Regional Economic Integration: Theoretical Concepts and their Application to the ASEAN Economic Community

Training Course “Challenges and Opportunities of the ASEAN Economic Community 2025”

Bangkok, March 10th 2016

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Why Countries Trade

Case: Foreign Trade Theory following David Ricardo

- Effects of international differences in productivity on foreign trade
- Two countries (England and Portugal) are producing two consumption goods (fabric and wine), using one homogenous production factor (labour)
- Production factor is domestically perfectly mobile between sectors but internationally entirely immobile between countries
- Example:

England	Portugal	
Fabric: $X^1_1 = 0{,}4\ N^1_1$	Fabric: $X^1_2 = 0{,}5\ N^1_2$	0,5/0,4 = 1,25 (25%)
Wine: $X^2_1 = 0{,}8\ N^2_1$	Wine: $X^2_2 = 1{,}5\ N^2_2$	1,5/0,8 = 1,875 (87,5%)

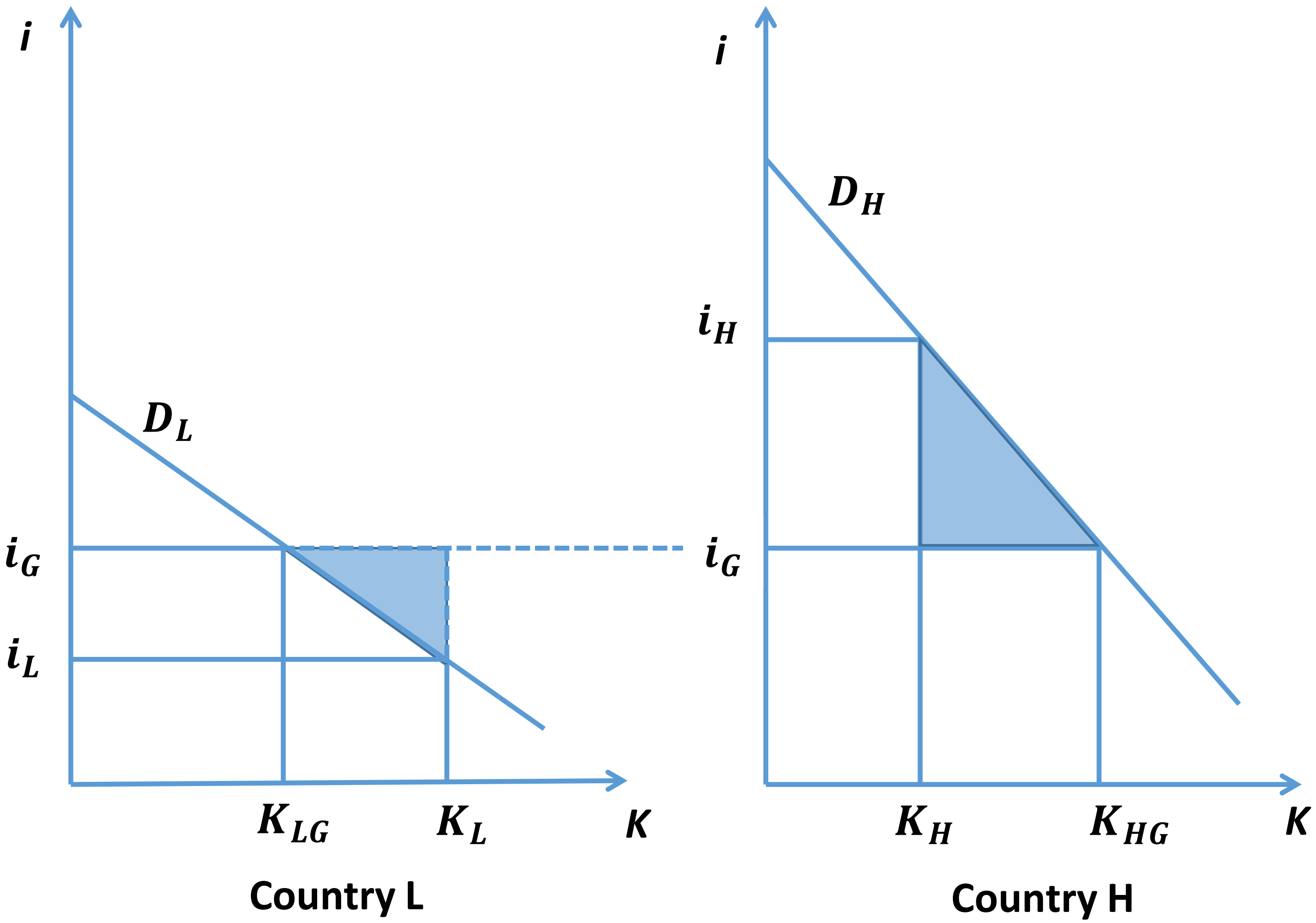
Why Countries Trade

- Free trade between England and Portugal increases volume of consumption goods available in both countries, although Portugal can produce both goods more productively
- Not absolute, but relative differences in productivity between two countries as precondition for international division of labour that is in the interest of both countries
- Advantages in productivity of Portugal compared to England have to be different in two sectors
- Advantage in productivity of Portugal for Wine (87,5%) is substantially higher than for Fabric (25%)
- England will produce and partly export fabric in exchange of imported wine from Portugal

Why Production Factors Flow

- Free Flow of Production Factors leads to effective reallocation of these factors in channelling them from uses with lower to uses with higher marginal productivity
- Example: Capital
  Initial situation:
  - Markets for capital in two countries are completely segmented, e.g. due to tax on cross-border capital movements.
  - Country H disposes of capital K_H, stock of capital in country L is K_L.
  - Due to assumptions of our model, interest rate equals marginal productivity of capital in both countries;
    Interest rate in country H is supposed to be higher than in country L

Why Production Factors Flow



K_L, K_H, i_L, i_H	Capital stock, interest rates in countries L, H under segmentation
$K_{LG}, K_{HG}, i_G,$	Capital employed, interest rate in countries L, H under shared market

Why Production Factors Flow

Perfect international mobility of capital is possible (elimination of tax):

- Investors from country L will invest in country H (flow of capital from L to H)
- Reallocation of capital leads to decrease in interest rate differential between countries H and L
