NAFTA 2.0: The USMCA

opening case

In his 2016 presidential campaign, Donald Trump repeatedly criticized the North American Free Trade Agreement (NAFTA) as an unfair deal in which Americans had been taken to the cleaners by Mexico. Trump claimed that NAFTA had cost American manufacturers millions of jobs, even though there is scant evidence to suggest that this is the case. After becoming president, Trump stuck to his word and initiated a renegotiation of NAFTA.

Trump's anti-NAFTA stance sent shockwaves through industry on both sides of the border. Since NAFTA was signed in 1994, trade between the United States, Canada, and Mexico has tripled to $1.3 trillion. In 2017, the United States exported $342 billion of goods and services to Canada and $277 billion to Mexico, while importing $339 billion from Canada and $355 billion from Mexico. The U.S. ran a $2.8 billion surplus in trade with Canada, and a $69 billion deficit with Mexico. Canada and Mexico are now the largest export markets for the United States, accounting for a third of all U.S. exports, and the largest sources of imports behind China.

The renegotiation of NAFTA was complicated by the fact that multilayered supply chains now span both sides of the U.S.–Mexican border. Nowhere is this more the case than in the automobile industry. Auto parts manufactured in the United States may be shipped to plants in Mexico, where finished cars are assembled and then shipped back to the United States for final sale (the converse also occurs, with parts manufactured in Mexico being shipped to U.S. final assembly plants). In 2017, U.S. producers exported $21 billion of finished automobiles and automotive parts to Mexico but imported $84 billion in autos and parts from Mexico. Without that $63 billion trade deficit in autos and auto parts, the United States would be running only a $6 billion trade deficit with Mexico.

Perhaps because he recognizes the lopsided nature of trade in auto and auto parts between the United States and Mexico, President Trump has taken it upon himself to criticize auto producers that have moved production to Mexico or are planning to do so. Following criticism from Trump, Ford canceled plans to build a $1.6 billion auto assembly plant in Mexico. President Trump has also criticized General Motors, Toyota, and BMW for their plans to invest in Mexican assembly operations. Jawboning aside, as part of the NAFTA renegotiations, the Trump administration was looking at different options for restructuring trade with Mexico. These include placing tariffs on imports of autos from Mexico.

In the event, on September 30th, 2018, the Trump Administration reached agreement with Mexico and Canada on a revised version of NAFTA. Known as the United States-Mexico-Canada Agreement, or USMCA for short, this agreement must now be ratified by legislators in all three countries. The USMCA does make some changes to the 25-year-old NAFTA agreement. Most significantly, NAFTA required automakers to

continued

produce 62.5 percent of a vehicle's content in North America to qualify for zero tariffs. The USMCA raises that threshold to 75%. That's meant to force automakers to source fewer parts for a car assembled in North America from Germany, Japan, South Korea or China. The new agreement also mandates that by 2023, 40% of parts for any tariff-free vehicle must come from a so-called "high wage" factory. Those factories must pay a minimum of $16 an hour in average salaries for production workers, which is about triple the average wage in a Mexican factory right now.

The Trump Administration clearly hopes these provisions will increase the production of automobiles and component parts in the United States. That may occur, but critics also note that the consequences may include higher costs to North American automobile producers, and higher prices for consumers. ●

Sources: U.S. Census Bureau, www.census.gov/foreign-trade/index.html, accessed April 10, 2018; Robbie Whelan, "Gloom Descends on Mexico's NAFTA Capital," *The Wall Street Journal*, January 26, 2017; Dudley Althaus and Christina Rogers, "Donald Trump's NAFTA Plan Would Confront Globalized Auto Industry," *The Wall Street Journal*, November 10, 2016; William Mauldin and David Luhnow, "Donald Trump Posed to Pressure Mexico on Trade," *The Wall Street Journal*, November 21, 2016; and Siobhan Hughes et al., "Trump Tariffs Spark GOP Rift," *The Wall Street Journal*, March 5, 2018.

Introduction

regional economic integration
Agreements among countries in a geographic region to reduce and ultimately remove tariff and nontariff barriers to the free flow of goods, services, and factors of production between each other.

The past two decades have witnessed a proliferation of regional trade blocs that promote **regional economic integration**. World Trade Organization (WTO) members are required to notify the WTO of any regional trade agreements in which they participate. By 2018, all members had notified the WTO of participation in one or more regional trade agreements. As of early 2018, there were 284 regional trade agreements in force.[1]

Consistent with the predictions of international trade theory and particularly the theory of comparative advantage (see Chapter 6), agreements designed to promote freer trade within regions are believed by economists to produce gains from trade for all member countries. The General Agreement on Tariffs and Trade (GATT) and its successor, the World Trade Organization, also seek to reduce trade barriers. However, the WTO has a global perspective and 164 members, which can make reaching an agreement extremely difficult. By entering into regional agreements, groups of countries aim to reduce trade barriers more rapidly than can be achieved under the auspices of the WTO. This has become an increasingly important policy approach in recent years, given the failure of the WTO to make any progress with its latest round of trade talks, the Doha Round, initiated in 2001 but currently in limbo (see Chapter 7). Given the failure of the Doha Round, national governments have felt that they can better advance their trade agenda through multilateral agreements than through the WTO.

Nowhere has the movement toward regional economic integration been more ambitious than in Europe. On January 1, 1993, the European Union formally removed many barriers to doing business across borders within the EU in an attempt to create a single market with 340 million consumers. Today, the EU has a population of more than 500 million and a gross domestic product of more than $17 trillion, making it slightly smaller than the United States in economic terms. That being said, the 2016 vote by the British to negotiate an exit from the EU (Brexit) has cast a cloud over the future of the European project (the British are set to exit the EU in March 2019).

Similar moves toward regional integration are being pursued elsewhere in the world. Canada, Mexico, and the United States entered into the NAFTA on January 1, 1994. Ultimately, NAFTA aimed to remove all barriers to the free flow of goods and services among the three countries. While the implementation of NAFTA has resulted in job losses in some sectors of the U.S. economy, in aggregate and consistent with the predictions of international trade theory, most economists argue that the benefits of greater regional trade outweigh any costs. As noted in the opening case, however, the administration of President Donald Trump criticized NAFTA, blaming it for significant job losses in the United States, and has negotiated a new agreement.

globalEDGE — Regional Trade Agreements

Regional economic integration is the focus of Chapter 9, and the value-added portion of globalEDGE™ that captures the ongoing development of major trade agreements worldwide is called "Regional Trade Agreements" (globaledge.msu.edu/global-resources/regional-trade-agreements). In this section of globalEDGE™, the most critical agreements of the some 300 that exist today are included, with direct access to the home pages for each agreement. The landing page for "Regional Trade Agreements" also includes globalEDGE's own "Trade Bloc Insights," which takes the user to a wealth of information and data (e.g., overview of each agreement, its history, countries included in the membership, related agreements, online resources, statistics, and an executive summary of what the agreement entails). In Chapter 9, we cover several of the trade agreements to provide an overview of the global marketplace. But which agreements are not covered in detail in the book, and which ones are covered on globalEDGE? What do you know, for example, about ECOWAS and SADC? How many members are in ECOWAS and SADC, respectively, and are any of these agreements overlapping? When were the treaties of ECOWAS and SADC started?

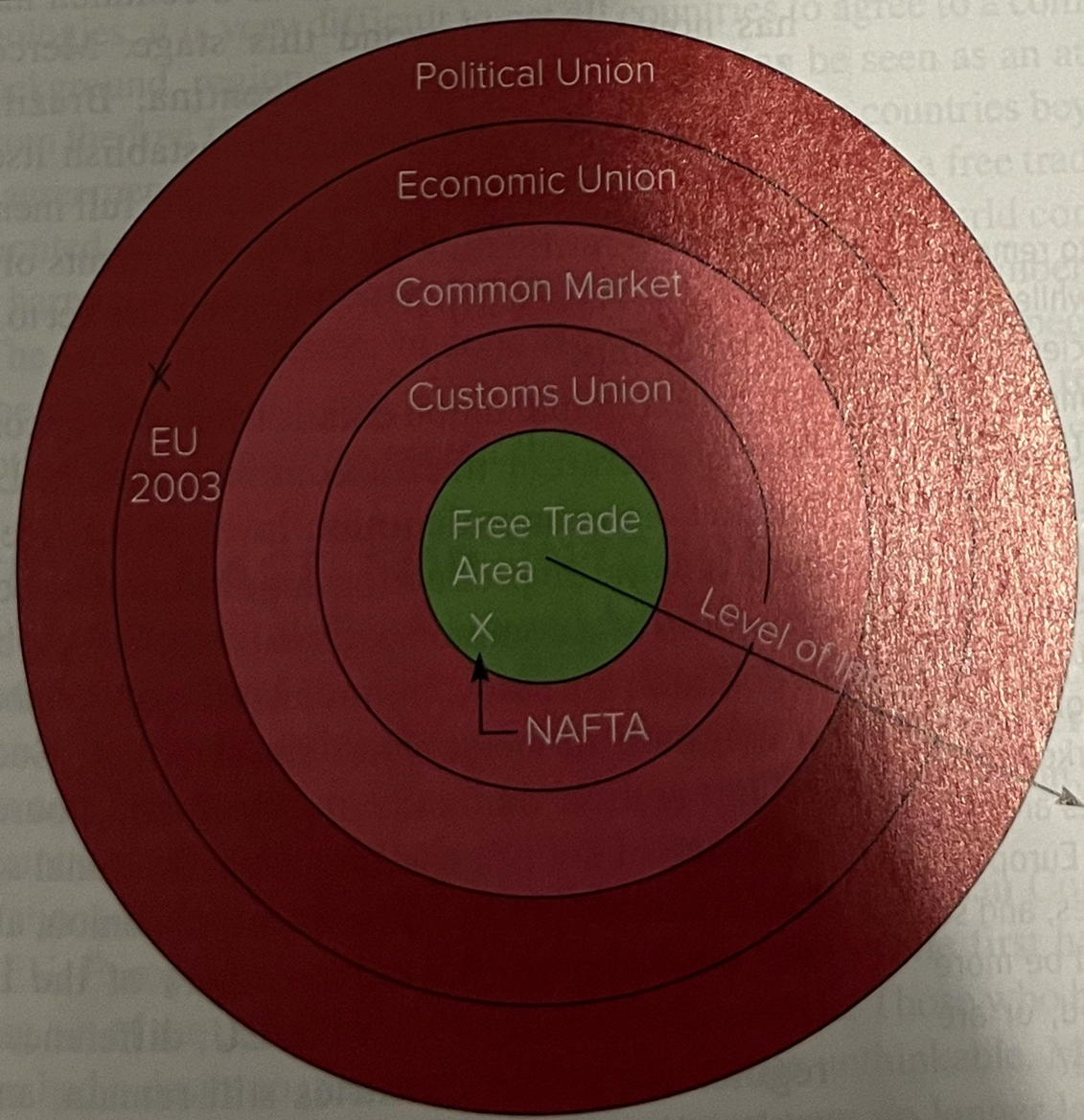
South America, too, has moved toward regional integration. For example, in 1991, Argentina, Brazil, Paraguay, and Uruguay implemented an agreement known as Mercosur to start reducing barriers to trade between each other, and although progress within Mercosur has been halting, the institution is still in place. There are also ongoing attempts at regional economic integration in Africa, where 26 countries signed an agreement to try and reduce tariffs and costly customs processes in order to stimulate economic growth in the region.

