Congo (2018).

World oil demand and supply balance, mb/d

World demand	2016	2017	2018	1Q19	2Q19	3Q19	4Q19	2019
OECD	47.07	47.61	48.01	47.76	47.15	48.45	48.57	47.99
Americas	24.89	25.07	25.60	25.19	25.32	26.07	26.16	25.69
Europe	14.04	14.38	14.33	14.08	14.22	14.71	14.29	14.33
Asia Pacific	8.14	8.15	8.08	8.50	7.61	7.68	8.12	7.97
DCs	31.56	32.13	32.62	32.96	32.84	33.46	33.19	33.11
FSU	4.57	4.64	4.76	4.70	4.68	4.96	5.04	4.84
Other Europe	0.70	0.72	0.74	0.75	0.71	0.75	0.84	0.76
China	11.80	12.32	12.71	12.63	13.19	12.98	13.43	13.06
(a) Total world demand	95.70	97.42	98.84	98.79	98.56	100.60	101.07	99.77

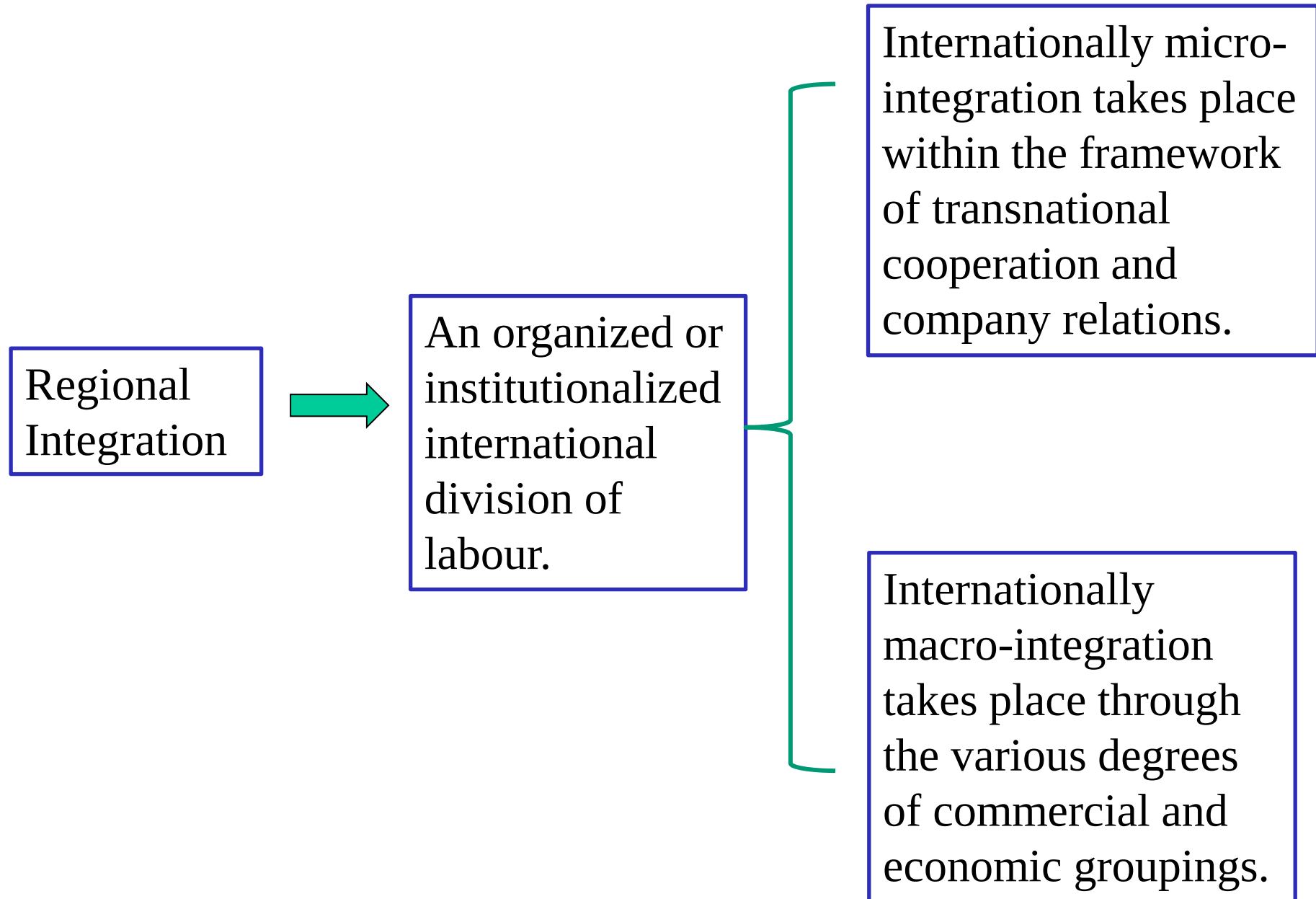
Non-OPEC supply	2016	2017	2018	1Q19	2Q19	3Q19	4Q19	2019
OECD	24.86	25.71	28.33	29.34	29.64	29.74	30.90	29.91
Americas	20.59	21.49	24.08	25.07	25.59	25.68	26.43	25.69
Europe	3.85	3.82	3.84	3.84	3.57	3.55	3.93	3.72
Asia Pacific	0.43	0.39	0.41	0.43	0.48	0.51	0.55	0.49
DCs	13.54	13.40	13.46	13.41	13.43	13.59	13.79	13.56
FSU	13.85	14.05	14.29	14.55	14.16	14.34	14.41	14.37
Other Europe	0.13	0.13	0.12	0.12	0.12	0.12	0.12	0.12
China	4.09	3.97	4.02	4.10	4.13	4.10	4.09	4.10
Processing gains	2.19	2.22	2.25	2.28	2.28	2.28	2.28	2.28
Total non-OPEC supply	58.68	59.48	62.47	63.80	63.76	64.17	65.60	64.34
OPEC NGLs + non-conventional oils	4.58	4.64	4.76	4.80	4.82	4.71	4.86	4.80
(b) Total non-OPEC supply and OPEC NGLs	63.26	64.12	67.24	68.60	68.58	68.89	70.46	69.13
OPEC crude oil production (secondary sources)	32.21	32.01	31.86	30.48	29.97	29.39	29.60	29.86
Total supply	95.47	96.13	99.10	99.08	98.55	98.28	100.06	98.99