- At the end, same interest rate (i_G) applies in both countries
- Reallocation of capital due to elimination of barriers to its free movement leads to increase of welfare in the integration area

Forms of Economic Integration

- Term “Economic Integration” describes a status and a process:
  - Status, in which barriers for economic activities between countries involved are abolished (static perspective).
  - Process of (gradual) reduction/elimination of these barriers (dynamic perspective)
- Between poles “Autarchy” and “Status of Economic Integration”: continuum of forms (steps).
- Forms characterized by
  - kind and degree of reduction/elimination of barriers for economic activities
  - introduction of coordinating and cooperating elements.

Forms of Economic Integration

1. Preferential Zone
   - At least two countries commit each other to mutually grant preferential conditions for trade in specific goods
   - Preferential conditions not granted to third countries
2. Free Trade Area
   - Member States involved commit each other to <u>eliminate</u> <u>all</u> existing barriers to trade between them.
   - No common foreign trade policy towards third countries
   - Rules of Origin to avoid that goods from third countries enter free trade area via country with the lowest external tariff and are then traded without barriers between Member States

Forms of Economic Integration

3. Customs Union
   - In addition to characteristics of free trade area, common external tariffs for third countries are agreed upon by Member States
4. Common Market
   - In addition to customs union, flow of services and production factors (labour and capital) is unrestrictedly liberalized
     - Right of free establishment for enterprises
     - Free movement of employees
     - Free flow of capital
   - To avoid that production factors are moving exclusively to some Member States: necessary to harmonize economic policies up to a certain degree (competition policy, tax policy)

Forms of Economic Integration

4. Economic (and Currency) Union
   - In addition to common market, national economic policies are harmonized to a high degree or even unified (macroeconomic stabilisation policy, monetary policy, redistribution policy and social policy)
   - Currency Union, if harmonization of economic policies also includes common currency leading to single exchange rate towards third countries
   - Economic (and currency union) is politically unsustainable, if internal disparities develop or intensify over time
     Need for
     - macroeconomic convergence between Member States
     - comprehensive structural and cohesion policy to reduce or eliminate welfare gaps

