

The Impact of Economic Integration In EU

Contents

Introduction

Trade effects

Income effects

The balance of payments effect

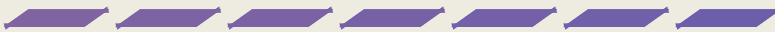
Economic Growth Effect

Introduction

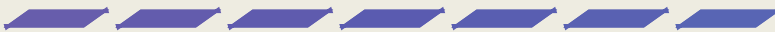
Economic integration has a number of different effects on the member countries and on the rest of the world.

These effects are represented in the following:

Trade effects



Income effects



The balance of payments effect



Economic growth effect



Trade effects

A major concern of the orthodox theory of free trade areas (FTAs) and customs unions (CUs) is

- the impact of **integration** on **trade**.

It is distinguished between five effects:



Internal Trade Creation

It is defined as the displacement of **high-cost domestic production** of a product in one member state by **lower-cost imports** from another member state.

This improves

- the global allocation of **resources** and
- It represents a step in the direction of free trade.

Before the Trade Union

lower Production Cost
(compared to country B)



No Trade



Higher production cost
(compared to country A)

After the Trade Union

lower Production Cost
(compared to country B)



Higher production cost
(compared to country A)

Trade Diversion

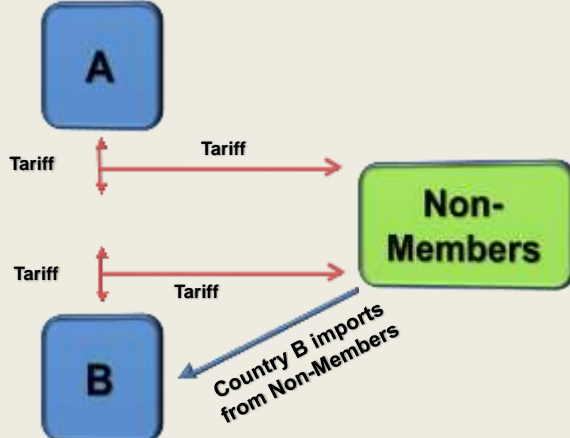
It is defined as the displacement of **lower-cost imports** of a product from a non-member state by **higher-cost imports** from a member state. This results from the discriminatory nature of the tariff.

This worsens

- the global allocation of resources,
- it represents a step towards protectionism.

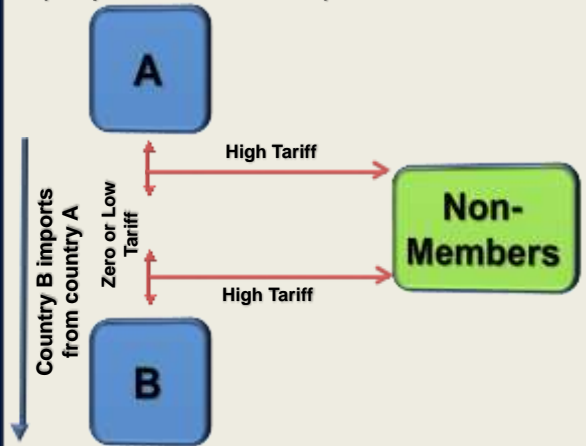
Before the Trade Union

Higher Production Cost
(compared to non-members)



After the Trade Union

Higher Production Cost
(compared to non-members)

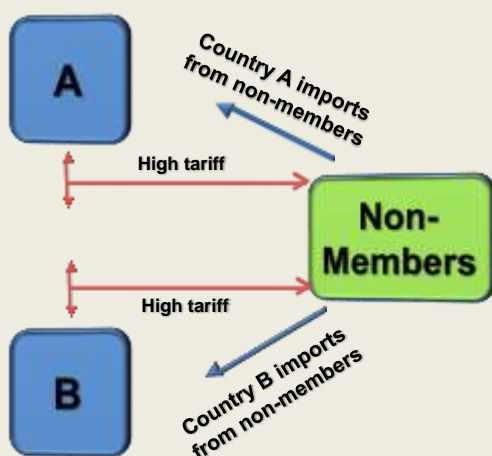


External Trade Creation

As CU results in a lower level of **external tariffs** or other restrictions compared with the situation before integration, the result will be **expanding trade** with non-member states.

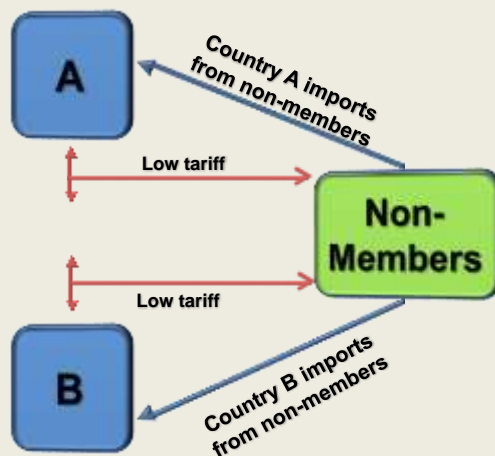
External trade creation can be also resulted from the fact that **faster economic growth** inside the trade union leads the member states to **import more** from the rest of the world.