Global economic integration – WTO

- Founded on January 1, 1995, the World Trade Organization's (WTO) prime objective was to strengthen the world trading system and be more effective than the General Agreement on Tariffs and Trade (GATT), the organization it replaced (WTO & GATT, 2006). As stated on its website (WTO About, 2006), "the World Trade Organization is the only global international organization dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments.
- The goal is to help producers of goods and services, exporters, and importers conduct their business." The WTO seeks to strengthen the world's trading system and, as a permanent organization, to be more effective in fostering comity than the provisional GATT organization which it replaced. The WTO is based in Geneva and organized with a Ministerial Conference as its highest authority. Meeting at least every two years, the Ministerial Conference is composed of representatives of all WTO member nations.

Theories of Regional Integration

The theory of regional integration refers to the commercial policy of discriminatively reducing or eliminating trade barriers only among the nations joining together.



Theoretical background: Liberalist vs Dirigist ideal of economic integration

- Liberalist see regional integration as a return to the pre- WW1 free trade ideals, that is, economic integration is synonymous with trade (and payments) liberalization.
- Liberalist views are synonymous with open regionalism which is now embraced by current and emerging RTAs, for example, CARICOM now embraces open regionalism.
- Dirigist see integration as expanded state intervention to address policy concerns affecting the entire region, policy coordination. Philips (1957- social aspect of European Economic Cooperation) argues that there is no alternative to a directed market. The market can be extended not by liberalizing it but by organizing it.

Five forms/levels of regional integration

- **Preferential Trading Arrangement (PTA)**: is a trading bloc that gives preferential access to certain products from the participating countries.
- **Free Trade Area (FTA)** : Lowering of some tariff barriers among members but the maintenance of individual tariff barriers against non-members
- **Customs Union**: Liberalized intra-regional trade, common external barriers
- **Common Market**: Liberalized intra-regional trade, common external barriers and unfettered factor mobility.
- **Economic Union**: Liberalized intra-regional trade, common external barriers, unfettered factor mobility and policy harmonization.