Forms of Economic Integration

	Free Trade between Member States	Common External Tarif towards Third Countries	Free Flow of Production Factors	Harmonization or Unification of Economic Policies
Free Trade Area	**x**	**---**	**---**	**---**
Customs Union	**x**	**x**	**---**	**---**
Common Market	**x**	**x**	**x**	**---**
Economic Union	**x**	**x**	**x**	**x**

- Actual economic integration does not strictly follow the schema above
- Already on steps like Free Trade Area and Customs Union: some movements of production factors
- Markets for production factors often already partially integrated, while not all barriers to trade in goods are eliminated

Forms of Economic Integration

- For all forms of integration:
  - Reduction or elimination of barriers applies only to Member States involved
  - Towards third countries, protectionist measures remain in place, are harmonized or even introduced
- Economic integration does not necessarily increase the welfare for Member States <u>and</u> the Rest of the World

Opportunities and Challenges of Economic Integration

Economic integration can result in the following advantages for economies involved and their different economic stakeholders

(1) Lower transaction and information costs

(2) Advantages due to specialisation

(3) Enhanced allocation of resources

(4) Economies of scale

(5) Improved efficiency due to increased competition

(6) Increase in investment

(7) Enabling trade with perishable goods

(8) Improved access to sea ports

(9) Greater product choice and lower costs of products for consumers

(10) Improvement of international negotiation position

Opportunities and Challenges of Economic Integration

(2) Advantages due to specialisation

Reduction of trade barriers leads to increased specialization of production of those goods, for which the economy disposes of comparative advantages.

Positive impact on development of Regional Value Chains

(5) Improved efficiency due to increased competition

Economic integration leads to more competitive market structures, since number of actual or potential suppliers increases.

-> Incentives to enterprises to eliminate internal inefficiencies and to search for product as well as process innovations.

Opportunities and Challenges of Economic Integration

Challenges for economies involved and their different economic stakeholders:

(1) Specialization
(2) Infant-industry
(3) Loss of tariff revenues
(4) Dumping
(5) Reduced consumer protection
(6) Loss of market share and employment
(7) Balance of payment crisis
(8) Autarchy argument
(9) Sovereignty forfeiting

Opportunities and Challenges of Economic Integration

(1) Specialization
Incipient structural changes can be accompanied by substantial problems of adjustment; regional disparities might be created or intensified.

(6) Loss of market share and employment
Disadvantages are faced by sectors (enterprises) with unfavourable cost resp. productivity structures compared to foreign competitors (low competitiveness). Leads to pressure to adjust or to loss of market share and employment. Stakeholders concerned (entrepreneurs, employees) often try to avoid adjustment and/or loss of market share by requesting protectionist measures on the political level.

