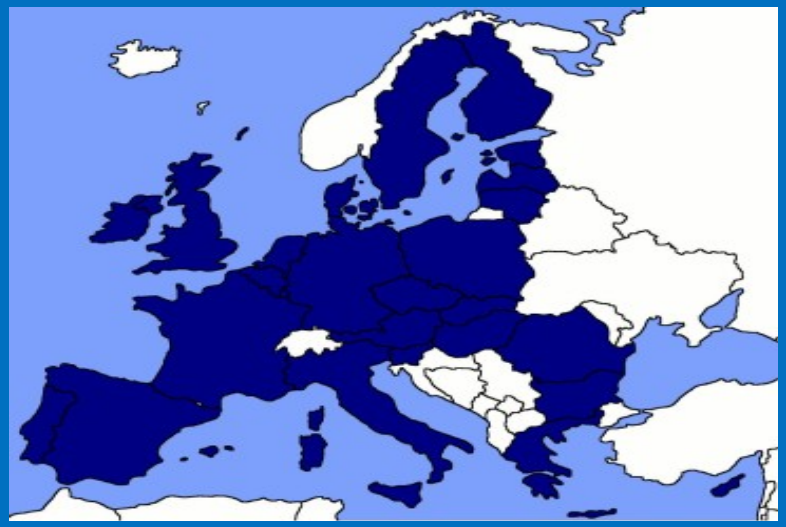
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European Economic Integration – 110451-0992 – 2014

II Theories of Economic Integration

CU



OCA



Prof. Dr. Günter S. Heiduk

Regional integration agreements = Cooperation/coordination between countries in geographic proximity (the latter is not a necessary condition)

Theories show that cooperation most probably leads to benefits for the participating countries

Types of arrangements: trade agreements, common markets agreements, monetary agreements, agreements on fiscal policy cooperation

The type of arrangement defines the “deepness” of integration

Besides deepening, regional integration can be widened

Preferential Trade Agreements (PTA)*

Countries offer tariff reductions to a set of partner countries in some product categories but keep the original tariffs for imports from non-participating countries, thus **discriminating** the latter. According to the general rule of the WTO (most-favoured nation clause) discrimination of preferential treatment for some countries is not allowed.

Note: In the literature PTA is also used more generally to describe all unilateral, bilateral, regional types of economic integration since they all incorporate some degree of "preferred" treatment.

Under the Generalized System of Preferences (GSP) the EU concedes unilateral preferences to approx. 80 developing African, Caribbean and Pacific countries (ACP) that were mostly former colonies of one of the EU's member states.
EU's GSP offers duty-free access to 176 developing countries and territories to the EU's market on a nonreciprocal basis. The EU GSP program was last renewed in 2008 and extended until December 31, 2011. A new proposal is currently under discussion and will probably come into force on 1st January 2014.

Free Trade Area (FTA)

Customs Union (CU)

A customs union is characterized by a group of countries that agree to eliminate tariffs between themselves
and to **set a common external tariff** on imports from the rest of the world. The CU avoids the problems related
to implementing and controlling rules of origin but it needs a high degree of mutual understanding and policy
cooperation. The member states can agree on the lowest, highest or any tariff in between.
Example: EU