Level of integration

NAFTA



Preferential Trading
Arrangement

Free Trade
Area

Customs
Union

Common
Market

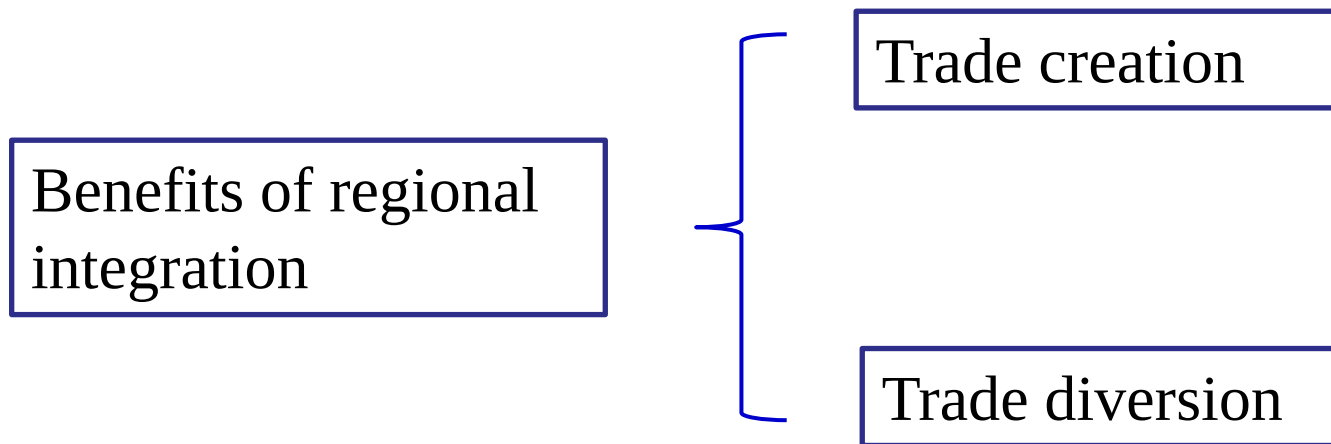
Economic
Union

EU

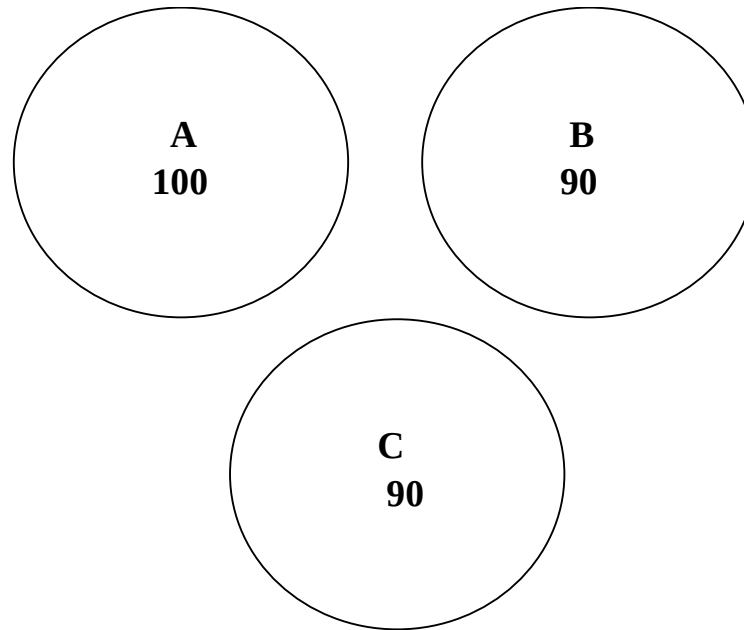
Characteristics of regional integration

Agreement	Lower Barriers Among members	Free trade among members	Common trade barriers	Free movement of labour and capital	Harmonization Of fiscal and monetary policies
Preferential Trading Arrangement	✓				
Free Trade Area	✓	✓			
Customs Union	✓	✓	✓		
Common Market	✓	✓	✓	✓	
Economic Union	✓	✓	✓	✓	✓

