Quadrant II - Notes

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Module Name: Forms, Objectives and Effects of Economic Integration

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Meaning of Economic Integration

- Economic integration is an arrangement among nations that typically includes the reduction or elimination of trade barriers and the coordination of monetary and fiscal policies.
- Economic integration aims to reduce costs for both consumers and producers and to increase trade between the countries involved in the agreement.
- Economic integration is sometimes referred to as regional integration as it often occurs among neighboring nations.
- When regional economies agree on integration, trade barriers fall and economic and political coordination increases.
- Specialists in this area define seven stages of economic integration: a preferential trading area, a free trade area, a customs union, a common market, an economic union, an economic and monetary union, and complete economic integration.
- The final stage represents a total harmonization of fiscal policy and a complete monetary union.
- The advantages of economic integration fall into three categories: trade benefits, employment, and political cooperation.
- Despite the benefits, economic integration has costs. These fall into two categories:

✓ 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.

Forms of Economic Integration:

- There are different degrees or levels of economic integration. The following are the five possible degrees or levels economics integration:

1. Free Trade Area
2. Custom Union
3. Common Market

4. Economic Union
5. Economic integration

Free Trade Area

- The first and least restrictive form of economic integration is the free trade/association which is a grouping of countries to facilitate free trade between them.
- The free trade areas abolishes all restrictions on trade among the members. However, each member is left free to determine its own commercial policy with non- members.

Custom Union

- A customs union is a more advanced level of economic integration than the free trade area.
- It not only eliminates all restrictions on trade among members but also adopt an uniform commercial policy against the non- members

Common Market

- The common market is a step ahead of the custom union. A common market allows free movement of labour and capital within the common market, besides having the two characteristics of the customs union, namely, free trade among members and uniform tariff policy towards outsiders.

Economic Union

- A still more advanced level of integration is the economic union.
- Apart from satisfying the conditions of the common market, the economic union achieves some degree of harmonisation of national economic policies, through a common central bank, unified monetary and fiscal policies etc. (Example: the European Union).

Economic Integration

- The ultimate form is full economic integration characterized by the abolition of all barriers to intrabloc movement of goods and factors. Unification of social as well as economic policies and all the members bound by decisions of supernormal authority consisting of executive, judicial and legislative branches.

Objectives of Economic Integration

- To obtain economic benefits from achieving a more efficient production structure by exploiting economies of scale through spreading fixed costs over larger regional markets, increased economic growth from foreign direct investment, learning from experiences etc.
- To pursue non-economic objectives such as strengthening political ties and managing migration flows.
- To ensure increased security of market access for smaller countries by forming regional trading blocs with larger countries.
- To improve members’ collective bargaining strength in multinational trade negotiations or to protest against the slow pace of trade negotiations.

- To promote regional infant industries which cannot be viable without a protected regional market.
- To prevent further damage to their trading strength due to further trade diversions from third countries.

Regional agreements frequently have political objectives and non economic dimensions, including national security, enhancement of bargaining power and bolstering the credibility of reforms (economic and political).

Effects of Economic Integration

Effects of Economic Integration are static and dynamic:

Static effects "involves a reallocation of resources among existing industries, using existing supplies of the factors and existing technology. Some industries expand, others contract, and consumers enjoy lower prices on certain products; otherwise everything goes on as before.

Dynamic effects refer to certain developments like increased completion, stimulus to technological changes, investment and increased economies scale of that make the union economy dynamic.

- There are two types of static effects namely production effects and Consumption effects.
- **Consumption Effects**
- Consumers in the customs union benefits from the positive production effects of the union, i.e.t the increased efficiency in resource allocation.
- Before the formation of the custom union, they would be obliged to buy expensive output of high cost domestic producers but after the formation of the union, they would have access to lowest costs and prices in the region.
- In other words, because of access to the low cost source of supply facilitated by the custom union, the real income of the consumer increases because a given amount of money income can buy more goods as price declines. This is the ***Positive Consumption Effects*** of the Custom Union.
- There is a parallel to the negative production effect also –the negative consumption effect. The customs union requires a uniform tariff on import of a commodity from non members.
- Before formation of the union, if member country was importing a commodity duty free from a non-member, it will now have to impose a duty on it resulting in the diversion of the consumer purchases from low cost outside producers to high cost producers inside the custom union.
- The falling consumer welfare from the decline in the real income due to rise in price is referred to as the ***"Negative Consumption Effects".***