This chapter explores the economic and political debate surrounding regional economic integration, paying particular attention to the economic and political benefits and costs of integration; reviews progress toward regional economic integration around the world; and maps the important implications of regional economic integration for the practice of international business. We will discuss current developments that threatened the future of the EU and NAFTA. Before tackling these objectives, we first need to examine the levels of integration that are theoretically possible.

Levels of Economic Integration

LO 9-1 Describe the different levels of regional economic integration.

Several levels of economic integration are possible in theory (see Figure 9.1). From least integrated to most integrated, they are a free trade area, a customs union, a common market, an economic union, and, finally, a full political union.



9.1 FIGURE Levels of economic integration

free trade area
A group of countries committed to removing all barriers to the free flow of goods and services between each other but pursuing independent external trade policies.

European Free Trade Association (EFTA)
A free trade association including Norway, Iceland, Liechtenstein, and Switzerland.

customs union
A group of countries committed to (1) removing all barriers to the free flow of goods and services between each other and (2) the pursuit of a common external trade policy.

common market
A group of countries committed to (1) removing all barriers to the free flow of goods, services, and factors of production between each other and (2) the pursuit of a common external trade policy.

economic union
A group of countries committed to (1) removing all barriers to the free flow of goods, services, and factors of production between each other; (2) the adoption of a common currency; (3) the harmonization of tax rates; and (4) the pursuit of a common external trade policy.

In a **free trade area**, all barriers to the trade of goods and services among member countries are removed. In the theoretically ideal free trade area, no discriminatory tariffs, quotas, subsidies, or administrative impediments are allowed to distort trade between members. Each country, however, is allowed to determine its own trade policies with regard to nonmembers. Thus, for example, the tariffs placed on the products of nonmember countries may vary from member to member. Free trade agreements are the most popular form of regional economic integration, accounting for almost 90 percent of regional agreements.[2]

The most enduring free trade area in the world is the **European Free Trade Association (EFTA)**. Established in January 1960, the EFTA currently joins four countries—Norway, Iceland, Liechtenstein, and Switzerland—down from seven in 1995 (three EFTA members—Austria, Finland, and Sweden—joined the EU on January 1, 1996). The EFTA was founded by those western European countries that initially decided not to be part of the European Community (the forerunner of the EU). Its original members included Austria, Great Britain, Denmark, Finland, and Sweden, all of which are now members of the EU. The emphasis of the EFTA has been on free trade in industrial goods. Agriculture was left out of the arrangement, each member being allowed to determine its own level of support. Members are also free to determine the level of protection applied to goods coming from outside the EFTA. Other free trade areas include the North American Free Trade Agreement, which we discuss in depth later in the chapter.

The customs union is one step farther along the road to full economic and political integration. A **customs union** eliminates trade barriers between member countries and adopts a common external trade policy. Establishment of a common external trade policy necessitates significant administrative machinery to oversee trade relations with nonmembers. Most countries that enter into a customs union desire even greater economic integration down the road. The EU began as a customs union, but it has now moved beyond this stage. Other customs unions include the current version of the Andean Community (formerly known as the Andean Pact) among Bolivia, Colombia, Ecuador, and Peru. The Andean Community established free trade between member countries and imposes a common tariff, of 5 to 20 percent, on products imported from outside.[3]

The next level of economic integration, a **common market**, has no barriers to trade among member countries, includes a common external trade policy, and allows factors of production to move freely among members. Labor and capital are free to move because there are no restrictions on immigration, emigration, or cross-border flows of capital among member countries. Establishing a common market demands a significant degree of harmony and cooperation on fiscal, monetary, and employment policies. Achieving this degree of cooperation has proved very difficult. For years, the European Union functioned as a common market, although it has now moved beyond this stage. Mercosur—the South American grouping of Argentina, Brazil, Paraguay, and Uruguay—hopes to eventually establish itself as a common market. Venezuela was accepted as a full member of Mercosur subject to ratification by the governments of the four existing members. As of early 2016, Paraguay has yet to ratify Venezuela's membership.

An economic union entails even closer economic integration and cooperation than a common market. Like the common market, an **economic union** involves the free flow of products and factors of production among member countries and the adoption of a common external trade policy, but it also requires a common currency, harmonization of members' tax rates, and a common monetary and fiscal policy. Such a high degree of integration demands a coordinating bureaucracy and the sacrifice of significant amounts of national sovereignty to that bureaucracy. The EU is an economic union, although an imperfect one because not all members of the EU have adopted the euro, the currency of the EU; differences in tax rates and regulations across countries still remain; and some markets, such as the market for energy, are still not fully deregulated.

Should Regional Economic Integration Be Based on Culture?

A free trade area is a group of countries committed to removing all barriers to the free flow of goods and services while at the same time pursuing independent external trade policies. A free trade area can be of the form of a customs union, common market, economic union, or political union. The European Union is an economic union—although some would say that the EU is striving for the approach of a political union as well. The EU, in reality, is an imperfect economic union because not all members of the EU have adopted the common currency, the euro, and countries differ in a variety of economic measures (e.g., taxes, regulations). But the most obvious reason the EU is an imperfect market is that the cultures of the independent countries in many cases are very different, from the Nordic countries to the southern European countries to the former eastern bloc European countries, and so on. Do you think regional economic integration should be more based on similarity in culture of the nations involved, or are market-based economic indicators the most appropriate?

The move toward economic union raises the issue of how to make a coordinating bureaucracy accountable to the citizens of member nations. The answer is through **political union** in which a central political apparatus coordinates the economic, social, and foreign policy of the member states. The EU is on the road toward at least partial political union. The European Parliament, which plays an important role in the EU, has been directly elected by citizens of the EU countries since the late 1970s. In addition, the Council of Ministers (the controlling, decision-making body of the EU) is composed of government ministers from each EU member. The United States provides an example of even closer political union; in the United States, independent states are effectively combined into a single nation.

political union
A central political apparatus coordinates economic, social, and foreign policy.

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LO 9-2
Understand the economic and political arguments for regional economic integration.

The Case for Regional Integration

The case for regional integration is both economic and political, and it is typically not accepted by many groups within a country, which explains why most attempts to achieve regional economic integration have been contentious and halting. In this section, we examine the economic and political cases for integration and two impediments to integration. In the next section, we look at the case against integration.

THE ECONOMIC CASE FOR INTEGRATION

The economic case for regional integration is straightforward. We saw in Chapter 6 how economic theories of international trade predict that unrestricted free trade will allow countries to specialize in the production of goods and services that they can produce most efficiently. The result is greater world production than would be possible with trade restrictions. That chapter also revealed how opening a country to free trade stimulates economic growth, which creates dynamic gains from trade. Chapter 8 detailed how foreign direct investment (FDI) can transfer technological, marketing, and managerial know-how to host nations. Given the central role of knowledge in boosting economic growth, opening a country to FDI also is likely to stimulate economic growth. In sum, economic theories suggest that free trade and investment is a positive-sum game, in which all participating countries stand to gain.

Given this, the theoretical ideal is an absence of barriers to the free flow of goods, services, and factors of production among nations. However, as we saw in Chapters 7 and 8, a case can be made for government intervention in international trade and FDI. Because many governments have accepted part or all of the case for intervention, unrestricted free trade and FDI have proved to be only an ideal. Although international institutions such as the WTO have been moving the world toward a free trade regime, success has been less than total. In a world of many nations and many political ideologies, it is very difficult to get all countries to agree to a common set of rules.

Against this background, regional economic integration can be seen as an attempt to achieve additional gains from the free flow of trade and investment between countries beyond those attainable under global agreements such as the WTO. It is easier to establish a free trade and investment regime among a limited number of adjacent countries than among the world community. Coordination and policy harmonization problems are largely a function of the number of countries that seek agreement. The greater the number of countries involved, the more perspectives that must be reconciled, and the harder it will be to reach agreement. Thus, attempts at regional economic integration are motivated by a desire to exploit the gains from free trade and investment.

THE POLITICAL CASE FOR INTEGRATION

The political case for regional economic integration also has loomed large in several attempts to establish free trade areas, customs unions, and the like. Linking neighboring economies and making them increasingly dependent on each other creates incentives for political cooperation between the neighboring states and reduces the potential for violent conflict. In addition, by grouping their economies, the countries can enhance their political weight in the world.

These considerations underlay the 1957 establishment of the European Community (EC), the forerunner of the EU. Europe had suffered two devastating wars in the first half of the twentieth century, both arising out of the unbridled ambitions of nation-states. Those who have sought a united Europe have always had a desire to make another war in Europe unthinkable. Many Europeans also believed that after World War II, the European nation-states were no longer large enough to hold

their own in world markets and politics. The need for a united Europe to deal with the United States and the politically alien Soviet Union loomed large in the minds of many of the EC's founders.[4] A long-standing joke in Europe is that the European Commission should erect a statue to Joseph Stalin, for without the aggressive policies of the former dictator of the old Soviet Union, the countries of western Europe may have lacked the incentive to cooperate and form the EC.

The establishment of NAFTA also had a political aspect to it. Many NAFTA supporters felt that the trade agreement would help promote democracy and economic growth in Mexico. This, they argued, would be good for the United States, since it would reduce the flow of illegal immigration from Mexico. In fact, illegal immigration from Mexico rose from 2.9 million in 1995 to almost 7 million in 2007. However, since then, the strong Mexican economy has indeed led to a reduction in illegal immigration from Mexico. By 2017 the number Mexican illegal immigrants living in the United States had fallen to 5.8 million.[5]

IMPEDIMENTS TO INTEGRATION

Despite the strong economic and political arguments in support, integration has never been easy to achieve or sustain for two main reasons. First, although economic integration aids the majority, it has its costs. While a nation as a whole may benefit significantly from a regional free trade agreement, certain groups will lose, at least in the short to medium term. Moving to a free trade regime can involve painful adjustments. Due to the establishment of NAFTA, some Canadian and U.S. workers in such industries as textiles—which employ low-cost, low-skilled labor—lost their jobs as Canadian and U.S. firms moved production to Mexico. The promise of significant net benefits to the Canadian and U.S. economies as a whole is little comfort to those who lose as a result of NAFTA. Such groups have been at the forefront of opposition to NAFTA and will continue to oppose any widening of the agreement.

A second impediment to integration arises from concerns over national sovereignty. For example, Mexico's concerns about maintaining control of its oil interests resulted in an agreement with Canada and the United States to exempt the Mexican oil industry from any liberalization of foreign investment regulations achieved under NAFTA. Concerns about national sovereignty arise because close economic integration demands that countries give up some degree of control over such key issues as monetary policy, fiscal policy (e.g., tax policy), and trade policy. This has been a major stumbling block in the EU. To achieve full economic union, the EU introduced a common currency, the euro, controlled by a central EU bank. Although most member states have signed on, Great Britain remained an important holdout. A politically important segment of public opinion in that country opposed a common currency on the grounds that it would require relinquishing control of the country's monetary policy to the EU, which many British perceive as a bureaucracy run by foreigners. In 1992, the British won the right to opt out of any single currency agreement. In 2016, the British held a referendum on their continuing membership of the EU and voted to leave the EU (discussed later in the chapter). Concerns over national sovereignty, particularly with regard to immigration policy, were the major factor persuading the British government that a referendum was necessary.

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LO 9-3

Understand the economic and political arguments against regional economic integration.