Before the Trade Union



(Note: the length of the arrow reflects the volume of exports)

After the Trade Union



(Note: the length of the arrow reflects the volume of exports)

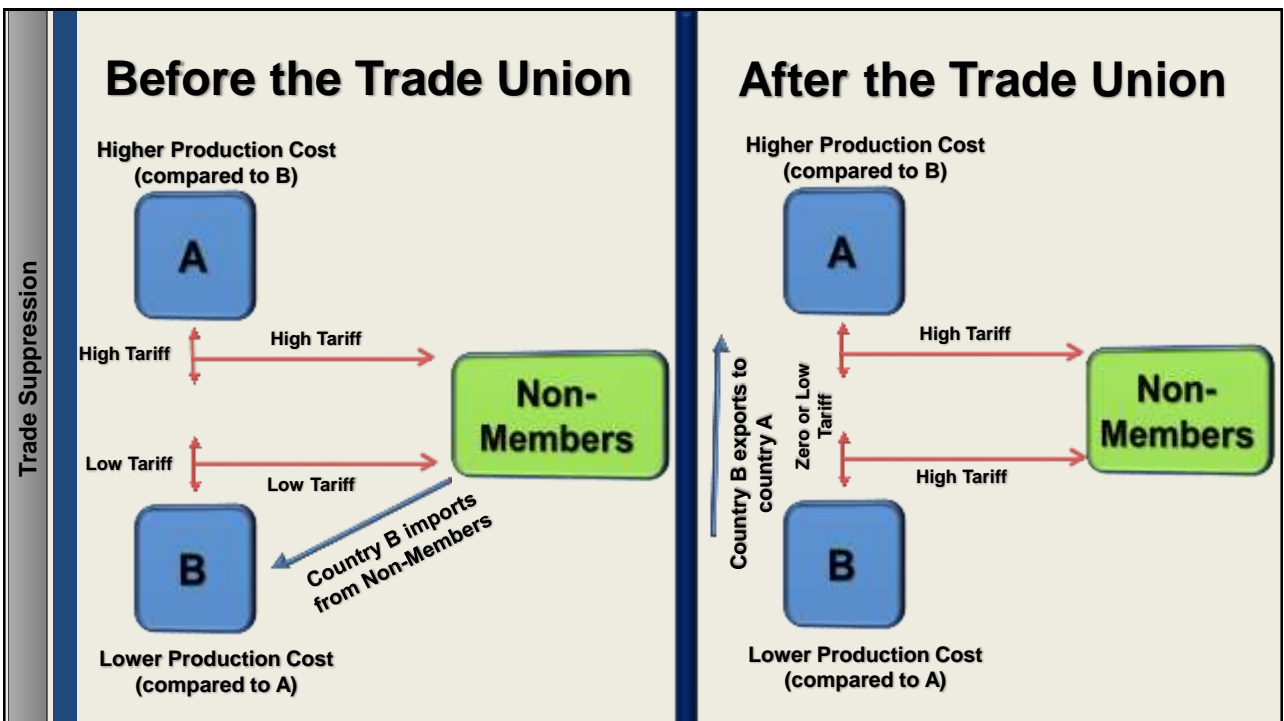
Trade Suppression

It is regarded as a **special form of trade diversion**.

In this case, the production of a **particular good** in one of the member states **disappears** following the formation of the union. As, the production **shifts to another member state** where costs are lower. However, prior to the formation of the union, the latter country imported the product from the rest of the world.

The reason for this situation is that:

a high tariff in the former country before the formation of the union made it **profitable** to produce the good, but import nothing at all. In the latter country, however, the tariff was low, discouraging domestic production and resulting in the good being imported.