Benefits of regional integration



Trade creation



20 percent tariff

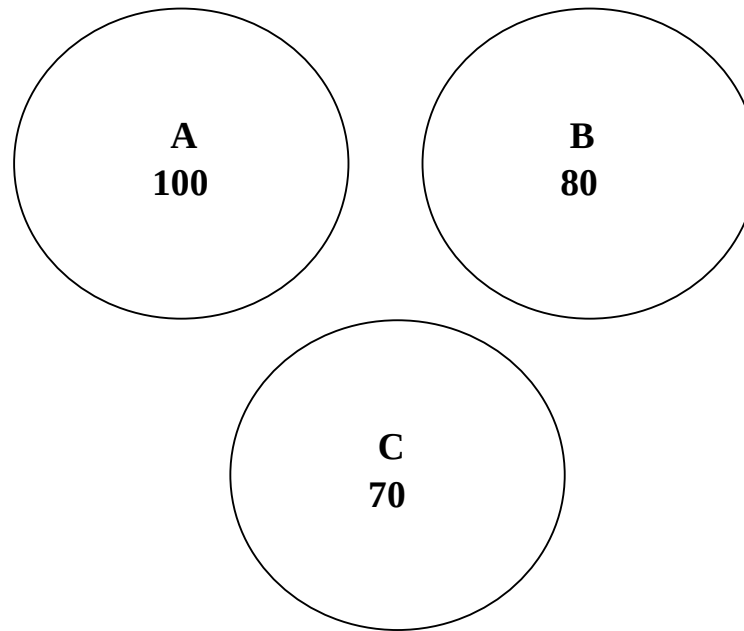
Before establishing a RIA between countries A and B:

A=100, $B=90 \times 1.2=108$, $C=90 \times 1.2=108$

After establishing a TIA between countries A and B:

A=100, **B=90**, $C=90 \times 1.2=108$

Trade diversion



20 percent tariff

Before establishing a RIA between countries A and B:
 $A=100$, $B=80 \times 1.2=96$, $C=70 \times 1.2=84$

After establishing a RIA between countries A and B:
 $A=100$, $B=80$, $C=70 \times 1.2=84$

Advantages of the Trading bloc:

- Members of the bloc have free access to each other's markets, which allows them to specialize not only at the regional but also at the state level.
- Because low-cost imports lead to lower priced imports, there is a consumption effect, with increased demand resulting from lower prices.
- Producers can benefit from economies of scale, resulting in lower costs and lower prices for consumers.
- Jobs are created as a result of increased trade among member countries.
- Local firms inside the bloc are protected from cheaper imports from outside (for example, protecting the EU Shoe industry from cheap imports from China and Vietnam).

Cost of regional integration

Cost of regional integration

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graph LR; A[Cost of regional integration] --- B[Diversion of trade]; A --- C[Erosion of national sovereignty]
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Diversion of trade

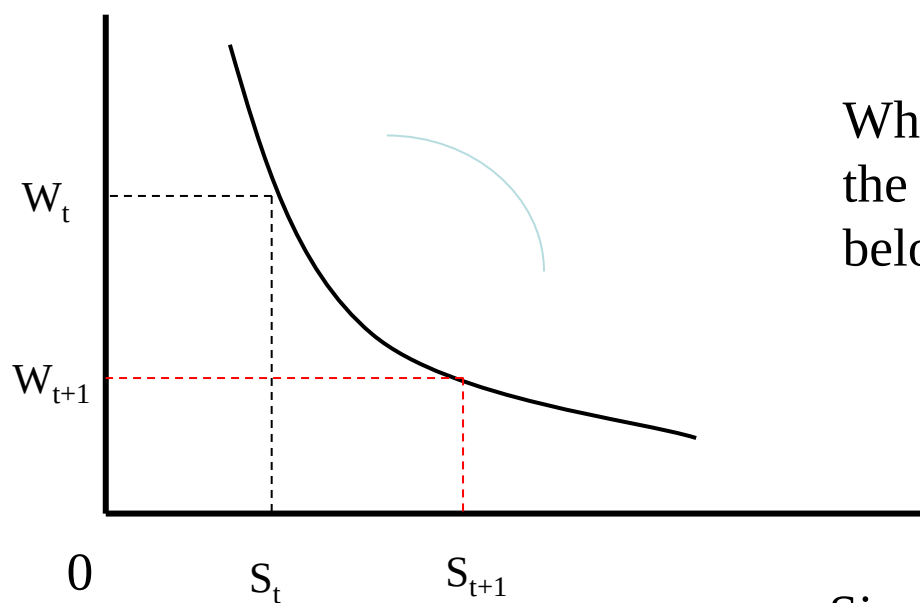
That is, trade can be diverted from nonmembers to members, even if it is economically detrimental for the member state.

