Lecture 14: Regional integration

- Hoekman/Kostecki Chapter 10: Institutional issues
- Puga/Venables (1998): Agglomeration model with regional integration
- Supplementary: Venables (2003) – using HOS or Ricardian framework
- Seminar 10 May: Regionalism/WTO, integration in "home market effect" model

Lecture notes etc.

- Note on the "home market effect" model
- Background note on parts of this lecture
- These slides
- Exercise + solution for seminar 10 May
- Seminar 10 May: Also some exam talk

Regional integration agreements (RIAs)

- 200 notified to GATT/WTO, half in the 1990's. Current acceleration.
- Terminology:
  – Free trade area
  – Customs union = common external tariff
  – Common market, + factor movements
  – Economic union, + harmonisation

Basic concepts

- RIA = lower trade barriers in bloc
- Trade diversion: Imports from low-cost third country replaced by imports from partner country
- Trade creation: Domestic production replaced by imports from partner country
- Magnitudes depend on trade/industrial structure and the level of trade costs

Legal basis

- Art. XXIV of GATT/WTO
  – External barriers not higher than before ("on the whole" for customs unions)
  – Should cover "substantially all the trade" in bloc
- GATS: Weaker wordings ("substantial sector coverage" etc.)
- If external tariff rises: Compensation

Example: Norwegian fish in the enlarged EU

- FTAs with Poland etc.: Zero tariff
- EU: High tariffs
- EFTA Agreements with new members cancelled
- Result: EU enlargement = higher tariffs for fish in Poland
- Did Norway have a right to compensation?

Trends in regionalism

- From the late 1950s: Western Europe, deepening since
- Failed integration among developing countries
- Late 1980s: Americas
- 2002: Asia
- Recently: North-South integration
- Recently: "Global regionalism"

Regional trading blocs

- Integration between countries at different income levels: Intermediate countries gain (Venables 2003)
- More complex integration models – article by Puga and Venables (1998)
- Based on new economic geography approach – cumulative processes for otherwise similar countries
- Core elements include "home market effect"

Basic model

- "Agriculture" (A) and "manufacturing" (M)
- A: Uses specific factor (land) + labour, traded freely
- M: Uses labour + intermediate M goods, iceberg trading costs
- M: Monopolistic competition à la Dixit-Stiglitz
- Intermediates = vertical linkages, externality

Agglomeration forces

- "Market size effect" is present
- Amplified by externality: High M production increases demand for M intermediates, and reduces costs due to better availability of intermediate M goods.
- But: High M production leads to higher wages and lower M price levels: These two forces reduce profitability of M firms and works against agglomeration

Agglomeration and trade barriers

- High trade barriers: Advantage to local suppliers, no agglomeration
- Low trade barriers: Proximity to markets and intermediate goods suppliers do not matter so much, and wage differences hinder agglomeration
- Intermediate trade barriers: Agglomeration may occur (U-curve)

Trade policy experiments

- Base case: 4 countries, two rich and two poor, constructed by means of low trading costs between the two rich ones, all M production in these two
- Multilateral liberalisation
- South-South free trade agreement
- North-South trade agreement

Main scenarios

- Details: See article
- Multilateral: Two stages: First S-S divergence, later full convergence
- S-S rta: Similar, but occurs later
- N-S rta: Good for the participating S country
- Moral: Trade liberalisation is good, but not always for all
- Full liberalisation is better than partial