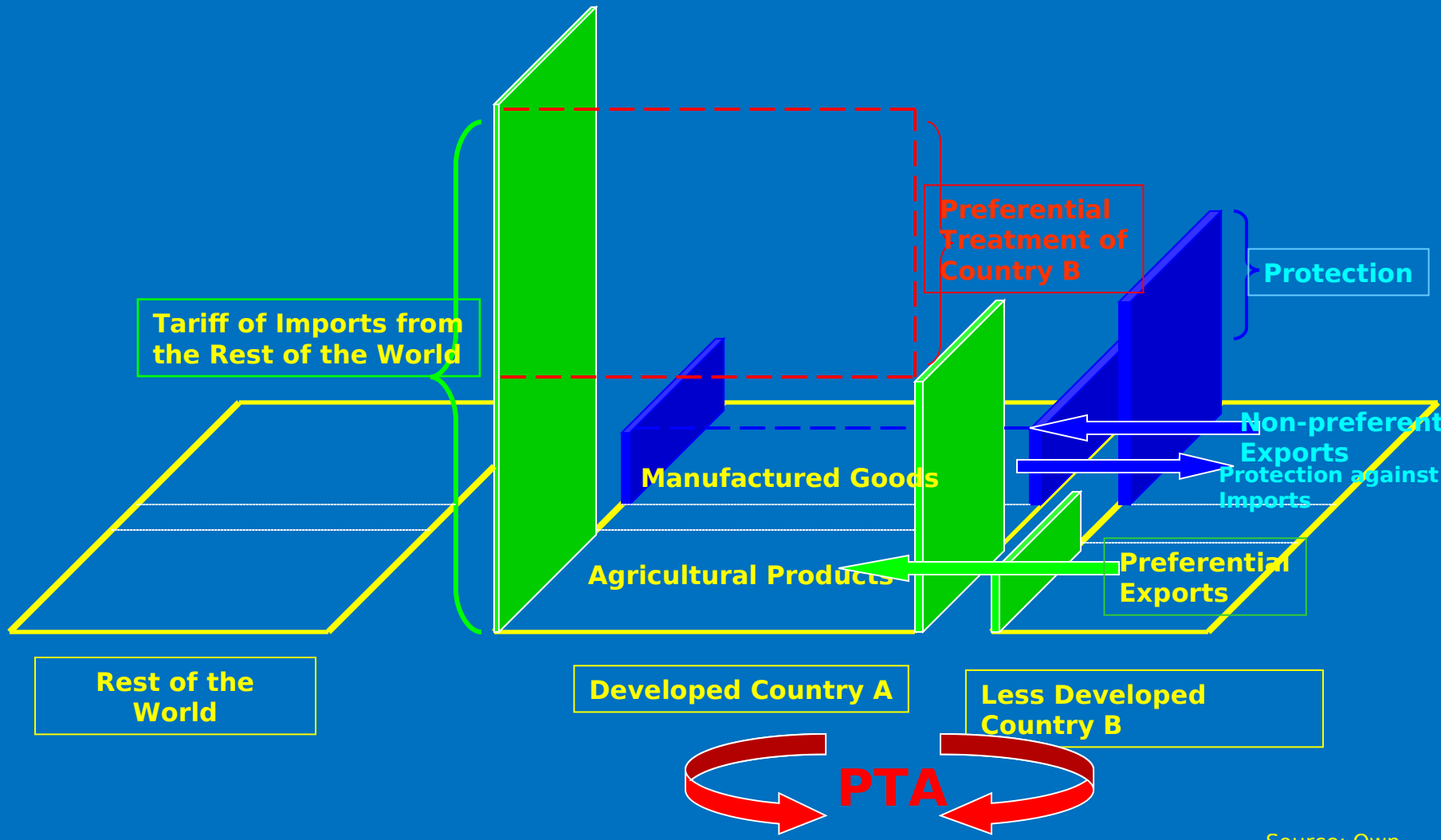
Common Market (CM)

In addition to the common external tariff, the member states of the CU agree on the **free internal mobility** of
capital and labour as well as on the freedom of establishment. The principle of *mutual recognition* guarantees
the free movement of goods and services without harmonising the member states national legislation.
The concept of *harmonization* refers either to harmonising the national laws or to harmonise substantive
conditions. Formal harmonization of national laws may even lead to differences in practice due to different
national environments. Example: EU

Economic Union

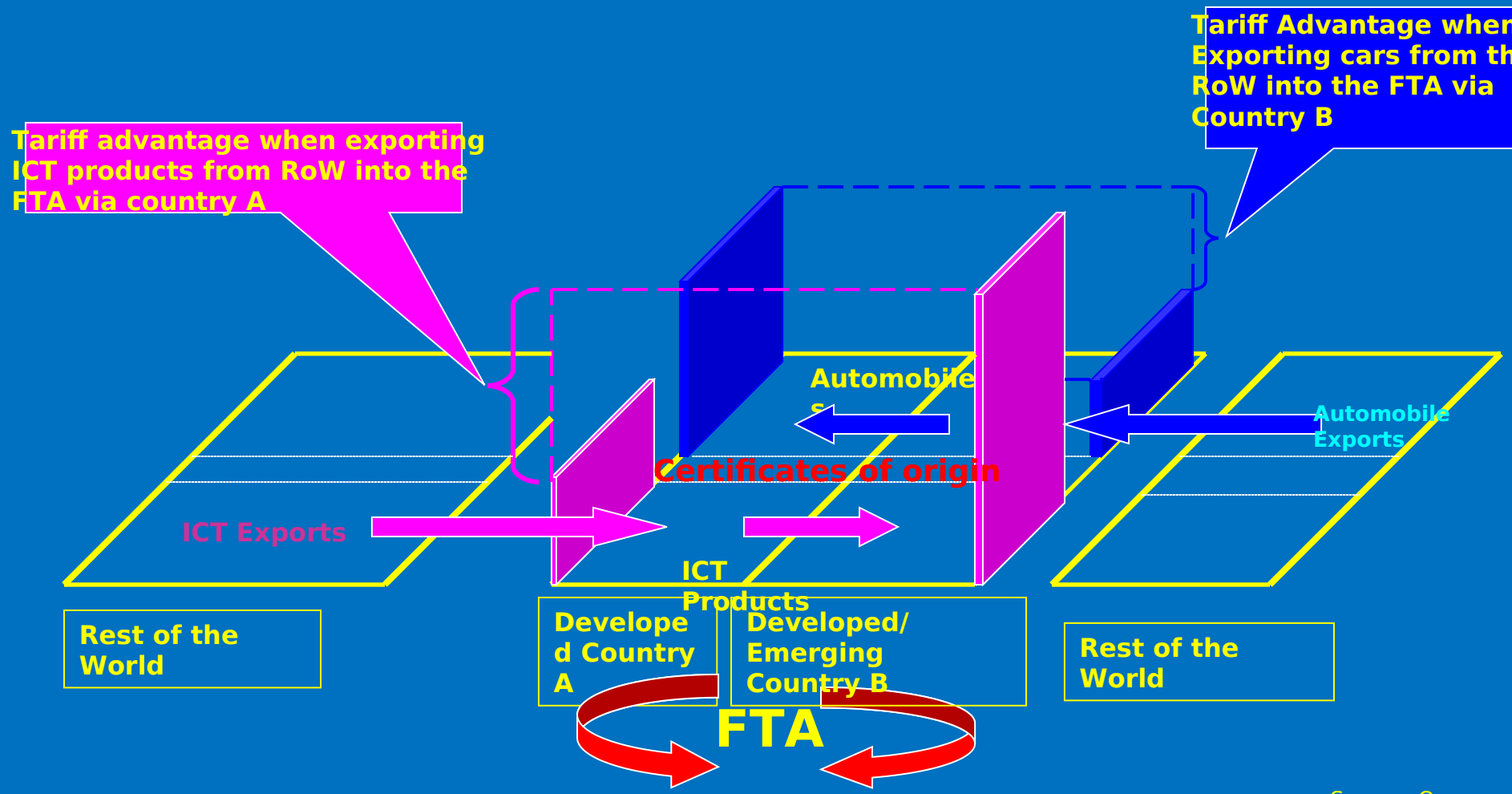
In addition to the Common Market concept, the Economic Union is characterized by the relegation of fiscal