Erosion of national sovereignty

Members of economic unions typically are required to adhere to rules on trade, monetary policy, and fiscal policies established by an unelected external policymaking body.

Expansion of the FTA and the Third Country

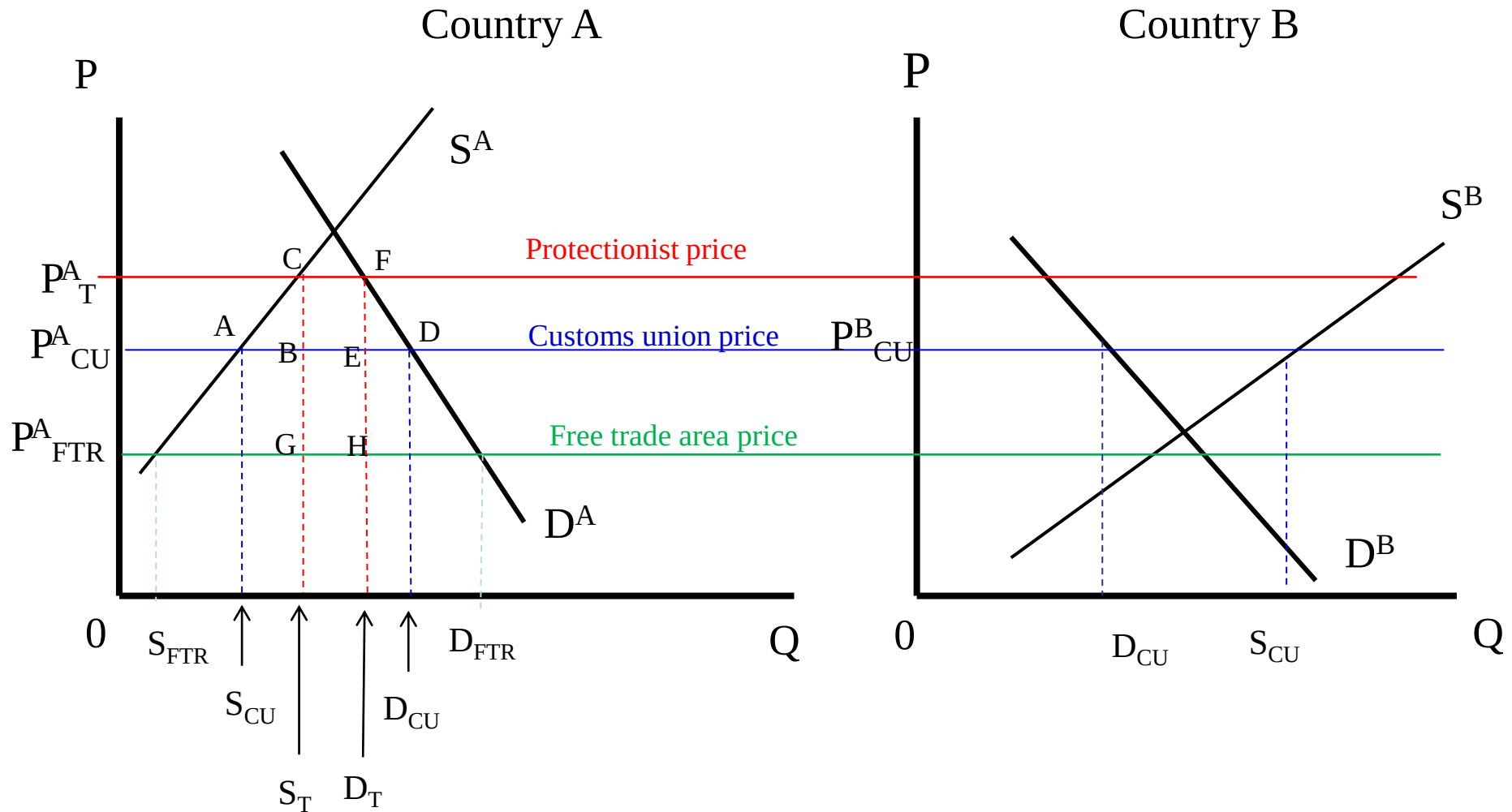
Welfare of
the third
country



When the size of FTA increases,
the welfare of the countries not
belong to the FTA will decrease.

Size of FTA

The positive and negative effects of a customs union



- Under free trade: Country A imports— $S^A_{FTR} D^A_{FTR}$ at world market price. Country B is not competitive because of its higher price.
- Country A introduces a tariff: Imports decrease $S^A_T D^A_T$
- Customs Union among countries A and IB: Tariff inside CU is abolished; former tariff of country A is now common tariff for imports from third countries. This increases the relative comparative advantage of country B. Trade inside the CU leads to an equilibrium price ($p^A_{CU} = p^B_{CU}$).
- Country A imports now $S^A_{CU} D^A_{CU} = S^B_{CU} p^B_{CU}$ from country IB.

Comparing CU with import tariff:

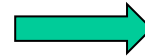
- Volume effects of the customs union:
 - Positive trade creation $S_{CU}^A S_T^A$
 - Positive trade expansion $D_{CU}^A D_T^A$
 - Negative trade diversion $S_T^A D_T^A$
- Welfare effect of the customs union:
 - Positive: $ABC + EDF$
 - Negative: $CFEB$

Disadvantages of the trading bloc:

- The benefits of free trade between countries in different blocs are lost.
- Trade blocs are likely to distort world trade and reduce the beneficial effects of specialization and comparative advantage.
- The development of one regional trading bloc is likely to stimulate the development of others. This can lead to trade disputes, such as those between the EU and NAFTA, including the recent Boeing (US)/Airbus (EU) dispute.

Regional Economic Integration Implications for Global Business

A change in Regional economic
integration arrangement



Global business
challenges

- Globalization, in the form of globalization of production and/or globalization of marketing, presents new opportunities for trade among nations.
- The ability to exchange good and services globally, to export products to distant lands, the opportunity to shift production to other countries (often to least-cost locations), the advances in communication and computing technologies, all of these things define the arena of global trade.
