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10.1 Introduction

- We examine economic integration in general and customs unions in particular.
- ▶ **Preferential trade arrangements:** barriers are lowered on trade among members than on trade with nonmember nations.
- ▶ **Free trade area:** all barriers are removed on trade among members, but each nation retains its own barriers to trade with nonmembers. Eg. EFTA (1960), NAFTA (1993), Japan-Singapore FTA (2004)
- ▶ **Customs union:** FTA + trade policies are harmonized among members toward nonmembers. EC (1993)
- ▶ **Common market:** CU + labor and capital are allowed to move freely among members. EU (before 2002)
- ▶ **Economic union:** CM + monetary and fiscal policies are harmonized. EU (after 2002)

10.2 Trade-Creating Customs Unions

10.2A. Trade Creation

- Trade creation occurs when some domestic production in a member nation is replaced by lower-cost imports from another member nation.
- A trade-creating customs union therefore raises the welfare of member nations.
- A trade-creating customs union may also raise the welfare of nonmembers because some of the increase in its real income spills over into increased imports from the rest of the world

10.2B. Illustration of a Trade-Creating Customs Union

10.2 Trade-Creating Customs Unions

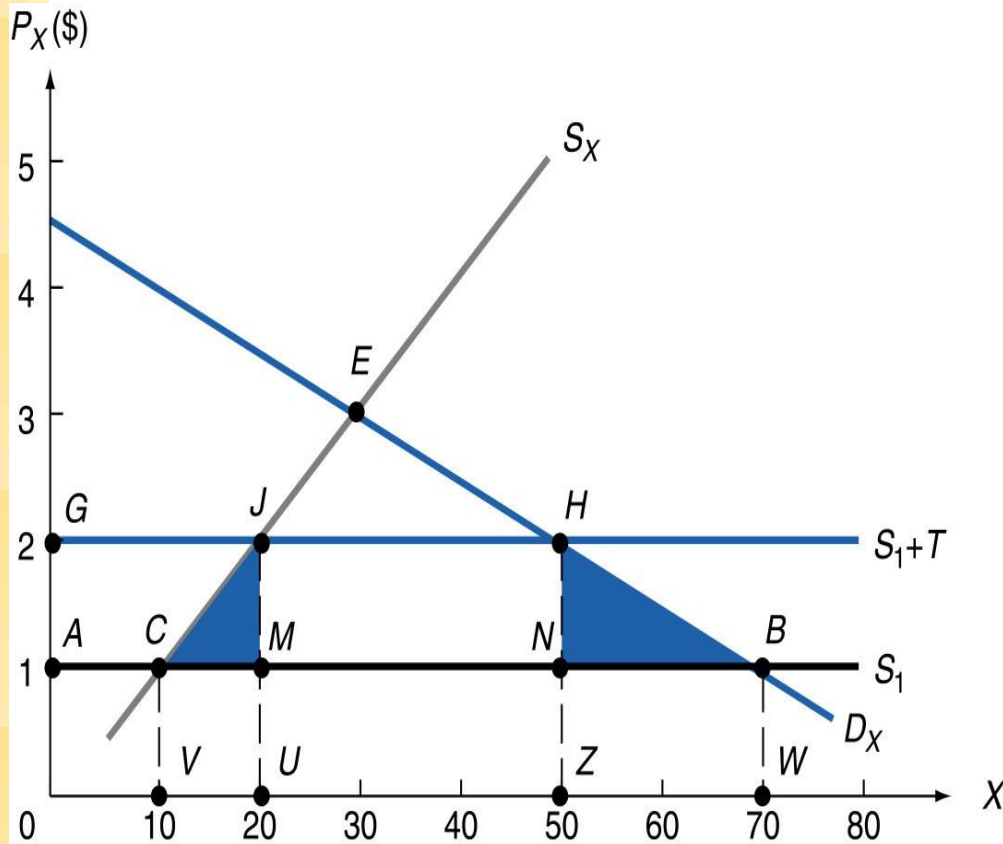


FIGURE 10-1 A Trade-Creating Customs Union .

- (1) Before CU (Home country = N2)
- Price of X ($P_{x1} = \$1$, $P_{x2} = \$3$, $P_{x3} = \$1.50$)
 - Price of X in N2 with 100% tariff = \$2
 - demand : 50X
 - supply : 20X
 - import : 30X from Nation 1
- (2) After CU (N2 & N1)
- Price of X in N2 = \$1
 - demand : 70X
 - supply : 10X
 - import : 60X
 - Net welfare gain = CJM+BHN

10.3 Trade-Diverting Customs Unions

10.2A. Trade Diversion

- Trade diversion occurs when lower-cost imports from outside the customs union are replaced by higher-cost imports from a member nation.
- A trade-diverting customs union results in both trade creation and trade diversion, and therefore can increase or reduce the welfare of union members.