Preferential Trade Agreement (PTA)



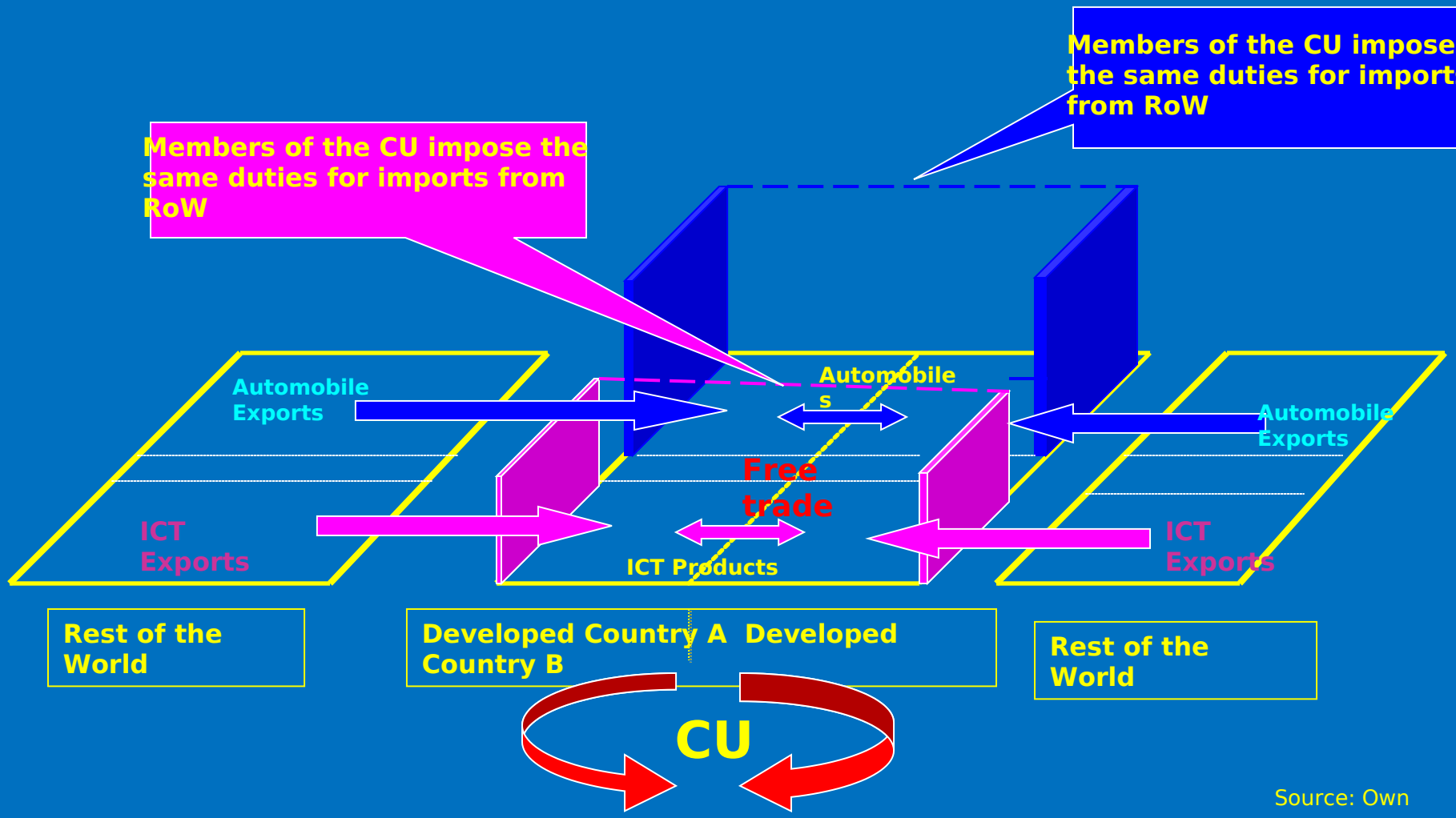
Source: Own

Free Trade Agreement (FTA)



Source: Own

Customs Union (CU)



Source: Own

Customs Union (1)

- **Effects:**

  - ✓ Trade creation

    Increasing division of labour (specialization) within the CU leads to higher efficiency of the production factors.