- In that arena, global and regional economic integration organizations establish **the rules of the game**. These organizations impact the global trade arena with increasing frequency and with profound implications for global business.

Opportunities with upside impacts

- Enable member countries' trade and business expansion.
- Investment flows and employment opportunities can be enhanced.
- Significantly lower transactions cost for global business enterprises operations.
- Greater cooperation among member countries in the area of science and technology will boost R&D in high value.

Threats with downside impacts

- Low-Price Seeking
 - Transparency implies that it will be easier for consumers to perform cross-country price comparisons.
 - Given ease of price comparisons, some form of price arbitrage may arise as consumers seek a product at its lowest price, no matter its country location.
- Downward Shift in Prices
 - As consumers undertake cross-country price comparisons and shift their purchase locus to a lowest price country, a downward shift in prices likely occurs.
 - Purchasing power parity and the law of one price explain an expectation of a downward shift in prices. While these concepts generally apply in situations of different currencies across countries, they have applications in a situation of nations switching from individual national currencies to a single currency such as the euro.
 - But, because the locus is one of a single currency rather than multiple currencies, there are no exchange rates to be adjusted. Instead, what is happening is a downward price pressure in all countries toward whatever is a product's lowest price point across the countries where it is sold.

- Revenue/Profit Erosion

- The implications of a movement toward low price points and downward pressure on prices are profound.
- As prices move toward a single price point across the countries under a regional integration agreement, the movement is in a downward rather than an upward direction for reasons of consumer price arbitrage.
- Management recognizes the inevitability of downward price movement in region.
- A downward pressure on prices means, in turn, that firms likely will experience erosion in revenues and likely decreases in profits.

Thank you
for your attention