10.2B. Illustration of a Trade-Creating Customs Union

10.3 Trade-Diverting Customs Unions

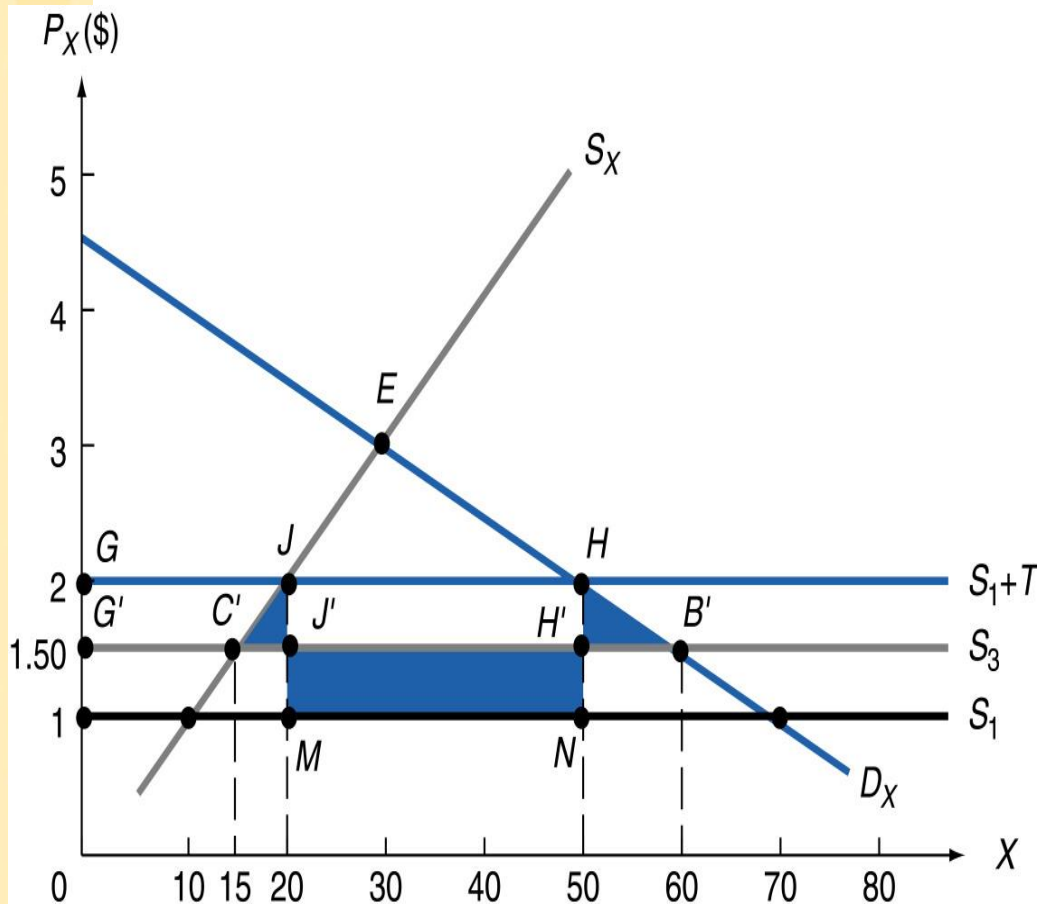


FIGURE 10-1 A Trade-Diverting Customs Union

- (1) Before CU (Home country = N2)
 - Price of X ($P_{x1} = \$1$, $P_{x2} = \$3$, $P_{x3} = \$1.50$)
 - Price of X in N2 with 100% tariff = \$2
 - demand : 50X
 - supply : 20X
 - import : 30X from Nation 1
- (2) After CU (N2 & N3)
 - Price of X in N2 = \$1.50
 - demand : 60X
 - supply : 15X
 - import : 45X
 - welfare gain = $CJ'M'$ + $B'HH'$
 - welfare loss = $J'H'MN$
 - Net welfare = ?

10.4 The Theory of the Second Best and Other Static Welfare Effects of Customs Union

10.4A. The Theory of the Second Best

- If all the conditions required to maximize welfare or reach Pareto optimum cannot be satisfied, trying to satisfy as many of these conditions as possible does not necessarily or usually lead to the second-best position.
- Examples:
- Thus, forming a customs union and removing trade barriers only among the members will not necessarily produce the second-best welfare position.

10.4 The Theory of the Second Best and Other Static Welfare Effects of Customs Union

10.4B. Conditions More Likely to Lead to Increased Welfare

- The higher are the preunion barriers of member.
- The lower are the customs union's barriers on trade with the rest of the world.
- The greater is the number of countries forming the customs union and the larger their size.
- The more competitive rather than complementary are the economies of member nations. – discuss!!
- The closer geographically are the members of the customs union.
- The greater is the preunion trade and economic relationship among potential members of the customs union.

10.4 The Theory of the Second Best and Other Static Welfare Effects of Customs Union

10.4C. Other Static Welfare Effects of Customs Union

- Administrations savings from the eliminations of customs officers, border patrols, etc for trade among member nations. (discuss the case of FTA as well!!)
- A trade-diverting customs union is likely to lead to an improvement in the collective terms of trade of the CU.
- A CU, by acting as a single unit in trade negotiations, is likely to have much more bargaining power than all of its members separately.