  - ✓ Trade expansion

    Increasing volume of trade inside the CU results from free trade between the member states (according to the neo-classical trade model).

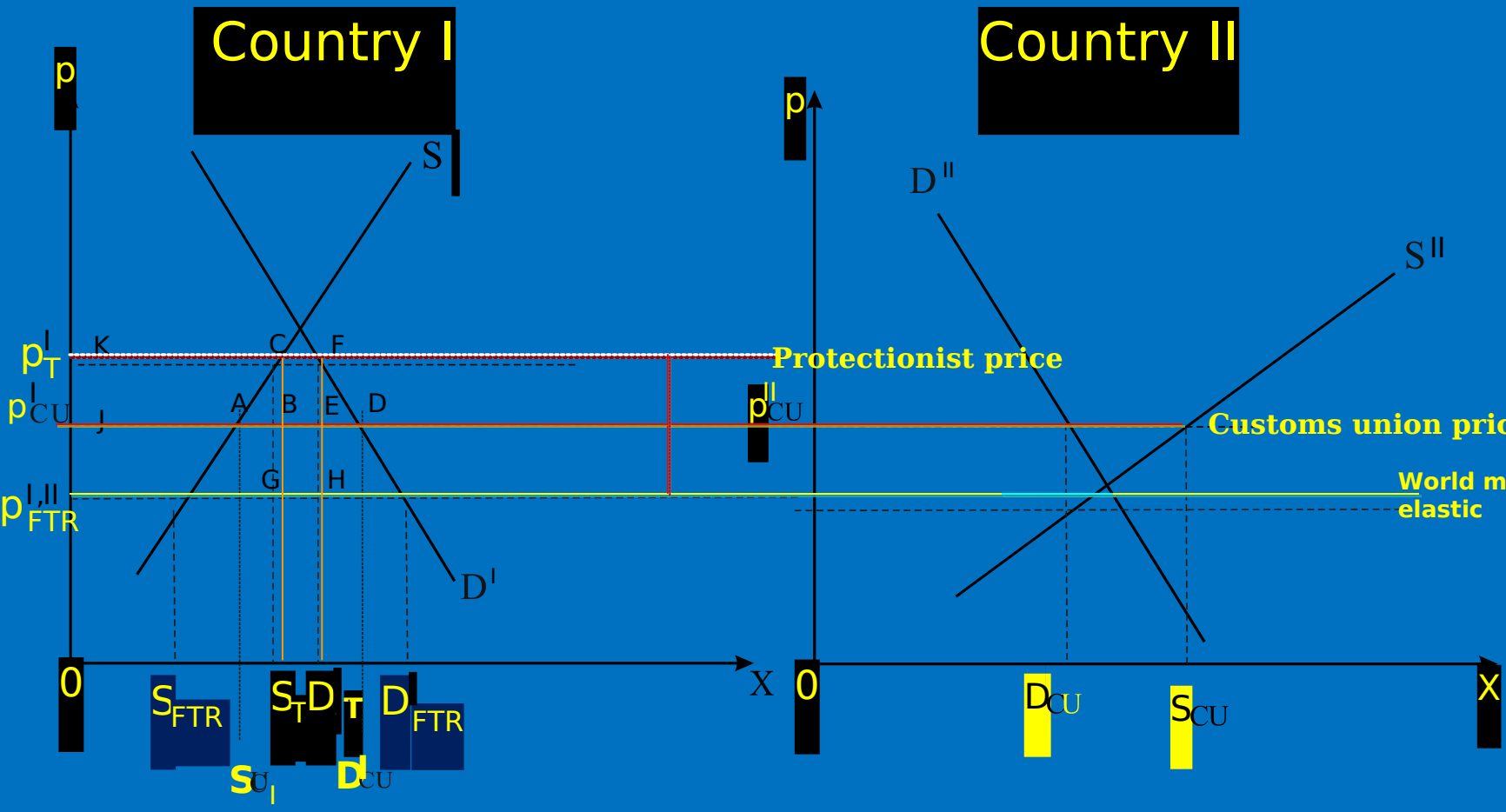
  - ✓ Trade diversion

    Former exporters from third countries lose their comparative advantage by being replaced by exporters inside the CU.