The Case against Regional Integration

Although the tide has been running in favor of regional free trade agreements, some economists have expressed concern that the benefits of regional integration have been oversold, while the costs have often been ignored.[6] They point out that the benefits of regional integration are determined by the extent of trade creation, as opposed to trade diversion. **Trade creation** occurs when high-cost domestic producers are replaced by low-cost producers within the free trade area. It may also occur when higher-cost external producers are replaced by lower-cost external producers within the free trade area. **Trade diversion** occurs when lower-cost external suppliers are replaced by higher-cost suppliers within the free trade area. A regional free trade agreement will benefit the world only if the amount of trade it creates exceeds the amount it diverts.

trade creation

Trade created due to regional economic integration; occurs when high-cost domestic producers are replaced by low-cost foreign producers within a free trade area.

trade diversion

Trade diverted due to regional economic integration; occurs when low-cost foreign suppliers outside a free trade area are replaced by higher-cost suppliers within a free trade area.

Suppose the United States and Mexico imposed tariffs on imports from all countries and then set up a free trade area, scrapping all trade barriers between themselves but maintaining tariffs on imports from the rest of the world. If the United States began to import textiles from Mexico, would this change be for the better? If the United States previously produced all its

own textiles at a higher cost than Mexico, then the free trade agreement has shifted production to the cheaper source. According to the theory of comparative advantage, trade has been created within the regional grouping, and there would be no decrease in trade with the rest of the world. Clearly, the change would be for the better. If, however, the United States previously imported textiles from Costa Rica, which produced them more cheaply than either Mexico or the United States, then trade has been diverted from a low-cost source—a change for the worse.

In theory, WTO rules should ensure that a free trade agreement does not result in trade diversion. These rules allow free trade areas to be formed only if the members set tariffs that are not higher or more restrictive to outsiders than the ones previously in effect. However, as we saw in Chapter 7, GATT and the WTO do not cover some nontariff barriers. As a result, regional trade blocs could emerge whose markets are protected from outside competition by high nontariff barriers. In such cases, the trade diversion effects might outweigh the trade creation effects. The only way to guard against this possibility, according to those concerned about this potential, is to increase the scope of the WTO so it covers nontariff barriers to trade. There is no sign that this is going to occur any time soon, however, so the risk remains that regional economic integration will result in trade diversion.

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Regional Economic Integration in Europe

LO 9-4

Explain the history, current scope, and future prospects of the world's most important regional economic agreements.

Europe has two trade blocs—the European Union and the European Free Trade Association. Of the two, the EU is by far the more significant, not just in terms of membership (the EU currently has 28 members, although the British have voted to exit the union and is scheduled to do so on March 29, 2019; the EFTA has four), but also in terms of economic and political influence in the world economy. The EU has been viewed as an emerging economic and political superpower of the same order as the United States, although the exit of Britain may alter this perception. Accordingly, we will concentrate our attention on the EU.[7]

EVOLUTION OF THE EUROPEAN UNION

The **European Union (EU)** is the product of two political factors: (1) the devastation of western Europe during two world wars and the desire for a lasting peace and (2) the European nations' desire to hold their own on the world's political and economic stage. In addition, many Europeans were aware of the potential economic benefits of closer economic integration of the countries.

European Union (EU)
An economic and political union of 28 countries (2017) that are located in Europe.

The forerunner of the EU, the European Coal and Steel Community, was formed in 1951 by Belgium, France, West Germany, Italy, Luxembourg, and the Netherlands. Its objective was to remove barriers to intragroup shipments of coal, iron, steel, and scrap metal. With the signing of the **Treaty of Rome** in 1957, the European Community (EC) was established. The name changed again in 1993 when the European Community became the European Union following the ratification of the Maastricht Treaty (discussed later).

Treaty of Rome
The 1957 treaty that established the European Community.

The Treaty of Rome provided for the creation of a common market. Article 3 of the treaty laid down the key objectives of the new community, calling for the elimination of internal trade barriers and the creation of a common external tariff and requiring member states to abolish obstacles to the free movement of factors of production among the members. To facilitate the free movement of goods, services, and factors of production, the treaty provided for any necessary harmonization of the member states' laws. Furthermore, the treaty committed the EC to establish common policies in agriculture and transportation.

The community grew in 1973, when Great Britain, Ireland, and Denmark joined. These three were followed in 1981 by Greece; in 1986 by Spain and Portugal; and in 1995 by Austria, Finland, and Sweden—bringing the total membership to 15 (East Germany became part of the EC after the reunification of Germany in 1990). Another 10 countries joined the EU on May 1, 2004—eight of them from eastern Europe plus the small Mediterranean nations of Malta and Cyprus. Bulgaria and Romania joined in 2007 and Croatia in 2013, bringing the total number of member states to 28 (see Map 9.1). Through these enlargements, the EU has become a global economic power. Right now, it looks as if the the number of members will fall to 27 in 2019 when Britain exits the EU.

9.1 MAP

Member states of the European Union in 2017.

Source: European Union, 1995–2017

POLITICAL STRUCTURE OF THE EUROPEAN UNION

The economic policies of the EU are formulated and implemented by a complex and still-evolving political structure. The four main institutions in this structure are the European Commission, the Council of the European Union, the European Parliament, and the Court of Justice.[8]

European Commission

Responsible for proposing EU legislation, implementing it, and monitoring compliance.

The **European Commission** is responsible for proposing EU legislation, implementing it, and monitoring compliance with EU laws by member states. Headquartered in Brussels, Belgium, it is run by a group of commissioners appointed by each member country for five-year renewable terms. Currently, there are 28 commissioners, one from each member state. A president of the commission is chosen by member states, and the president then chooses other members in consultation with the states. The entire commission has to be approved by the European Parliament before it can begin work. The commission has a monopoly in proposing European Union legislation. The commission makes a proposal, which goes to the Council of the European Union and then to the European Parliament. The council cannot legislate without a commission proposal in front of it. The commission is also responsible for implementing aspects of EU law, although in practice much of this must be delegated to member states. Another responsibility of the commission is to monitor member states to make sure they are complying with EU laws. In this policing role, the commission will normally ask a state to comply with any EU laws that are being broken. If this persuasion is not sufficient, the commission can refer a case to the Court of Justice.

The European Commission's role in competition policy has become increasingly important to business in recent years. Since 1990, when the office was formally assigned a role in competition policy, the EU's competition commissioner has been steadily gaining influence as the chief

management FOCUS

The European Commission and Intel

In May 2009, the European Commission announced that it had imposed a record €1.06 billion ($1.45 billion) fine on Intel for anticompetitive behavior. This fine was the result of an investigation into Intel's competitive conduct during the period from October 2002 to December 2007. During this period, Intel's market share of microprocessor sales to personal computer manufacturers consistently exceeded 70 percent. According to the commission, Intel illegally used its market power to ensure that its major rival, AMD, was at a competitive disadvantage, thereby harming "millions of European consumers."

The commission charged that Intel granted major rebates to PC manufacturers—including Acer, Dell, Hewlett-Packard, Lenovo, and NEC—on the condition that they purchased all or almost all their supplies from Intel. Intel also made payments to some manufacturers in exchange for them postponing, canceling, or putting restrictions on the introduction or distribution of AMD-based products. Intel also apparently made payments to Media Saturn Holdings, the owner of Media Markt chain of superstores, for selling only Intel-based computers in Germany, Belgium, and other countries.

Under the order, Intel had to change its practices immediately, pending any appeal. The company was also required to write a bank guarantee for the fine, although that guarantee is held in a bank until the appeal process is exhausted.

For its part, Intel immediately appealed the ruling. The company insisted that it had never coerced computer makers and retailers with inducements and maintained that it had never paid to stop AMD products from reaching the market in Europe. Although Intel acknowledges that it did offer rebates, it claimed that they were never conditional on specific actions by manufacturers and retailers aimed to limit AMD. In June 2014, an EU court rejected Intel's appeal and upheld the judgment against the company.

Sources: M. Hachman, "EU Hits Intel with $1.45 Billion Fine for Antitrust Violations," *PCMAG.com*, May 13, 2009; J. Kanter, "Europe Fines Intel $1.45 Billion in Antitrust Case," *The New York Times*, May 14, 2009; T. Fairless, "EU Court Upholds Record Fine against Intel," *The Wall Street Journal*, June 12, 2014.

regulator of competition policy in the member nations of the EU. As with antitrust authorities in the United States, which include the Federal Trade Commission and the Department of Justice, the role of the competition commissioner is to ensure that no one enterprise uses its market power to drive out competitors and monopolize markets. In 2009, for example, the commission fined Intel a record €1.06 billion for abusing its market power in the computer chip market. (See the accompanying Management Focus for details.) The previous record for a similar abuse was €497 million imposed on Microsoft in 2004 for blocking competition in markets for server computers and media software. The commissioner also reviews proposed mergers and acquisitions to make sure they do not create a dominant enterprise with substantial market power.[9] For example, in 2000 a proposed merger between Time Warner of the United States and EMI of the United Kingdom, both music recording companies, was withdrawn after the commission expressed concerns that the merger would reduce the number of major record companies from five to four and create a dominant player in the $40 billion global music industry.

The **European Council** represents the interests of member states. It is clearly the ultimate controlling authority within the EU because draft legislation from the commission can become EU law only if the council agrees. The council is composed of one representative from the government of each member state. The membership, however, varies depending on the topic being discussed. When agricultural issues are being discussed, the agriculture ministers from each state attend council meetings; when transportation is being discussed, transportation ministers attend; and so on. Before 1987, all council issues had to be decided by unanimous agreement among member states. This often led to marathon council sessions and a failure to make progress or reach agreement on commission proposals. In an attempt to clear the resulting logjams, the Single European Act formalized the use of majority voting rules on issues "which have as their object the establishment and functioning of a single market." Most other issues, however, such as tax regulations and immigration policy, still require unanimity among council members if they are to become law. The votes that a country gets in the council are related to the size of the country. For example, Germany, a large country, has 29 votes, whereas Denmark, a much smaller state, has seven votes.

European Council
The heads of state of EU members and the president of the European Commission.

As of 2016, the **European Parliament** has 751 members and is directly elected by the populations of the member states. The parliament, which meets in Strasbourg, France, is primarily a consultative rather than legislative body. It debates legislation proposed by the commission and

European Parliament
Elected EU body that provides consultation on issues proposed by the European Commission.

forwarded to it by the council. It can propose amendments to that legislation, which the commission and ultimately the council are not obliged to take up but often will. The power of the parliament recently has been increasing, although not by as much as parliamentarians would like. The European Parliament now has the right to vote on the appointment of commissioners as well as veto some laws (such as the EU budget and single-market legislation).

One major debate waged in Europe during the past few years is whether the council or the parliament should ultimately be the most powerful body in the EU. Some in Europe expressed concern over the democratic accountability of the EU bureaucracy. One side argued that the answer to this apparent democratic deficit lay in increasing the power of the parliament, while others think that true democratic legitimacy lies with elected governments, acting through the Council of the European Union.[10] After significant debate, in December 2007, the member states signed a new treaty, the **Treaty of Lisbon**, under which the power of the European Parliament was increased. When it took effect in December 2009, for the first time in history the European Parliament was the co-equal legislator for almost all European laws.[11] The Treaty of Lisbon also created a new position, a president of the European Council, who serves a 30-month term and represents the nation-states that make up the EU.

Treaty of Lisbon
A European Union–sanctioned treaty that will allow the European Parliament to become the co-equal legislator for almost all European laws.