10.5 Dynamic Benefits from Customs Union

10.5A. Dynamic Benefits from CU

- Increased competition among firms in the CU
- Economies of scale effect
- Stimulus to investment
- Better utilization of the economic resources (in the case of common market).

10.5B Caveats

- Joining a CU is only a second-best solution at best: The best policy is to “unilaterally” eliminate all trade barriers. (Discuss!!)
- Controversies over whether regional blocs are building blocks or stumbling blocks to free multilateral trade.

10.6 History of Attempts a Economic Integration

10.6A. The European Union

- Founded in 1958 as a CU, with 5 members (West Germany, France, Belgium, the Netherlands and Luxembourg.)
- As of 2004, 25 member countries with 10 new East European countries.
- Romania, Turkey, Bulgaria, and Croatia may join soon.

10.6B The European Free Trade Association

- Founded in 1960 as an FTA, with 7 members (UK, Austria, Denmark, Norway, Portugal, Sweden and Switzerland)

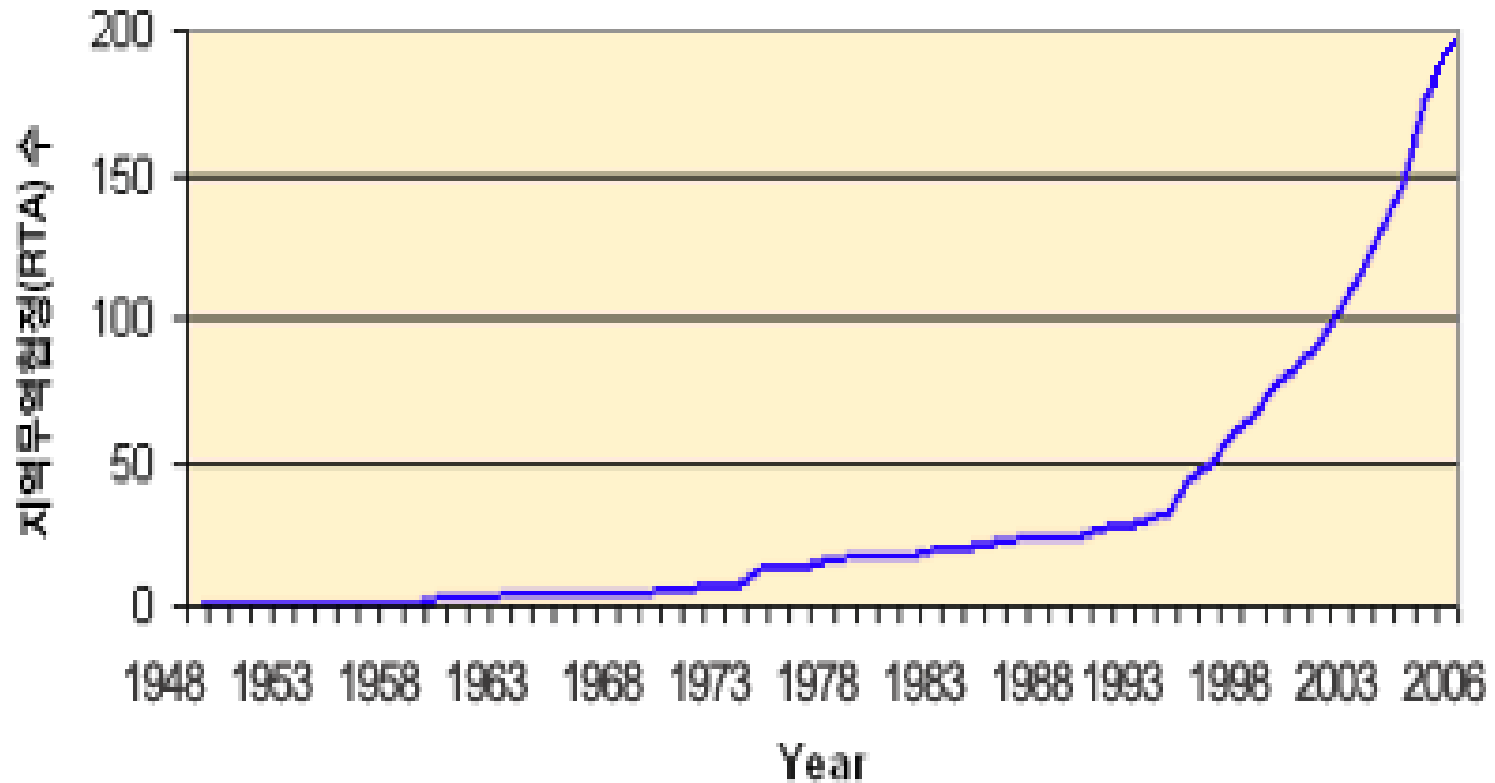
10.6C The North American Free Trade Agreement

- Founded in 1993 as an FTA, with 3 members (US, Canada, and Mexico)
- May be extended to the Free Trade Area of the Americas (FTAA)

10.6D Economic Integration among Developing Countries

- Founded in 1993 as an FTA, with 3 members (US, Canada, and Mexico)
- May be extended to the Free Trade Area of the Americas (FTAA)

10.7 Supplement: Worldwide Regionalism



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