  - ✓ Trade deflection

    In case of a free trade zone, imports from third countries enter the zone in the member state with the lowest tariff ➔ In order to avoid this effect, the member states set up rules of origin.

Customs Union (2)



Customs Union (3)

A) Free trade: Country I imports $S^{I}_{FTR} D^{I}_{FTR}$ at world market price. Country II is not competitive

because of ist higher price. $S^{I}_{T} D^{I}_{T}$

B) Country I introduces a tariff: Imports decrease

C) Customs Union among I and II: Tariff inside CU is abolished; former tariff of country I is now common

tariff for imports from third countries. Th $p^{I,II}_{CU}$ ases the relative comparative advantage of country II.

$$S^{I}_{CU} D^{I}_{CU} = S^{II}_{CU} D^{II}_{CU}$$

Trade inside the CU leads to an equilibrium price ( ).

Country I imports now from country II.

omparing CU with import tariff:

a) **Volume effects**

- **Positive trade creation** $S^{I}_{CU} S^{I}_{T}$
- **Positive trade expansion** $D^{I}_{CU} D^{I}_{T}$
- **Negative trade diversion** $S^{I}_{T} D^{I}_{T}$

b) Welfare effects of the CU:

- **Positive ABC + EDF**
- **Negative: GHEB**

Customs Union (4)

- The advantages of a CU are higher,

✓ the larger the number of countries joining the CU

✓ the lower the disadvantage of the joining countries compared to the third countries

✓ the higher the decrease of the import price after building the CU

✓ the lower the common external tariff of the CU (e.g. not higher than the lowest tariff
of the CU member states before establishing the CU)

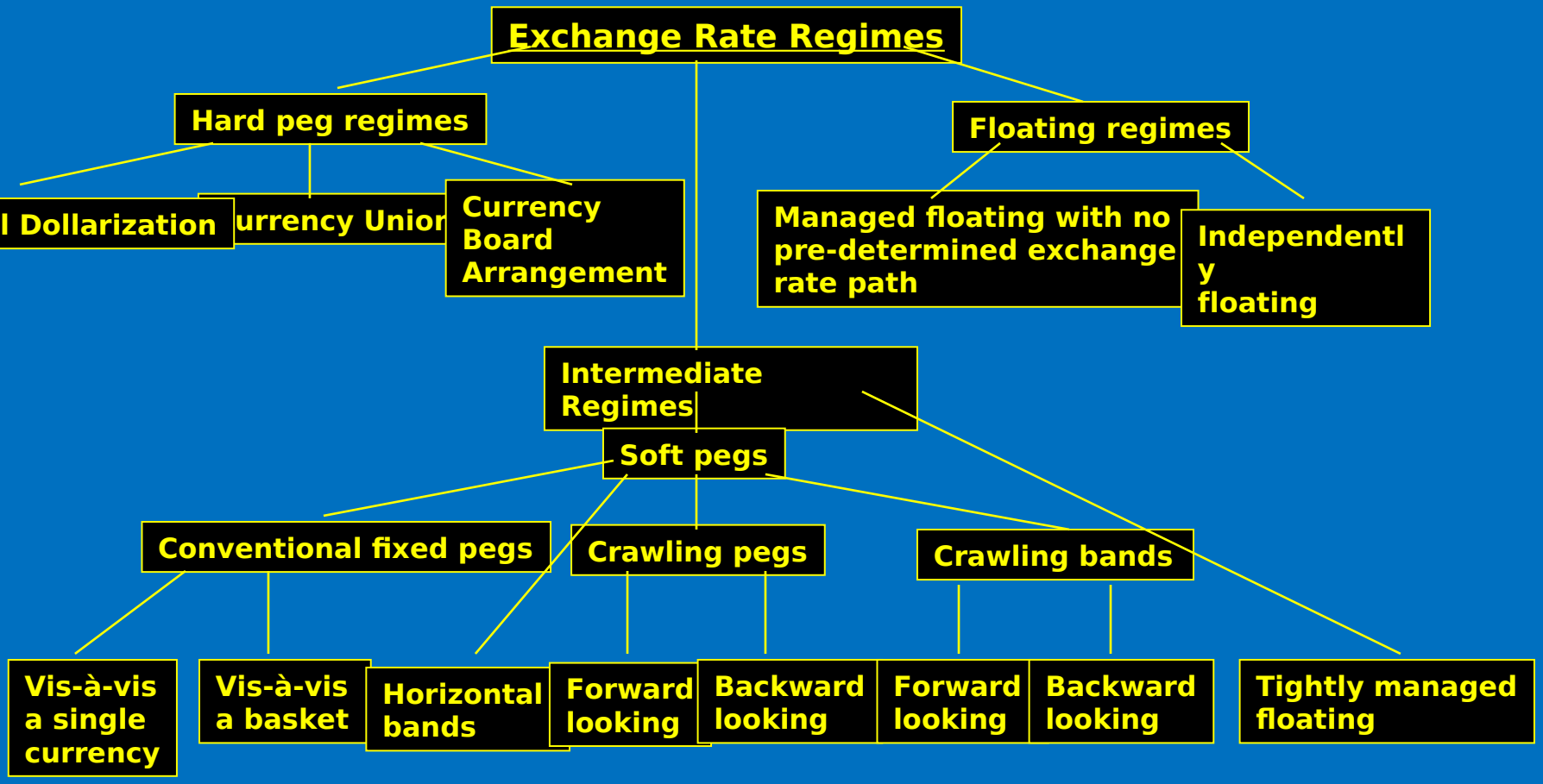
✓ the higher the level of the tariffs before establishing the CU