The **Court of Justice**, which is composed of one judge from each country, is the supreme appeals court for EU law. Like commissioners, the judges are required to act as independent officials, rather than as representatives of national interests. The commission or a member country can bring other members to the court for failing to meet treaty obligations. Similarly, member countries, member companies, or member institutions can bring the commission or council to the court for failure to act according to an EU treaty.

Court of Justice
Supreme appeals court for EU law.

THE SINGLE EUROPEAN ACT

The Single European Act was born of a frustration among members that the community was not living up to its promise. By the early 1980s, it was clear that the EC had fallen short of its objectives to remove barriers to the free flow of trade and investment among member countries and to harmonize the wide range of technical and legal standards for doing business. Against this background, many of the EC's prominent businesspeople mounted an energetic campaign in the early 1980s to end the EC's economic divisions. The EC responded by creating the Delors Commission. Under the chairperson Jacques Delors, the commission proposed that all impediments to the formation of a single market be eliminated by December 31, 1992. The result was the Single European Act, which became EC law in 1987.

The Objectives of the Act

The purpose of the Single European Act was to have one market in place by December 31, 1992. The act proposed the following changes:[12]

- Remove all frontier controls among EC countries, thereby abolishing delays and reducing the resources required for complying with trade bureaucracy.
- Apply the principle of "mutual recognition" to product standards. A standard developed in one EC country should be accepted in another, provided it met basic requirements in such matters as health and safety.
- Institute open public procurement to nonnational suppliers, reducing costs directly by allowing lower-cost suppliers into national economies and indirectly by forcing national suppliers to compete.
- Lift barriers to competition in the retail banking and insurance businesses, which should drive down the costs of financial services, including borrowing, throughout the EC.
- Remove all restrictions on foreign exchange transactions between member countries by the end of 1992.
- Abolish restrictions on cabotage—the right of foreign truckers to pick up and deliver goods within another member state's borders—by the end of 1992. Estimates suggested this would reduce the cost of haulage within the EC by 10 to 15 percent.

All those changes were expected to lower the costs of doing business in the EC, but the single-market program was also expected to have more complicated supply-side effects. For example, the expanded market was predicted to give EC firms greater opportunities to exploit economies of scale. In addition, it was thought that the increase in competitive intensity brought about by

removing internal barriers to trade and investment would force EC firms to become more efficient. To signify the importance of the Single European Act, the European Community also decided to change its name to the European Union once the act took effect.

Impact The Single European Act has had an impact on the EU economy.[13] The act provided the impetus for the restructuring of substantial sections of European industry. Many firms have shifted from national to pan-European production and distribution systems in an attempt to realize scale economies and better compete in a single market. The results have included faster economic growth than would otherwise have been the case. According to empirical research, the single market raised GDP by between 2 and 5 percent in its first 15 years (different empirical studies generated different results, although all pointed to a positive impact).[14] However, 25 years after the formation of a single market, there is little doubt that the reality still falls short of the ideal. Although the EU is undoubtedly moving toward a single marketplace, long-established legal, cultural, and language differences among nations mean that implementation has been uneven.

Is Greece a Good Member of the European Union?

In April 2014, Greece held its first bond sale since 2010, raising about $4.2 billion as investors flocked to secure bonds from the hard-hit country. Greece stopped issuing bonds in 2010 amid the country's economic crisis. The 2014 bond sale was hailed as a sign that Greece is recovering and heading in the right direction. As most observers agree, Greece has struggled to deal with its financial crisis, and has, among many measures, taken on more than $330 billion worth of bailouts and implemented various austerity measures to fix the country's finances. The government's bond sale is a return to international markets for Greece and a step toward the country reducing its dependence on foreign aid—a crucial step to regain confidence from investors and other countries. The bond sale's success is a reason for optimism in Greece and throughout Europe, especially the European Union countries, as it not only shows investors' renewed confidence in the Greek economy, but perhaps also in the euro zone's recovery in general. Do you think that the European Union is only as strong as its weakest link or as strong as its strongest country?

Source: T. Ford, "globalEDGE Blog: High Demand for Greece's Return to Bond Market," April 11, 2014, http://globalEDGE.msu.edu.

THE ESTABLISHMENT OF THE EURO

In February 1992, EC members signed the **Maastricht Treaty**, which committed them to adopting a common currency by January 1, 1999.[15] The euro is now used by 19 of the 28 member states of the European Union; these 19 states are members of what is often referred to as the *euro zone*. It encompasses 330 million EU citizens and includes the powerful economies of Germany and France. Many of the countries that joined the EU on May 1, 2004, and the two that joined in 2007 originally planned to adopt the euro when they fulfilled certain economic criteria—a high degree of price stability, a sound fiscal situation, stable exchange rates, and converged long-term interest rates (the current members had to meet the same criteria). However, the events surrounding the EU sovereign debt crisis of 2010–2012 persuaded many of these countries to put their plans on hold, at least for the time being (further details provided later).

Maastricht Treaty
Treaty agreed to in 1992, but not ratified until January 1, 1994, that committed the 12 member states of the European Community to a closer economic and political union.

Establishment of the euro was a remarkable political feat with few historical precedents. It required participating national governments to give up their own currencies and national control over monetary policy. Governments do not routinely sacrifice national sovereignty for the greater good, indicating the importance that the Europeans attach to the euro. By adopting the euro, the EU has created the second most widely traded currency in the world after the U.S. dollar. Some believe that the euro could come to rival the dollar as the most important currency in the world.

Three long-term EU members—Great Britain, Denmark, and Sweden—decided to sit on the sidelines. The countries agreeing to the euro locked their exchange rates against each other January 1, 1999. Euro notes and coins were not actually issued until January 1, 2002. In the interim, national currencies circulated in each participating state. However, in each country, the national currency stood for a defined amount of euros. After January 1, 2002, euro notes and coins were issued and the national currencies were taken out of circulation. By mid-2002, all prices and routine economic transactions within the euro zone were in euros.

Benefits of the Euro Europeans decided to establish a single currency in the EU for a number of reasons. First, they believe that businesses and individuals realize significant savings from having to handle one currency, rather than many. These savings come from lower foreign exchange and hedging costs. For example, people going from Germany to France no longer have to pay a commission to a bank to change German deutsche marks into French francs. Instead, they are able to use euros. According to the European Commission, such savings amount to 0.5 percent of the European Union's GDP.

Second, and perhaps more important, the adoption of a common currency makes it easier to compare prices across Europe. This has been increasing competition because it has become easier for consumers to shop around. For example, if a German finds that cars sell for less in France than Germany, he may be tempted to purchase from a French car dealer rather than his local car dealer. Alternatively, traders may engage in arbitrage to exploit such price differentials, buying cars in France and reselling them in Germany. The only way that German car dealers will be able to hold onto business in the face of such competitive pressures will be to reduce the prices they charge for cars. As a consequence of such pressures, the introduction of a common currency has led to lower prices, which translates into substantial gains for European consumers.

Third, faced with lower prices, European producers have been forced to look for ways to reduce their production costs to maintain their profit margins. The introduction of a common currency, by increasing competition, has produced long-run gains in the economic efficiency of European companies.

Fourth, the introduction of a common currency has given a boost to the development of a highly liquid pan-European capital market. Over time, the development of such a capital market should lower the cost of capital and lead to an increase in both the level of investment and the efficiency with which investment funds are allocated. This could be especially helpful to smaller companies that have historically had difficulty borrowing money from domestic banks. For example, the capital market of Portugal is very small and illiquid, which makes it extremely difficult for bright Portuguese entrepreneurs with a good idea to borrow money at a reasonable price. However, in theory, such companies can now tap a much more liquid pan-European capital market.

Finally, the development of a pan-European, euro-denominated capital market will increase the range of investment options open to both individuals and institutions. For example, it will now be much easier for individuals and institutions based in, let's say, Holland to invest in Italian or French companies. This will enable European investors to better diversify their risk, which again lowers the cost of capital, and should also increase the efficiency with which capital resources are allocated.[16]

Costs of the Euro

The drawback, for some, of a single currency is that national authorities have lost control over monetary policy. Thus, it is crucial to ensure that the EU's monetary policy is well managed. The Maastricht Treaty called for establishment of the independent European Central Bank (ECB), similar in some respects to the U.S. Federal Reserve, with a clear mandate to manage monetary policy so as to ensure price stability. The ECB, based in Frankfurt, is meant to be independent from political pressure—although critics question this. Among other things, the ECB sets interest rates and determines monetary policy across the euro zone.

The implied loss of national sovereignty to the ECB underlies the decision by Great Britain, Denmark, and Sweden to stay out of the euro zone. Many in these countries are suspicious of the ECB's ability to remain free from political pressure and to keep inflation under tight control.

In theory, the design of the ECB should ensure that it remains free of political pressure. The ECB is modeled on the German Bundesbank, which historically has been the most independent and successful central bank in Europe. The Maastricht Treaty prohibits the ECB from taking orders from politicians. The executive board of the bank, which consists of a president, vice president, and four other members, carries out policy by issuing instructions to national central banks. The policy itself is determined by the governing council, which consists of the executive board plus the central bank governors from the euro zone countries. The governing council votes on interest rate changes. Members of the executive board are appointed for eight-year nonrenewable terms, insulating them from political pressures to get reappointed. So far, the ECB has established a solid reputation for political independence.

Can the Euro Survive?

It seems like experts and interested observers are always debating the merits of the euro and its likelihood of survival. The answers lie in examining several interesting facts of the European Union. First, the lack of a European treasury is a missing piece of the puzzle. Without it, the ECB is limited in the assistance it can provide to euro zone member-states. In theory, the European Central Bank (ECB) could bail out those member-states burdened with excessive debt by printing more money. However, that would require the approval of all of the EU member countries (not just the countries that use the euro as their national currency). Germany is typically opposed to any measure that may light the fires of inflation. Some of the EU members also think it is unfair to bail out those states that have lived beyond their means for many years. It is difficult to compare the difficulties within the EU to those of other nations that have faced similar problems and survived. But the basic question remains, will the euro survive?

Source: http://seekingalpha.com.

According to critics, another drawback of the euro is that the EU is not what economists would call an optimal currency area. In an **optimal currency area**, similarities in the underlying structure of economic activity make it feasible to adopt a single currency and use a single exchange rate as an instrument of macroeconomic policy. Many of the European economies in the euro zone, however, are very dissimilar. For example, Finland and Portugal have different wage rates, tax regimes, and business cycles, and they may react very differently to external economic shocks. A change in the euro exchange rate that helps Finland may hurt Portugal. Obviously, such differences complicate macroeconomic policy. For example, when euro economies are not growing in unison, a common monetary policy may mean that interest rates are too high for depressed regions and too low for booming regions.

optimal currency area
Region in which similarities in economic activity make a single currency and exchange rate feasible instruments of macroeconomic policy.

One way of dealing with such divergent effects within the euro zone is for the EU to engage in fiscal transfers, taking money from prosperous regions and pumping it into depressed regions. Such a move, however, opens a political can of worms. Would the citizens of Germany forgo their "fair share" of EU funds to create jobs for underemployed Greece workers? Not surprisingly, there is strong political opposition to such practices.