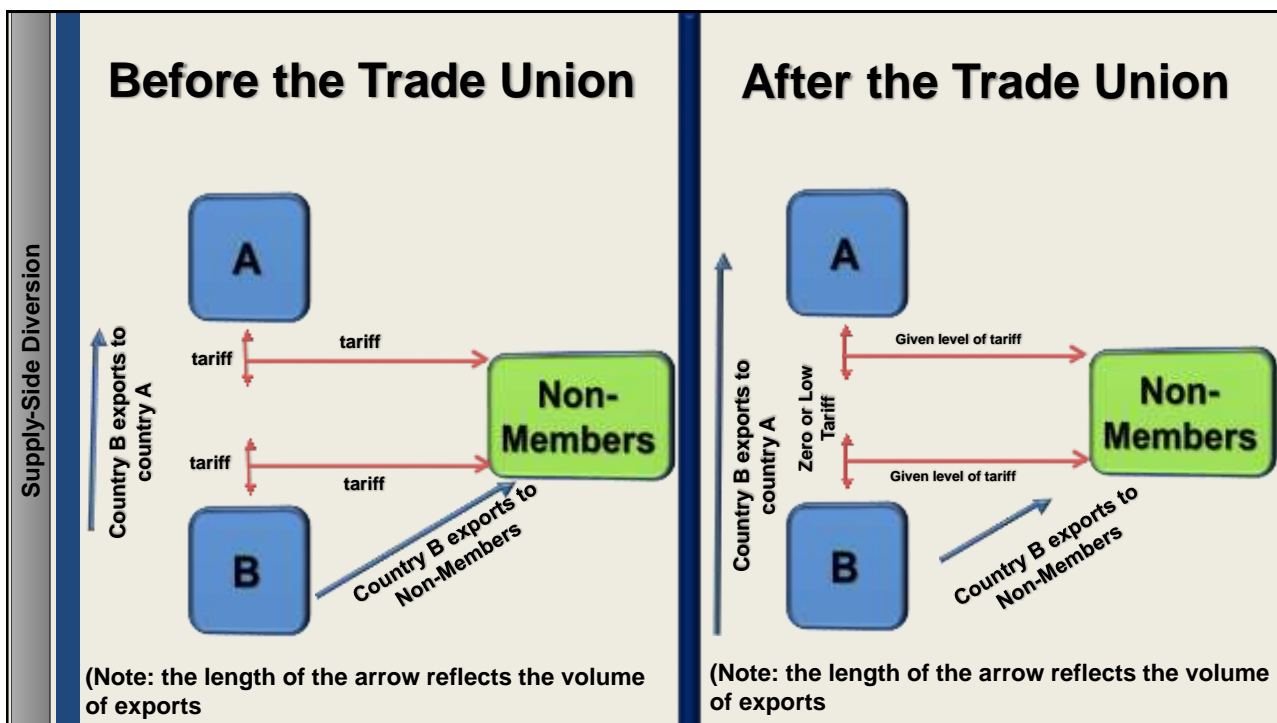


Supply-Side Diversion

This will take place when, due to a **supply-side constraint** (e.g. shortage of capacity), increased exports of a product to a member state following integration result in **reduced exports of the product to a non-member state**.

Note

Such an effect is likely to be of a **short-term** nature only, as, over time, producers will expand their capacity to meet the greater demand for their product.



Income effects

Income effect is due to the fact that:

- changes in **trade patterns** have potential influence on economic welfare (production and consumption).

From a **global point of view**, **trade creation** is **welfare-enhancing**, while **trade diversion** is **welfare-decreasing**.

However, for members of the trade union, trade diversion will **raise the real incomes (welfare-enhancing)** of the exporting countries, while **lowering the real incomes (lowering welfare)** of importing countries.

Tariff liberalization in differentiated goods industries tends to result in more **intra industry trade (IIT)**

- i.e., two-way trade in different varieties of the same product.
- This makes possible further gains to **consumers** from having a wider variety of goods to choose from.
- IIT in differentiated goods is also more likely to yield dynamic welfare gain from decreasing **average cost** and increasing **competition**.

- In general, **Both inter and intra-industry trade** may have other positive long-run effects on output in the trade union.

For example,

Output may be increased as a result of firms investing more in order to:

- ✓ take advantage of the wider market
- ✓ cope with increased competition, which may also spur firms to engage in more technological innovation.

The balance of payments effect

Economic integration may also have an effect on the balance of payments of individual countries.

This could be:

- ✓ favorable (if exports increase by more than imports) (i.e., a **positive balance of payments effect**)
- ✓ unfavorable (if imports expand more than exports) (i.e., an **adverse balance of payments effect**)

Note: The adverse balance of payment might be difficult to be expected.

For example,

At the time when the EC was set up, there was a concern that *Italy* would experience an **adverse balance of payments effect** because of a lower degree of industrial competitiveness.

However, It is clear that these concerns proved unwarranted, as the Italian economy thrived after the formation of the EC.

Likewise, there was a concern when the *UK* joined the EC in 1973 that the effect on the balance of payments would be adverse. Since UK tariffs on industrial goods imported from the EC were slightly higher than on such goods when exported to the EC, so after joining the EC, British imports from the EC could be expected to rise by more than British exports to the EC.

However, such concerns proved not to be true.

An adverse balance of payments effect, however, **need not be a matter of concern**, providing the country is prepared to allow the real exchange rate to fall.

This can happen either by:

- Adopting a floating exchange rate
- Reducing the country's price level below that of the rest of the world.

When the exchange rate is floating,

- The nominal rate may well fall if the balance of payments deteriorates,

Although this may not be the case if large inflows of capital from abroad create greater demand for the currency on foreign exchange markets.

When the price level is reduced,

- The terms of trade is improved

Reducing the price level maybe more difficult to achieve, if prices are slow to fall in response to a **tightening of monetary and fiscal policy**.

Thank you