- Empirical test of EU-15 – Turkey CU based on a gravity model:

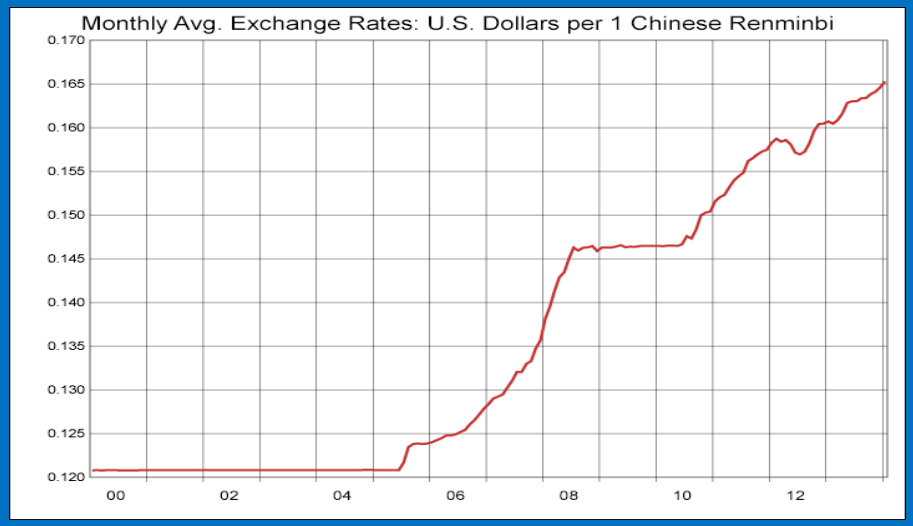
" .....the increased integration of Turkey with the EU decreased the exports of each of the EU-15 countries to the other 14 countries, whereas it has raised both the exports of the EU-15 to Turkey as well as the exports of Turkey to the EU-15."

A. Adam and B. Moutos, The Trade Effects of the EU-Turkey Customs Union, in: The World Economy, 2008, Vol. 31/5, 685-700.

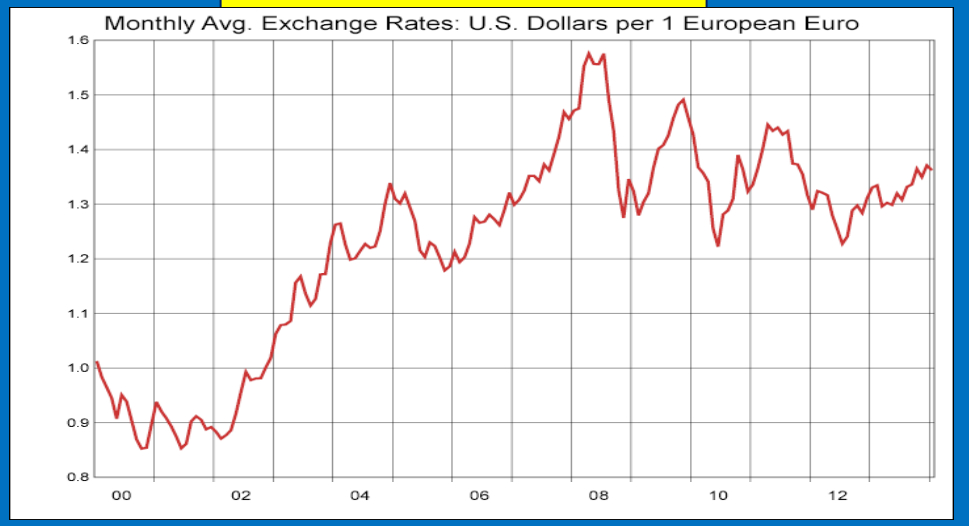
Theory of Optimum Currency Areas (OCA) (1)