The Euro Experience

Since its establishment January 1, 1999, the euro has had a volatile trading history against the world's major currency, the U.S. dollar. After starting life in 1999 at €1 = $1.17, the euro stood at a robust all-time high of €1 = $1.54 in early March 2008. One reason for the rise in the value of the euro was that the flow of capital into the United States stalled as the U.S. financial markets fell during 2007 and 2008. Many investors took money out of the United States, selling dollar-denominated assets such as U.S. stocks and bonds, and purchasing euro-denominated assets. Falling demand for U.S. dollars and rising demand for euros translated into a fall in the value of the dollar against the euro. Furthermore, in a vote of confidence in both the euro and the ability of the ECB to manage monetary policy within the euro zone, many foreign central banks added more euros to their supply of foreign currencies. In the first three years of its life, the euro never reached the 13 percent of global reserves made up by the deutsche mark and other former euro zone currencies. The euro didn't jump that hurdle until early 2002 and hit 28 percent in 2009. By the end of 2017, the euro accounted for about 20 percent of global foreign exchange reserves.[17]

Euro sign sculpture.
©Bloomberg/Getty Images

Since 2008 however, the euro has weakened against a basket of currencies, reflecting persistent concerns over slow economic growth and large budget deficits among several EU member states, particularly Greece, Portugal, Ireland, Italy, and Spain. During the 2000s, all these governments had sharply increased their government debt to finance public spending. Government debt as a percentage of GDP hit record levels in many of these nations. By 2010, private investors became increasingly concerned that these nations would not be able to service their sovereign debt, particularly given the economic slowdown following the 2008–2009 global financial crisis. They sold off government bonds of troubled nations, driving down bond prices and driving up the cost of government borrowing (bond prices and interest rates are inversely related). This led to fears that several national governments, particularly Greece, might default on their sovereign debt, plunging the euro zone into an economic crisis.

To try to stave off such a sovereign debt crisis, in May 2010, the euro zone nations and the International Monetary Fund (IMF) agreed to a €110 billion bailout package to help rescue Greece. In November 2010, the EU and IMF agreed to a bailout package for Ireland of €85 billion; in May 2011, euro zone countries and the IMF instituted a €78 billion bailout plan for Portugal. In return for these loans, all three countries had to agree to sharp reductions in government spending, which meant slower economic growth and high unemployment until government debt was reduced to more sustainable levels. While Italy and Spain did not request bailout packages, both countries were forced by falling bond prices to institute austerity programs that required big reductions in government spending. The euro zone nations also set up a permanent bailout fund—the European Stability Mechanism—worth about €500 billion, which was designed to restore confidence in the euro. As detailed in the accompanying Country Focus, by 2012 Greece had been granted two more bailout packages in an attempt to forestall a full-blown default on payment of its sovereign debt. As might be expected, economic turmoil within the EU led to a decline in the value of the euro. By early 2018, the dollar-euro exchange rate stood at €1 = $1.23, below its 2008 value. The euro also declined by 20 to 30 percent against most of the world's other major currencies between late 2008 and early 2017, but has staged a partial recovery since then largely on stronger economic growth in the EU.

Potentially troubling for the long-run success of the euro, many of the newer EU nations that had committed to adopting the euro put their plans on hold. Countries like Poland and the Czech Republic had no desire to join the euro zone and then have their taxpayers help bail out the profligate governments of countries like Italy and Greece. To compound matters, the sovereign debt crisis had exposed a deep flaw in the euro zone: It was difficult for fiscally more conservative nations like Germany to limit profligate spending by the governments of other nations that might subsequently create strains and impose costs on the entire euro zone. The Germans in particular found themselves in the unhappy position of having to underwrite loans to bail out the governments of Greece, Portugal, and Ireland. This started to erode support for the euro in the stronger EU states. To try to correct this flaw, 25 of the then 27 countries in the EU signed a fiscal pact in January 2012 that made it more difficult for member states to break tight new rules on government deficits (the United Kingdom and Czech Republic abstained; Croatia joined in 2013).

ENLARGEMENT OF THE EUROPEAN UNION

Enlargement of the EU into eastern Europe has been discussed since the collapse of communism at the end of the 1980s. By the end of the 1990s, 13 countries had applied to become EU members. To qualify for EU membership, the applicants had to privatize state assets, deregulate markets, restructure industries, and tame inflation. They also had to enshrine complex EU laws into their own systems, establish stable democratic governments, and respect human rights.[18] In December 2002, the EU formally agreed to accept the applications of 10 countries, and they joined May 1, 2004. The new members included the Baltic countries, the Czech Republic, and the larger nations of Hungary and Poland. The only new members not in eastern Europe were the Mediterranean island nations of Malta and Cyprus. Their inclusion in the EU expanded the union to 25 states, stretching from the Atlantic to the borders of Russia; added 23 percent to the landmass of the EU; brought 75 million new citizens into the EU, building an EU with a population of 450 million people; and created a single continental economy with a GDP of close to €11 trillion. In 2007, Bulgaria and Romania joined, and in 2013, Croatia joined, bringing total membership to 28 nations.

country FOCUS

The Greek Sovereign Debt Crisis

When the euro was established, some critics worried that free-spending countries in the euro zone (such as Italy and Greece) might borrow excessively, running up large public-sector deficits that they could not finance. This would then rock the value of the euro, requiring their more sober brethren, such as Germany or France, to step in and bail out the profligate nation. In 2010, this worry became a reality as a financial crisis in Greece hit the value of the euro.

The financial crisis had its roots in a decade of free spending by the Greek government, which ran up a high level of debt to finance extensive spending in the public sector. Much of the spending increase could be characterized as an attempt by the government to buy off powerful interest groups in Greek society, from teachers and farmers to public-sector employees, rewarding them with high pay and extensive benefits. To make matters worse, the government misled the international community about the level of its indebtedness. In October 2009, a new government took power and quickly announced that the 2009 public-sector deficit, which had been projected to be around 5 percent, would actually be 12.7 percent. The previous government had apparently been cooking the books.

This shattered any faith that international investors might have had in the Greek economy. Interest rates on Greek government debt quickly surged to 7.1 percent, about 4 percentage points higher than the rate on German bonds. Two of the three international rating agencies also cut their ratings on Greek bonds and warned that further downgrades were likely. The main concern now was that the Greek government might not be able to refinance some €20 billion of debt that would mature in April or May 2010. A further concern was that the Greek government might lack the political willpower to make the large cuts in public spending necessary to bring down the deficit and restore investor confidence.

Nor was Greece alone in having large public-sector deficits. Three other euro zone countries—Spain, Portugal, and Ireland—also had large debt loads, and interest rates on their bonds surged as investors sold out. This raised the specter of financial contagion, with large-scale defaults among the weaker members of the euro zone. If this did occur, the EU and IMF would most certainly have to step in and rescue the troubled nations. With this possibility, once considered very remote, investors started to move money out of euros, and the value of the euro started to fall on the foreign exchange market.

Recognizing that the unthinkable might happen—and that without external help, Greece might default on its government debt, pushing the EU and the euro into a major crisis—in May 2010, the euro zone countries, led by Germany, along with the IMF agreed to lend Greece up to €110 billion. These loans were judged sufficient to cover Greece's financing needs for three years. In exchange, the Greek government agreed to implement a series of strict austerity measures. These included tax increases, major cuts in public-sector pay, reductions in benefits enjoyed by public-sector employees (e.g., the retirement age was increased to 65 from 61, and limits were placed on pensions), and reductions in the number of public-sector enterprises from 6,000 to 2,000. However, the Greek economy contracted so fast in 2010 and 2011 that tax revenues plunged. By the end of 2011, the Greek economy was almost 29 percent smaller than it had been in 2005, while unemployment approached 20 percent. The contracting tax base limited the ability of the government to pay down debt. By early 2012, yields on 10-year Greek government debt reached 34 percent, indicating that many investors now expected Greece to default on its sovereign debt. This forced the Greek government to seek further aid from the euro zone countries and the IMF. As a condition for a fresh €130 billion bailout plan, the Greek government had to get holders of Greek government bonds to agree to the biggest sovereign debt restructuring in history, In effect, bondholders agreed to write off 53.5 percent of the debt they held.

While the Greek government did not technically default on its sovereign debt, to many it seemed as if the EU and IMF had orchestrated an orderly partial default. By early 2014, it looked as if the Greek economy had finally turned a corner and was on the way to recovery. Yields on 10-year bonds had fallen below 8 percent, and the government was running a budget surplus before interest payments.

Unfortunately, things took a turn for the worse in 2014, when it became clear that despite economic progress, Greece did not have the funds to repay its creditors on time and would have to issue new bonds in order to do so. Following a decision to call a snap election, in January 2015, a radical left-wing "anti-bailout" party was swept into power. The financial minister of the new government suggested that Greece should default on its scheduled debt repayments to its largest creditor, Germany. This initiated a crisis in the euro zone and helped precipitate a sharp decline in the value of the euro against the U.S. dollar. Following further negotiations, Greece's creditors agreed to a third bailout in late 2015—but only after Greece agreed to implement further austerity measures and economic reforms. Whether this will prove to be any more successful than the prior two bailouts remains to be seen.

Sources: "A Very European Crisis," *The Economist*, February 6, 2010, pp. 75–77; L. Thomas, "Is Debt Trashing the Euro?" *The New York Times*, February 7, 2010, pp. 1, 7; "Bite the Bullet," *The Economist*, January 15, 2011, pp. 77–79; "The Wait Is Over," *The Economist*, March 17, 2012, pp. 83–84; "Aegean Stables," *The Economist*, January 11, 2014; Liz Alderman, "Greece's Debt Crisis Explained," *The New York Times*, November 8, 2015.

The new members were not able to adopt the euro for several years, and free movement of labor among the new and existing members was prohibited until then. Consistent with theories of free trade, the enlargement should create added benefits for all members. However, given the small size of the eastern European economies (together they amount to only 5 percent of the GDP of current EU members), the initial impact will probably be small. The biggest notable change might be in the EU bureaucracy and decision-making processes, where budget negotiations among 28 nations are bound to prove more problematic than negotiations among 15 nations.

Left standing at the door is Turkey. Turkey, which has long lobbied to join the union, presents the EU with some difficult issues. The country has had a customs union with the EU since 1995, and about half its international trade is already with the EU. However, full membership has been denied because of concerns over human rights issues (particularly Turkish policies toward its Kurdish minority). In addition, some on the Turkish side suspect the EU is not eager to let a primarily Muslim nation of 74 million people, which has one foot in Asia, join the EU. The EU formally indicated in December 2002 that it would allow the Turkish application to proceed with no further delay in December 2004 if the country improved its human rights record to the satisfaction of the EU. In December 2004, the EU agreed to allow Turkey to start accession talks in October 2005, but in late 2016, the European Parliament voted to suspend negotiations following Turkish government purges of opposition groups and a belief that Turkey was tilting towards authoritarianism.

Welcome sign to Croatia when the country joined the European Union.
©FREDERICK FLORIN/AFP/Getty Images

BRITISH EXIT FROM THE EUROPEAN UNION (BREXIT)

On June 23, 2016, and by a narrow margin, the British electorate voted in a national referendum to leave the EU. In early 2017, the British government formally notified the EU of its intention to exit the EU. Under the Treaty of Lisbon, it had two years to negotiate the terms of exit with the EU, which was scheduled to occur on March 29, 2019. While the British have enjoyed the benefits of free trade within Europe, a segment of the population has never been comfortable with the loss of national sovereignty implied by membership within the EU. The British have often railed against regulations imposed by the EU bureaucracy in Brussels, and more recently, immigration has become a key issue. Immigration from within the EU hit record levels in 2015. Much of that immigration has been from eastern Europe. Many of the immigrants have been low skilled and work in restaurants, hotels, and retail stores. The campaign for leaving the EU claimed that exit would allow the British to "take back control" of immigration. In the referendum, London, Scotland, and Northern Ireland voted to stay in the EU, whereas most of the rest of the country voted for exit. The vote was also split by age and education. The younger and more educated voted to stay in the EU, while the older and less educated voted to leave.