Opportunities and Challenges of Economic Integration

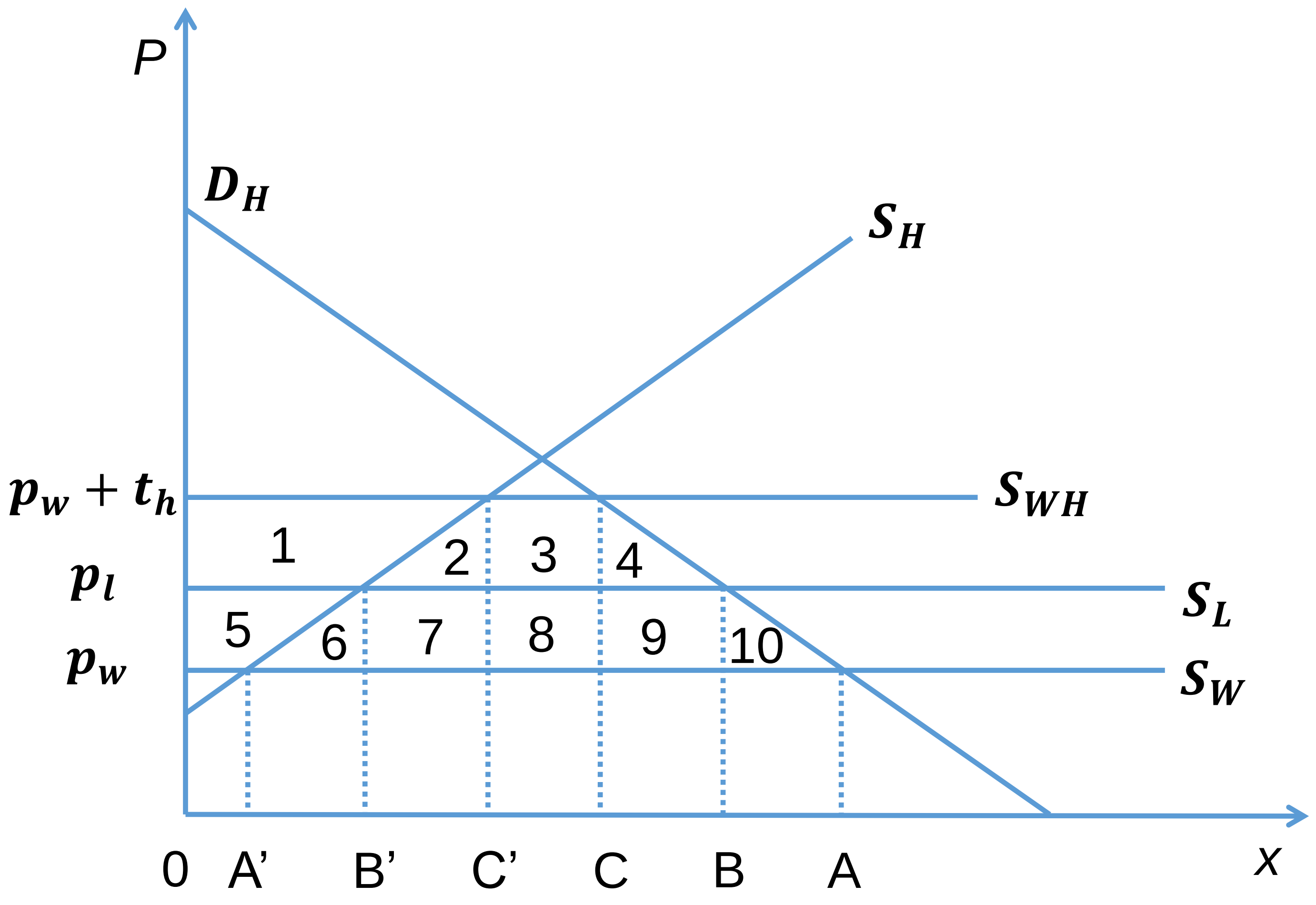
- Welfare / utility considerations are supposed to be the determinants for the behaviour of stakeholders involved
- Complexity of economic integration processes having different effects for different economic subjects (enterprises, households, public sector), economic sectors and countries (home country, other Member States, third countries).

Theoretical Effects of a Free Trade Area

Example:

- Three countries involved: Home Country (H), other Member State (L) and Rest of the World (W)
- Analysis for Home Country (H)
- Supply of domestic producers (e.g. for CD-players) increases with increase in market price (S_H)
- Demand of consumers for CD-players increases with decrease in market price (D_H)
- Supply of world market is entirely price-elastic (horizontal supply curve S_W)
- Supply of other Member State (L) is also entirely price-elastic (horizontal supply curve S_L)
- Entrepreneurs in L produce less efficiently than entrepreneurs in the Rest of the World

Theoretical Effects of a Free Trade Area



Theoretical Effects of a Free Trade Area

Initial Situation:

- Country H imposes tariff t_h on imports from other Member State (not show in the graph) and Rest of the World
- Initial import price is $p_w + t_h$
- Prior to creation of free trade area
  - Domestic enterprises produce OC’
  - Domestic households consume OC
  - Difference CC’ is imported from the Rest of the World
- Tax revenue is $(CC')*t_h$

Theoretical Effects of a Free Trade Area

Free Trade Area:

- Entrepreneurs from other Member State L can export CD-players without tariff at price p_l to Home Country
- Production by domestic enterprises decreases from OC’ to OB’ by B’C’ (production side trade creation)
- Consumption of domestic households increases from OC to OB by CB (consumption side trade creation)
- Imports from Rest of the World are entirely replaced by imports from other Member State (C’C, trade diversion)

Theoretical Effects of a Free Trade Area

Welfare effects:

- Producer surplus decreases by area 1
- Consumer surplus increases by area 1 + 2 + 3 + 4
- Tariff revenue decreases by area 3 + 8
- Total welfare effect is equal to (2 + 4 – 8) and can be positive or negative

Elements for economic integration processes to be effective

Three essential elements of regional economic integration processes in order to be effective

(1) Regional agreements

- Harmonization of regulations
- Reduction/Elimination of barriers

(2) Implementation of regional agreements on the national level

- Adoption of national laws and regulations
- Application of amended procedures

(3) Actors (mainly of the private sector) make use of the improved framework for more trade, investments and employment

Different Elements of the Implementation of Regional Economic Integration

Regional Agreement

Identification of necessary amendments in national regulations and procedures

„Translation“ of regional agreements into national regulations (amendment of laws)

Implementing Decree

Application of amended regulations by national administration

Use of (harmonisied, simplified) regulations and procedures by entrepreneurs and consumers

Effects on Trade and Investment

Monitoring of regional economic integration processes

Monitoring should take place on different levels

1. Implementation of regional economic integration strategies (mainly measures on the regional level, e.g. approval of regional agreements)
2. Compliance
   “Translation” of regional agreements into national regulations and procedures
3. Readiness of the private sector (and consumers) to make use of economic integration
   Awareness / information of the private sector (and consumers) about economic integration; competitiveness of enterprises; access to regional market (B2B)

Monitoring of regional economic integration processes

4. Extent of de-facto reduction of barriers among Member States
   Costs and time to trade and invest, alignment of costs for production factors, such as interest rates and wages
5. Impact on economic indicators
   Trade and investment flows as well as other economic and socio-economic indicators such as economic structure, productivity and employment

Implementation Gap and reasons behind it

A large number of regional agreements are not implemented on the national level

Why is there an implementation gap?

1. Missing information and awareness about the content of regional agreements
2. Political Economy
    - Regional economic integration processes regularly create winners and losers
    - National politicians are more interested in their own re-election than in the welfare of the entire region
    - If losers are not compensated by the gains of the winners, are well organized and politically well connected, they may slow down the implementation of reforms.

Implementation Gap and reasons behind it

- Winners and losers <u>among Member States</u>
  - Member States are heterogeneous – economic structures differ
  - For the same reform measure, some Member States might win, others might lose
- Winners and losers <u>within one Member State</u>
  - Producers of the good in question
  - Producers of complementary or of substitute goods
  - Consumers
  - Trade forwarders
  - Government
  - Customs officers

Different stakeholders are affected differently by regional economic integration processes

Implementation Gap and reasons behind it

Why is there an implementation gap? (continued)

3. Lack of organizational and technical capacities to implement regional agreements
   - Government and National Assembly: to translate regional agreements into national laws and regulations
   - Public administration: to apply the amended laws and regulations
   - Private sector: to apply the improved framework conditions
4. Lack of ownership of relevant stakeholders on the national level

Implementation Gap and reasons behind it

Steps towards an improved implementation

From a national perspective

1. Improve information of and awareness about regional agreements
2. Improve ownership of stakeholders involved
3. Make regional agreements beneficial for the economy
   - Analysis of special characteristics of the economy
   - Elaboration / presentation of national positions in regional negotiations
4. Analysis of political economy
   - Who gains, who loses from a reform process?
   - Who has which influence on political decision making processes?
5. Strengthening capacities of relevant stakeholders to implement regional agreements on the national level

Implementation Gap and reasons behind it

From a regional perspective

- Compensation mechanisms to achieve a “Pareto-optimal” solution (A gains 100, B loses 50, A compensates B with 60, A gains 40, B gains 10, everybody is better off)
- Approval of bundles of reform measures (Reform 1 leads to gains for A (+50) and losses for B (-30); Reform 2 leads to losses for A (-30) and gains for B (+50) – approve reforms A and B at the same time)