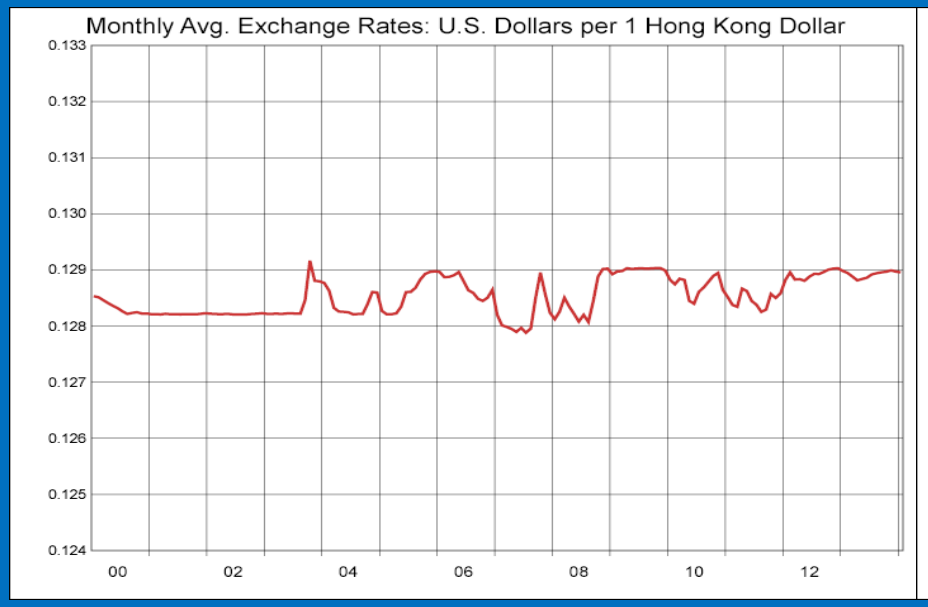
Currency peg RMB/ US Dollar till May 2005



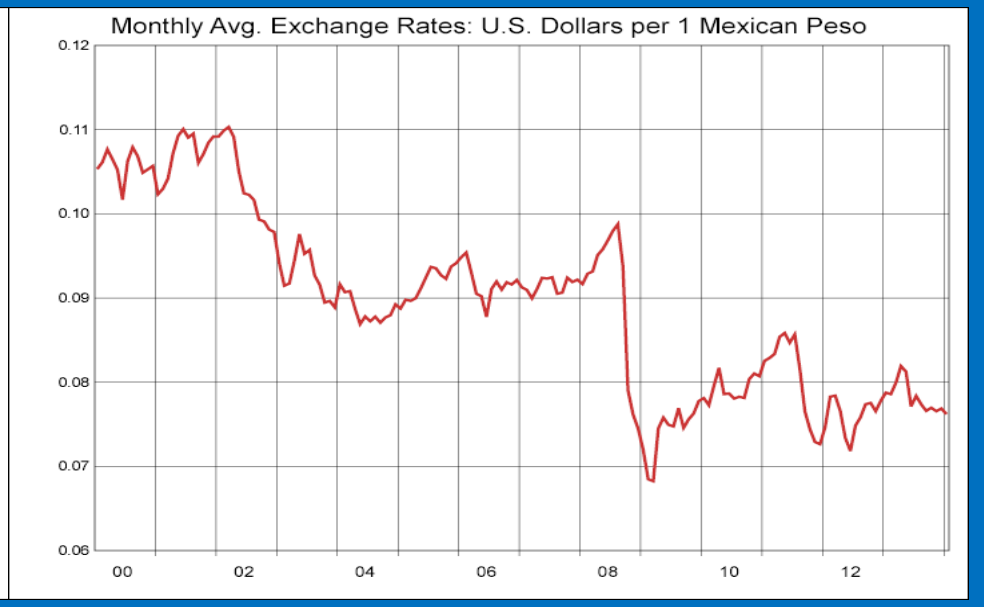
Floating Euro / US Dollar



Currency board HongKong Dollar / US Dollar



Crawling peg Mexican Peso / US Dollar



Theory of Optimum Currency Areas (2)

Robert A. Mundell (1961). A Theory of Optimum Currency Areas.

No. 4, 657-665.

"I have argued that the stabilization argument for flexible exchange rates is valid only if it is based on regional currency areas. If the world can be divided into regions within each of which there is factor mobility and between which there is factor immobility, then each of these regions should have a separate currency which fluctuates relative to all other currencies."[24]

OCA: One of the most important contributions on the discussion of selecting an exchange rate system for a given country.

Currency area: Area in which exchange rates are fixed, or which has a common currency.

Modern concept of the state: "One country, one currency"!

But, Mundell's question: "How large should the territory using a single currency be?"

OCA Theory: Search for ***criteria*** that would define "the OCA within

Theory of Optimum Currency Areas (3)

Criteria

High degree of factor mobility = OCA; low degree = flexible exchange rates

If *demand shifts* from products of country B to products of country A, a depreciation of the B currency would restore external balance, relieve unemployment in B and contain inflation in A. "This is the most favourable case for flexible rates based on national currencies". But the continent (USA) is also divided in two regions, which do not correspond to the countries. Currency depreciation cannot solve the problem generated from demand shifts between regions inside one country. Mundell suggests a high degree of factor mobility across regions within a country or between countries to stabilize asymmetric shocks.