The impending exit of Britain creates an existential problem for the EU. Britain is the EU's second largest national economy. It is seen by many smaller member countries as an important counterweight to the economic power of Germany. In the aftermath of the British vote, right-wing politicians in Holland, Denmark, and France also called for referendums on continuing EU membership, raising fears that the British vote might trigger a "rush for the exits." While this seems unlikely to occur, there is little doubt that an EU without Britain will lose some of its economic and political clout on the world stage, and the EU itself will be diminished. Given the importance of immigration in the British vote, further expansion of the EU now seems unlikely, particularly with regard to Turkey.

As for Britain, most experts predict that the country will bear short- to medium-term costs as a result of this decision.[19] Britain is now less likely to attract inward investment from foreign multinationals, some multinationals may move operations to other EU countries to maintain access to the single market, exports to the EU may fall, London risks losing its position as the financial capital of Europe, and economic growth may be lower than it otherwise might have been. Furthermore, given that the Scots voted by a large margin to stay in the EU, this once again raises the possibility of Scottish independence from the United Kingdom. In the long run, whether Britain benefits from exit depends on its ability to negotiate trade deals with the EU and other major economic powers—including the United States, Japan, and China—to replace the benefits it will lose by exiting from the EU. In a world that is becoming increasingly resistant to free trade deals, there is no guarantee that the British will be able to do this. The British government would certainly like to extract favorable trade terms wth the EU as part of its exit negotiations, but the EU is likely to insist that in order to get full access to the single market, the British adopt EU regulations permitting the free movement of labor. This is something that the British are unlikely to accept given how important an issue immigration was in the referendum.

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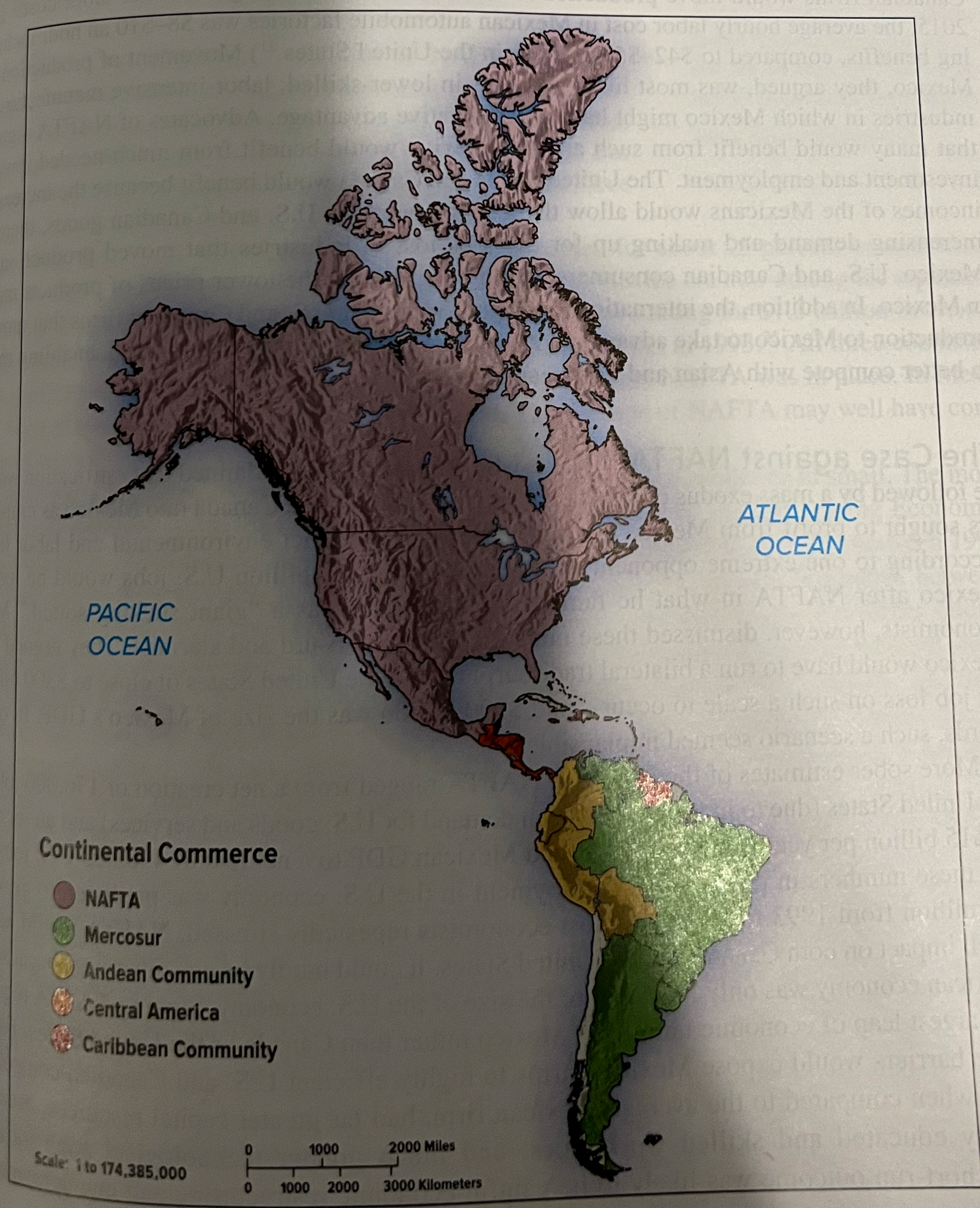
Regional Economic Integration in the Americas

No other attempt at regional economic integration comes close to the EU in its boldness or its potential implications for the world economy, but there have been significant attempts at regional economic integration in the Americas. The most notable is the North American Free Trade Agreement which at the time of writing is in the process of being superseded by the USMCA (see the Opening Case). In addition to NAFTA, several other trade blocs are in the offing in the Americas (see Map 9.2), the most significant of which appear to be the Andean Community and Mercosur.

THE NORTH AMERICAN FREE TRADE AGREEMENT

The governments of the United States and Canada in 1988 agreed to enter into a free trade agreement, which took effect January 1, 1989. The goal of the agreement was to eliminate all tariffs on bilateral trade between Canada and the United States by 1998. This was followed in 1991 by talks among the United States, Canada, and Mexico aimed at establishing a **North American Free Trade Agreement (NAFTA)** for the three countries. The talks concluded in August 1992 with an agreement in principle, and the following year, the agreement was ratified by the governments of all three countries. The agreement became law January 1, 1994.[20]

North American Free Trade Agreement (NAFTA)
Free trade area among Canada, Mexico, and the United States.



9.2 MAP
Economic integration in the Americas.

NAFTA'S Contents The contents of NAFTA include the following:

- Abolition by 2004 of tariffs on 99 percent of the goods traded among Mexico, Canada, and the United States.
- Removal of most barriers on the cross-border flow of services, allowing financial institutions, for example, unrestricted access to the Mexican market by 2000.
- Protection of intellectual property rights.
- Removal of most restrictions on foreign direct investment among the three member countries, although special treatment (protection) will be given to Mexican energy and railway industries, American airline and radio communications industries, and Canadian culture.
- Application of national environmental standards, provided such standards have a scientific basis. Lowering of standards to lure investment is described as being inappropriate.
- Establishment of two commissions with the power to impose fines and remove trade privileges when environmental standards or legislation involving health and safety, minimum wages, or child labor are ignored.

The Case for NAFTA Proponents of NAFTA have argued that the free trade area should be viewed as an opportunity to create an enlarged and more efficient productive base for the entire region. Advocates acknowledge that one effect of NAFTA would be that some U.S. and Canadian firms would move production to Mexico to take advantage of lower labor costs. (In 2015, the average hourly labor cost in Mexican automobile factories was $8–$10 an hour including benefits, compared to $42–$58 an hour in the United States.[21]) Movement of production to Mexico, they argued, was most likely to occur in lower-skilled, labor-intensive manufacturing industries in which Mexico might have a comparative advantage. Advocates of NAFTA argued that many would benefit from such a trend. Mexico would benefit from much-needed inward investment and employment. The United States and Canada would benefit because the increased incomes of the Mexicans would allow them to import more U.S. and Canadian goods, thereby increasing demand and making up for the jobs lost in industries that moved production to Mexico. U.S. and Canadian consumers would benefit from the lower prices of products made in Mexico. In addition, the international competitiveness of U.S. and Canadian firms that moved production to Mexico to take advantage of lower labor costs would be enhanced, enabling them to better compete with Asian and European rivals.

Did You Know?
Did you know that NAFTA was thought to produce a "giant sucking sound"?

Visit your instructor's Connect® course and click on your eBook or SmartBook® to view a short video explanation from the authors.

The Case against NAFTA Those who opposed NAFTA claimed that ratification would be followed by a mass exodus of jobs from the United States and Canada into Mexico as employers sought to profit from Mexico's lower wages and less strict environmental and labor laws. According to one extreme opponent, Ross Perot, up to 5.9 million U.S. jobs would be lost to Mexico after NAFTA in what he famously characterized as a "giant sucking sound." Most economists, however, dismissed these numbers as being absurd and alarmist. They argued that Mexico would have to run a bilateral trade surplus with the United States of close to $300 billion for job loss on such a scale to occur—and $300 billion was the size of Mexico's GDP. In other words, such a scenario seemed implausible.

More sober estimates of the impact of NAFTA ranged from a net creation of 170,000 jobs in the United States (due to increased Mexican demand for U.S. goods and services) and an increase of $15 billion per year to the joint U.S. and Mexican GDP to a net loss of 490,000 U.S. jobs. To put these numbers in perspective, employment in the U.S. economy was predicted to grow by 18 million from 1993 to 2003. As most economists repeatedly stressed, NAFTA would have a small impact on both Canada and the United States. It could hardly be any other way, because the Mexican economy was only 5 percent of the size of the U.S. economy. Signing NAFTA required the largest leap of economic faith from Mexico rather than Canada or the United States. Falling trade barriers would expose Mexican firms to highly efficient U.S. and Canadian competitors that, when compared to the average Mexican firm, had far greater capital resources, access to highly educated and skilled workforces, and much greater technological sophistication. The short-run outcome was likely to be painful economic restructuring and unemployment in

Mexico. But advocates of NAFTA claimed there would be long-run dynamic gains in the efficiency of Mexican firms as they adjusted to the rigors of a more competitive marketplace. To the extent that this occurred, they argued, Mexico's economic growth rate would accelerate, and Mexico might become a major market for Canadian and U.S. firms.[22]

Environmentalists also voiced concerns about NAFTA. They pointed to the sludge in the Rio Grande and the smog in the air over Mexico City and warned that Mexico could degrade clean air and toxic waste standards across the continent. They pointed out that the lower Rio Grande was the most polluted river in the United States and that, with NAFTA, chemical waste and sewage would increase along its course from El Paso, Texas, to the Gulf of Mexico.

There was also opposition in Mexico to NAFTA from those who feared a loss of national sovereignty. Mexican critics argued that their country would be dominated by U.S. firms that would not really contribute to Mexico's economic growth but instead would use Mexico as a low-cost assembly site while keeping their high-paying, high-skilled jobs north of the border.