Price and wage flexibility are particularly important in the very short run to facilitate the adjustment process following a shock.

Alternatively, if nominal prices and wages are downward rigid some measure of real flexibility could be achieved by means of exchange rate adjustments.

Capital mobility, respectively highly integrated financial markets, are crucial

Theory of Optimum Currency Areas (4)

High degree of openness

McKinnon **(1963) suggests the higher the openness within a country or a region, the more changes in *international prices* would directly and indirectly impact on *domestic prices*. The higher the degree of openness, the more changes in international prices of *tradables* are likely to be transmitted to the *domestic cost of living*. Hence, the nominal exchange rate would be less useful as an adjustment instrument.**

Measuring economic openness: the degree of trade integration (i.e., the ratio of reciprocal exports plus imports over GDP) with the partner countries; the share of tradables versus non-tradable goods and services in production and consumption; the marginal propensity to import; and international capital mobility. These concepts overlap but are not necessarily synonymous. An economy could display a high share of tradables but have low imports and exports (and exhibit a low foreign trade multiplier).

Theory of Optimum Currency Areas (5)

High product diversification

***Kenen* (1969) proposes that a *high diversification* in production and consumption dilutes the possible impact of shocks specific to any particular sector. Therefore, diversification reduces the need for changes in the terms of trade via the nominal exchange rate and provides "insulation" against a variety of disturbances.**
More diversified partner countries are more likely to endure small costs from forsaking nominal exchange rate changes amongst them and find a single currency beneficial.

Fiscal integration

Countries sharing a *supra-national fiscal transfer system* that would allow them to redistribute funds to a member country affected by an adverse asymmetric shock would also be facilitated in the adjustment to such shocks and might require less

Theory of Optimum Currency Areas (6)

tical Commitment

hat ultimately counts, however, is that all members are willing

ive up their independence in matters of money, credit, and

rest. Practically, therefore, an optimum currency area is a

on no part of which insists on creating money and having a

netary policy of its own."

Machlup (1977). A History of Thought on Economic Integration. Columbia University
s, 71.

n the last two decades the OCA Theory has experienced further refinement, especially in
ework of general equilibrium models.

Towards a “General Theory of Regional Trade Agreements“

nalysis of the impact of RTAs on

- **the static allocation of resources (allocation effect)**
  - **- Perfect competiton and constant returns**
  - **- Differentiating between small and large country**
  - **- Market structure, scale economies, imperfect competition**
- **the accumulation of productive factors (accumulation effect)**
  - **- Medium-term effects: Investment creation and diversion**
  - **- long-run growth effects**
- **the spatial allocations of resources (location effect)**
  - **- Location of firms**
  - **- Linkages and agglomeration**
  - **- Labor mobility**
  - **- Industrial agglomeration**

mpirics **Computable equilibrium models**

ource: Baldwin, R.E. And Venables, A.J. (2004), *Regional Economic Integration*
tp://graduateinstitute.ch/webdav/site/ctei/shared/CTEI/Baldwin/Publications/Chapters/Trade%20Theory/Baldwin_Venables_Handbook.pdf

Regional Integration from a Political Perspective

National preference formation versus "liberal intergovernmentalism"

- Single market	- Interstate bargaining
- Common commercial policy	- Pooling and delegation of sovereignty
- Single currency	- Credible commitments
- Fiscal federalism	- Collective decisions
- Common foreign and security policy	- Creating new central organs with
- Common army	decision-making power

"…in areas of key importance to the national interest, nations prefer the certainty, or the self-controlled uncertainty, of national self-reliance, to the uncontrolled uncertainty"

Hoffmann, S. (1966), *Obstinate or Obsolete? The Fate of the Nation State and the Case of Western Europe,* Daedalus 98, p. 882.

Integration mechanisms

- **Spill-over e**

Source: Laursen, F. (2008), *Theory and Practice of Regional Integration,* Jean Monnet/Robert Schuman Paper Series,

Comparative Regional Integration

pproaches

Institutional architecture

EU: Supranational institutions, pooling of sovereignty, inter-state bargaini

ASEAN: National sovereignty, cooperation, consultation, consensus

Role of the state

EU: Construction of a supranational entity

ASEAN: Principle of non-interference, intergovernmental, no commitment
exclusive or shared competences

Interdependence and globalization

EU and ASEAN: Regionalization as "products of member state (or 'membe
economy) adaptations to globalization, with particular
dynamics dedicated by the interplay of national interests,
culture, norms and geopolitical context.
Desire for a multipolar and multilateral approach to
global challenges."

Murray, P. (2010), *Comparative regional Integration in the EU and East Asia: Moving beyond Integration Snobbery,* International Politics, 47, p. 315.