As NAFTA Nurtures Mexican Economy, Illegal Immigration Dwindles?

The large wave of immigration from Mexico to the United States that began four decades ago, most of it unauthorized, has to a large degree ended. As a report from the Pew Hispanic Center confirms, net migration from Mexico to the United States sank to about zero in the past five years. Did the North American Free Trade Agreement (NAFTA) play a role? Yes and no. Actually, the number of Mexicans living illegally in the United States shot up from 2.5 million in 1995, the year after NAFTA took effect, to 11 million in 2013. The main reason was the booming U.S. economy, which generated huge demands for labor just as the share of Mexico's population aged 15 to 39, prime migration years, was peaking at about 75 percent. Migration plummeted after 2005 because of reduced U.S. demand for labor and the slowing of Mexican population growth but also because NAFTA started to pay off in the form of dynamic new export industries in Mexico, such as automobile manufacturing. Do you think there will be continued decline in immigration of people from Mexico to the United States in future years because of the NAFTA agreement, or will the immigration decline (or potential increase) be due to factors that are not tied to NAFTA?

Source: www.lehighvalleylive.com.

NAFTA: The Results Studies of NAFTA's impact suggest its initial effects muted, and both advocates and detractors may have been guilty of exaggeration.[23] On average, studies indicate that NAFTA's overall impact has been small but positive.[24] NAFTA was meant to increase trade among the three member states, and it appears to have done so.

In 1990, U.S. trade with Canada and Mexico accounted for about 25 percent of total U.S. trade. By 2017, the figure was over 40 percent. Canada and Mexico are now among the top three trading partners of the United States (the other is China), accounting for $1.3 trillion in cross-border trade in goods and services in 2017, up from $290 billion in 1993.[25] All three countries also experienced strong productivity growth in the first 10 years NAFTA was in place. In Mexico, labor productivity has increased by 50 percent. The passage of NAFTA may well have contributed to this.

Estimates suggest that employment effects of NAFTA have been moderate to small. The most pessimistic estimate of job losses comes from a study published by the left-leaning Economic Policy Institute. This study suggests that the United States lost about 850,000 jobs between 1993 and 2013 due to NAFTA, or 42,500 jobs a year on average. To put this loss in context, between 1992 and 2000, the U.S. economy created 2.86 million jobs *every year* on average. Other studies suggest that NAFTA had a far more moderate job impact in the United States. One recent study concluded that at most, 5 percent of U.S. job losses per year can be traced to NAFTA, and most of those who lose jobs find work elsewhere. Similarly, a review of empirical studies by the OECD concluded that "the net employment effects were relatively small, although there were adjustments across sectors displacing workers."[26]

A study of the welfare effects of NAFTA, which take into account its impact on national income, suggest that Mexico and the United States saw small welfare gains of 1.31 percent and 0.08 percent, respectively, while Canada suffered a welfare loss of 0.06 percent. The same study noted that real wages increased for all NAFTA members, with Mexico registering the largest gain. Similarly, a study by the Peterson Institute for International Economics concluded that the United States was $127 billion richer every year thanks to NAFTA. These studies support the general conclusion that contrary to political rhetoric, the impact of NAFTA has been quite small.[27]

NAFTA and the USMCA Despite data suggesting that NAFTA has had a small positive impact on U.S. national income and, at worse, a small negative impact on employment, the trade

deal continues to be the target of criticism. Politicians on both the right (Donald Trump) and the left (Bernie Sanders) have taken aim at NAFTA, claiming that the free trade area has been responsible for significant job losses in the United States. While the economic data does not offer support for these assertions, anecdotal evidence of job layoffs due to NAFTA can be found in some sectors, such as the automobile industry where Mexico has made major gains in recent years.

USMCA (United States-Mexico-Canada Agreement)
This is a regional trade agreement between the United States, Canada and Mexico that is designed to replace NAFTA. The agreement has been signed by the leaders of all three countries, but at the time of publication has not yet been ratified by the legislatures of these countries.

Despite the muted impact of NAFTA, following the accession of Donald Trump to the U.S. presidency, NAFTA has been renegotiated. Known as the **United States-Mexico-Canada Agreement**, or USMCA for short, this new agreement does make some changes to the 25-year-old NAFTA treaty. Most significantly, NAFTA required automakers to produce 62.5 percent of a vehicle's content in North America to qualify for zero tariffs. The USMCA raises that threshold to 75%. The idea is the compel automakers to source fewer parts for a car assembled in North America from Germany, Japan, South Korea or China.

The USMCA agreement also mandates that by 2023, 40% of parts for any tariff-free vehicle must come from a so-called "high wage" factory. Those factories must pay a minimum of $16 an hour in average salaries for production workers, which is about triple the average wage in a Mexican factory right now.

The Trump Administration clearly hopes these provisions will increase the production of automobiles and component parts in the United States. Critics see the USMCA as likely to result in trade diversion rather than trade creation, and argue that the consequences may include higher costs to North American automobile producers, and higher prices for consumers.

THE ANDEAN COMMUNITY

Andean Community
A 1969 agreement among Bolivia, Chile, Ecuador, Colombia, and Peru to establish a customs union.

Bolivia, Chile, Ecuador, Colombia, and Peru signed an agreement in 1969 to create the Andean Pact. The **Andean Community** was largely based on the EU model but was far less successful at achieving its stated goals. The integration steps begun in 1969 included an internal tariff reduction program, a common external tariff, a transportation policy, a common industrial policy, and special concessions for the smallest members, Bolivia and Ecuador.

By the mid-1980s, the Andean Pact had all but collapsed and had failed to achieve any of its stated objectives. There was no tariff-free trade among member countries, no common external tariff, and no harmonization of economic policies. Political and economic problems seem to have hindered cooperation among member countries. The countries of the Andean Pact have had to deal with low economic growth, hyperinflation, high unemployment, political unrest, and crushing debt burdens. In addition, the dominant political ideology in many of the Andean countries during this period tended toward the radical-socialist end of the political spectrum. Because such an ideology is hostile to the free market economic principles on which the Andean Pact was based, progress toward closer integration could not be expected.

The tide began to turn in the late 1980s when, after years of economic decline, the governments of Latin America began to adopt free market economic policies. In 1990, the heads of the five current members of the Andean Community—Bolivia, Ecuador, Peru, Colombia, and Venezuela—met in the Galápagos Islands. The resulting Galápagos Declaration effectively relaunched the Andean Pact, which was renamed the Andean Community in 1997. The declaration's objectives included the establishment of a free trade area by 1992, a customs union by 1994, and a common market by 1995. This last milestone has not been reached. A customs union was implemented in 1995—although Peru opted out and Bolivia received preferential treatment until 2003. The Andean Community now operates as a customs union. In December 2005, it signed an agreement with Mercosur to restart stalled negotiations on the creation of a free trade area between the two trading blocs. Those negotiations are proceeding at a slow pace. In late 2006, Venezuela withdrew from the Andean Community as part of that country's attempts to join Mercosur.

MERCOSUR

Mercosur
Pact among Argentina, Brazil, Paraguay, and Uruguay to establish a free trade area.

Mercosur originated in 1988 as a free trade pact between Brazil and Argentina. The modest reductions in tariffs and quotas accompanying this pact reportedly helped bring about an 80 percent increase in trade between the two countries in the late 1980s.[28] This

success encouraged the expansion of the pact in March 1990 to include Paraguay and Uruguay as full members. In 2012, the pact was further expanded when Venezuela joined Mercosur. However, in 2016 Venezuela was suspended from Mercosur for violating the pact's democratic principles and engaging in widespread human rights violations.

The initial aim of Mercosur was to establish a full free trade area by the end of 1994 and a common market sometime thereafter. In December 1995, Mercosur's members agreed to a five-year program under which they hoped to perfect their free trade area and move toward a full customs union—something that has yet to be achieved.[29] For its first eight years or so, Mercosur seemed to be making a positive contribution to the economic growth rates of its member states. Trade among the four core members quadrupled between 1990 and 1998. The combined GDP of the four member states grew at an annual average rate of 3.5 percent between 1990 and 1996, a performance that is significantly better than the four attained during the 1980s.[30]

However, Mercosur had its critics, including Alexander Yeats, a senior economist at the World Bank, who wrote a stinging critique.[31] According to Yeats, the trade diversion effects of Mercosur outweigh its trade creation effects. Yeats pointed out that the fastest-growing items in intra-Mercosur trade were cars, buses, agricultural equipment, and other capital-intensive goods that are produced relatively inefficiently in the four member countries. In other words, Mercosur countries, insulated from outside competition by tariffs that run as high as 70 percent of value on motor vehicles, are investing in factories that build products that are too expensive to sell to anyone but themselves. The result, according to Yeats, is that Mercosur countries might not be able to compete globally once the group's external trade barriers come down. In the meantime, capital is being drawn away from more efficient enterprises. In the near term, countries with more efficient manufacturing enterprises lose because Mercosur's external trade barriers keep them out of the market.

Mercosur hit a significant roadblock in 1998, when its member states slipped into recession and intrabloc trade slumped. Trade fell further in 1999, following a financial crisis in Brazil that led to the devaluation of the Brazilian real, which immediately made the goods of other Mercosur members 40 percent more expensive in Brazil, their largest export market. At this point, progress toward establishing a full customs union all but stopped. Things deteriorated further in 2001, when Argentina, beset by economic stresses, suggested the customs union be temporarily suspended. Argentina wanted to suspend Mercosur's tariff so that it could abolish duties on imports of capital equipment, while raising those on consumer goods to 35 percent (Mercosur had established a 14 percent import tariff on both sets of goods). Brazil agreed to this request, effectively halting Mercosur's quest to become a fully functioning customs union.[32] Hope for a revival arose in 2003, when new Brazilian President Lula da Silva announced his support for a revitalized and expanded Mercosur modeled after the EU with a larger membership, a common currency, and a democratically elected Mercosur parliament.[33] In 2010, the members of Mercosur did agree on a common customs code to avoid outside goods having to pay tariffs more than once, an important step toward achieving a full customs union. Since 2010, however, Mercosur has made little forward progress, and the jury is still out on whether it will become a fully functioning customs union.

CENTRAL AMERICAN COMMON MARKET, CAFTA, AND CARICOM

Two other trade pacts in the Americas have not made much progress. In the early 1960s, Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua attempted to set up a **Central American Common Market**. It collapsed in 1969, when war broke out between Honduras and El Salvador after a riot at a soccer match between teams from the two countries. Since then, the member countries have made some progress toward reviving their agreement (the five founding members were joined by the Dominican Republic). The proposed common market was given a boost in 2003, when the United States signaled its intention to enter into bilateral free trade negotiations with the group. These culminated in a 2004 agreement to establish a free trade agreement between the six countries and the United States. Known as the **Central America Free Trade Agreement (CAFTA)**, the aim is to lower trade barriers between the United States and the six countries for most goods and services.

Central American Common Market
A trade pact among Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua, which began in the early 1960s but collapsed in 1969 due to war.

Central America Free Trade Agreement (CAFTA)
The agreement of the member states of the Central American Common Market joined by the Dominican Republic to trade freely with the United States.

A customs union was to have been created in 1991 among the English-speaking Caribbean countries under the auspices of the Caribbean Community. Referred to as **CARICOM**, it was established in 1973. However, it repeatedly failed to progress toward economic integration. A formal commitment to economic and monetary union was adopted by CARICOM's member states in 1984, but since then, little progress has been made. In October 1991, the CARICOM governments failed, for the third consecutive time, to meet a deadline for establishing a common external tariff. Despite this, CARICOM expanded to 15 members by 2005. In early 2006, six CARICOM members established the **Caribbean Single Market and Economy (CSME)**. Modeled on the EU's single market, CSME's goal is to lower trade barriers and harmonize macroeconomic and monetary policy between member states.[34]

CARICOM
An association of English-speaking Caribbean states that are attempting to establish a customs union.

Caribbean Single Market and Economy (CSME)
The six CARICOM members that agreed to lower trade barriers and harmonize macroeconomic and monetary policies.

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Regional Economic Integration Elsewhere

Numerous attempts at regional economic integration have been tried throughout Asia, Africa, and elsewhere. One of the most significant is the Association of Southeast Asian Nations (ASEAN), although there have been numerous attempts to establish free trade agreements in Africa (see the closing case in this chapter), and there are ongoing efforts to establish free trade agreements between the United States and 11 other nations bordering the Pacific (the Trans Pacific Partnership, or TPP) and the United States and the European Union (the Transatlantic Trade and Investment Partnership, or TTIP).

ASSOCIATION OF SOUTHEAST ASIAN NATIONS

Formed in 1967, the **Association of Southeast Asian Nations (ASEAN)** includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam. Laos, Myanmar, Vietnam, and Cambodia have all joined recently, creating a regional grouping of 600 million people with a combined GDP of some $2 trillion (see Map 9.3). The basic objective of ASEAN is to foster freer trade among member countries and to achieve cooperation in their industrial policies. Progress so far has been limited, however.

Association of Southeast Asian Nations (ASEAN)
Formed in 1967, an attempt to establish a free trade area among Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Vietnam, and Thailand.

Until recently, only 5 percent of intra-ASEAN trade consisted of goods whose tariffs had been reduced through an ASEAN preferential trade arrangement. This may be changing. In 2003, an ASEAN Free Trade Area (AFTA) among the six original members of ASEAN came into full effect. The AFTA has cut tariffs on manufacturing and agricultural products to less than 5 percent. However, there are some significant exceptions to this tariff reduction. Malaysia, for example, refused to bring down tariffs on imported cars until 2005 and then agreed to lower the tariff only to 20 percent, not the 5 percent called for under the AFTA. Malaysia wanted to protect Proton, an inefficient local carmaker, from foreign competition. Similarly, the Philippines has refused to lower tariff rates on petrochemicals, and rice, the largest agricultural product in the region, will remain subject to higher tariff rates until at least 2020.[35]

Notwithstanding such issues, ASEAN and AFTA are at least progressing toward establishing a free trade zone. Vietnam joined the AFTA in 2006, Laos and Myanmar in 2008, and Cambodia in 2010. The goal was to reduce import tariffs among the six original members to zero by 2010 and to do so by 2015 for the newer members (although important exceptions to that goal, such as tariffs on rice, will persist).

ASEAN signed a free trade agreement with China that removes tariffs on 90 percent of traded goods. This went into effect January 1, 2010. Trade between China and ASEAN members more than tripled during the first decade of the twenty-first century, and this agreement should spur further growth.[36]

REGIONAL TRADE BLOCS IN AFRICA

African countries have been experimenting with regional trade blocs for half a century. Nominally there are now 19 trade blocs on the African continent. Many countries are members of more than one group. Although the number of trade groups is impressive, progress toward the establishment of meaningful trade blocs has been slow.

9.3 MAP

ASEAN countries.

Many of these groups have been dormant for years. Significant political turmoil in several African nations has persistently impeded any meaningful progress. Also, deep suspicion of free trade exists in several African countries. The argument most frequently heard is that because these countries have less developed and less diversified economies, they need to be "protected" by tariff barriers from unfair foreign competition. Given the prevalence of this argument, it has been hard to establish free trade areas or customs unions.

A meaningful attempt to reenergize the free trade movement in Africa occurred in early 2001, when Kenya, Uganda, and Tanzania, member states of the East African Community (EAC), committed themselves to relaunching their bloc, 24 years after it collapsed. The three countries, with 80 million inhabitants, intend to establish a customs union, regional court, legislative assembly, and, eventually, a political federation.

Their program includes cooperation on immigration, road and telecommunication networks, investment, and capital markets. However, while local business leaders welcomed the relaunch as a positive step, they were critical of the EAC's failure in practice to make progress on free trade. At the EAC treaty's signing in November 1999, members gave themselves four years to negotiate

a customs union, with a draft slated for the end of 2001. But that fell far short of earlier plans for an immediate free trade zone, shelved after Tanzania and Uganda, fearful of Kenyan competition, expressed concerns that the zone could create imbalances similar to those that contributed to the breakup of the first community.[37] Nevertheless, in 2005 the EAC did start to implement a customs union. In 2007, Burundi and Rwanda joined the EAC. The EAC established a common market in 2010 and is now striving toward an eventual goal of monetary union.

In 2015, in what is a promising sign, representatives from 26 African nations signed an agreement pledging to work together to establish a free trade area that would remove or reduce many tariffs and eliminate time-consuming customs procedures between them. Known as the Tripartite Free Trade Area (TFTA), this common market would encompass more than 630 million people and link together three existing regional trading blocks in Southern and Eastern Africa with a combined gross domestic product of $1.2 trillion and more than $102 billion in trade among member states (see this chapter's closing case for further details). This was followed up by an even more ambitious free trade pact, known as the Continental Free Trade Area (CAFTA), which 44 countries signed onto in March of 2018 (again, see this chapter's closing case for further details). Whether these pacts will be more meaningful than prior attempts to liberalize trade in Africa remains to be seen, but African leaders do seem to be actively embracing free trade like never before so there are reasons for optimism.

OTHER TRADE AGREEMENTS

As noted in Chapter 7, following the failure of the Doha Round of talks to extend the WTO, the United States and many other nations have placed renewed emphasis on bilateral and multilateral trade agreements. Under President Obama, the United States was pursuing two major multilateral trade agreements: the Trans Pacific Partnership (TPP) with 11 other Pacific Rim countries (including Australia, New Zealand, Japan, South Korea, Malaysia, and Chile) and the Transatlantic Trade and Investment Partnership (TTIP) with the European Union. However, President Trump pulled the United States out of the TPP and negotiations on the TTIP have been put on hold.

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Focus on Managerial Implications

LO 9-5

Understand the implications for management practice that are inherent in regional economic integration agreements.

REGIONAL ECONOMIC INTEGRATION THREATS

Currently, the most significant developments in regional economic integration are occurring in the EU and NAFTA. Although some of the Latin American trade blocs and ASEAN may have economic significance in the future, developments in the EU and NAFTA currently have more profound implications for business practice. Accordingly, in this section, we concentrate on the business implications of those two groups. Similar conclusions, however, could be drawn with regard to the creation of a single market anywhere in the world.

Opportunities

Regional economic integration has created significant opportunities for businesses to grow the market for their goods and services and lower their factor costs. Markets that were formerly protected from foreign competition have become more open, and the costs of doing business have fallen. The latter is particularly true in the case of the EU's single market and, to a lesser extent, NAFTA (and its successor the USMCA). In these zones, free movement of goods and services across borders, harmonized product standards, simplified tax regimes, and in the case of the euro zone a single currency, have made it increasingly possible for businesses to realize potentially significant cost economies by centralizing production of products, or component parts, in those EU and NAFTA/UMSCA locations where the mix of factor costs and skills is optimal. Rather than producing a product in each of the 28 EU countries (27 after the British exit) or the three NAFTA/USMCA countries, a firm may be able to serve the whole EU or North American market from a single location. This location must be chosen carefully, of course, with an eye on local factor costs and skills. Pursuit of such gain has led to the establishment of extensive cross border supply chains in both the EU and North America, which in turn implies that the economies of these regions have become more tightly integrated.

That being said, it is important to recognize that even after the removal of barriers to trade and investment, enduring differences in culture and competitive practices might limit the ability of companies to realize cost economies by centralizing production in key locations and producing a standardized product for a single multiple-country market. Consider the case of Atag Holdings NV, a Dutch maker of kitchen appliances.[38] Atag thought it was well placed to benefit from the single market but found it tough going. Atag's plant is just one mile from the German border and near the center of the EU's population. The company thought it could cater to both the "potato" and "spaghetti" belts—marketers' terms for consumers in northern and southern Europe—by producing two main product lines and selling these standardized "euro-products" to "euro-consumers." The main benefit of doing so is the economy of scale derived from mass production of a standardized range of products. Atag quickly discovered that the "euro-consumer" was a myth. Consumer preferences vary much more across nations than Atag had thought. Consider ceramic cooktops: Atag planned to market just two varieties throughout the EU but found it needed 11. Belgians, who cook in huge pots, require extra-large burners. Germans like oval pots and burners to fit. The French need small burners and very low temperatures for simmering sauces and broths. Germans like oven knobs on the top; the French want them on the front. Most Germans and French prefer black and white ranges; the British demand a range of colors, including peach, pigeon blue, and mint green.

Threats Just as the emergence of single markets creates opportunities for business, it also presents a number of threats. For one thing, the business environment within each grouping has become more competitive. The lowering of barriers to trade and investment among countries has led to increased price competition throughout the EU and NAFTA/USMCA.

Over time, price differentials across nations will decline in a single market. This is a direct threat to any firm doing business in EU or NAFTA/USMCA countries. To survive in the tougher single-market environment, firms must take advantage of the opportunities offered by the creation of a single market to rationalize their production and reduce their costs. Otherwise, they will be at a severe disadvantage.

A further threat to firms outside these trading blocs arises from the likely long-term improvement in the competitive position of many firms within the areas. This is particularly relevant in the EU, where many firms have historically been limited by a high-cost structure in their ability to compete globally with North American and Asian firms. The creation of a single market and the resulting increased competition in the EU produced serious attempts by many EU firms to reduce their cost structure by rationalizing production. This transformed many EU companies into more efficient global competitors. The message for non-EU businesses is that they need to respond to the emergence of more capable European competitors by reducing their own cost structures.

Another threat to firms outside of trading areas is the threat of being shut out of the single market by the creation of a "trade fortress." The charge that regional economic integration might lead to a fortress mentality is most often leveled at the EU. Although the free trade philosophy underpinning the EU theoretically argues against the creation of any fortress in Europe, occasional signs indicate the EU may raise barriers to imports and investment in certain "politically sensitive" areas, such as autos. Non-EU firms might be well advised, therefore, to set up their own EU operations. This could also occur in the NAFTA countries, but it seems less likely.

The emerging role of the European Commission in competition policy suggests the EU is increasingly willing and able to intervene and impose conditions on companies proposing mergers and acquisitions. This is a threat insofar as it limits the ability of firms to pursue the corporate strategy of their choice. The commission may require significant concessions from businesses as a precondition for allowing proposed mergers and acquisitions to proceed. While this constrains the strategic options for firms, it should be remembered that in taking such action, the commission is trying to maintain the level of competition in Europe's single market, which should benefit consumers.

Finally, there is a clear threat to business in the growing opposition to free trade areas. We have seen this in the United States, where President Trump pulled the U.S. out of the TPP and initiated a contentious renegotiation of NAFTA. We have also seen it in the European Union, where the scheduled exit of the British in March 2019 (Brexit) might result in the weakening of the EU. If the EU and NAFTA/UMSCA are diminished, some of the gains from trade will be lost, and many of the benefits that businesses enjoyed will disappear as well.