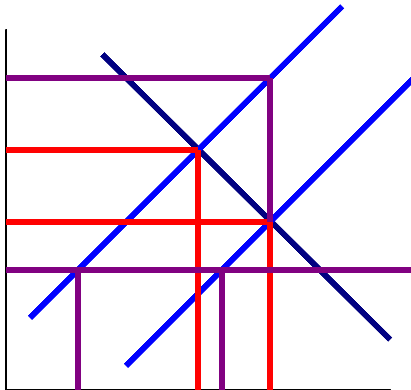
Economic Integration

1. Economic integration refers to the merging of national economies and the blurring of the boundaries that separate economic activity in one nation state from another.

   In addition, the use of boundaries by a nation state will reduce economic efficiency. Examples of boundaries include

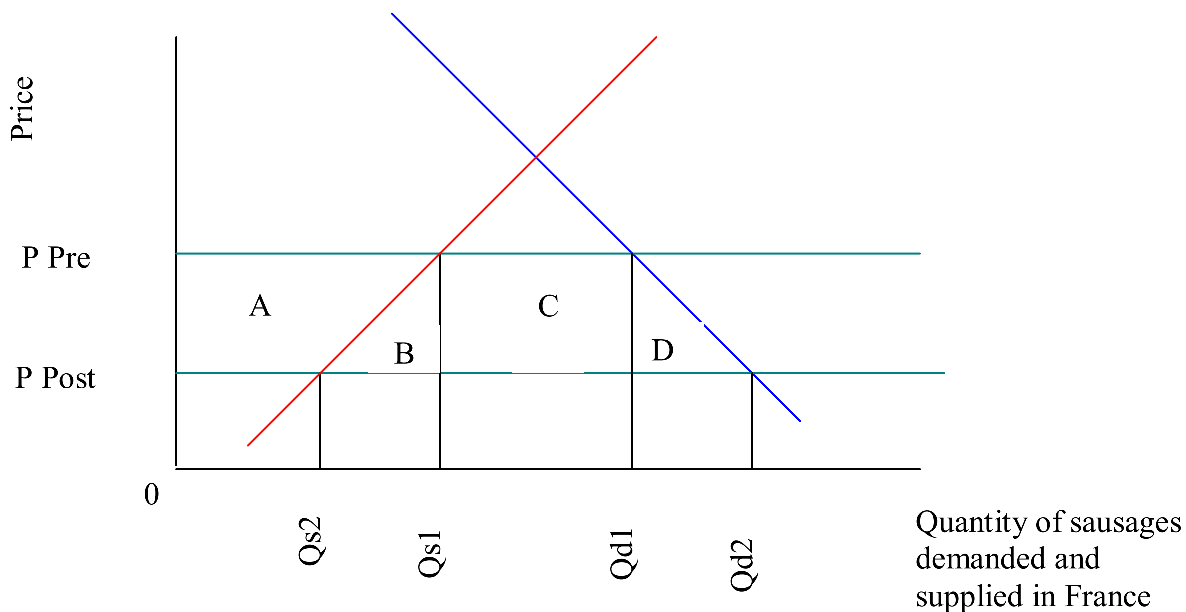
   - The use of tariffs, which will lead to an increase in the price of imports. The increase in prices will decrease consumer demand and will stimulate domestic supply.
   - Quotas have the same affect as tariffs, where it will limit imports and hence raise the price level.
   - Government subsidies will lead to a domestic price decrease.



The use of the subsidy will lower domestic prices from Pe to P1. Therefore, with domestic prices it will encourage domestic consumers to purchase their goods and services domestically and not on the European Market.

There are also five levels of economic integration; firstly, there is a Free Trade Area, this is the weakest form of economic integration and involves the removal of tariffs and quotas on trade between member states. Member states also have the right to determine their own trade policies on states outside the FTA.
Secondly, there is a customs union, where the problems of trade deflection are avoided, and goes beyond negative integration, during this stage, tariffs and quotas are again removed between member states as well as member states agreeing to a common external tariff on trade with non members.
The third stage of economic integration is a Common or Single Market, where the creation of conditions for a genuine single borderless market increases the degree of actual and potential competition. During this stage, there is a removal on the restrictions of free movement of labour and capital between member states. In addition, NTB's are removed by the harmonisation of product standards, employment laws taxation and competition policies. There is also the adoption of common policies in one or more areas.
The penultimate stage is an Economic Union, where there is an extension of the degree of integration found in the Single Market.
The characteristics in this stage are to increase the degree of harmonisation and coordination of economic policies and to have some degree of centralisation of economic policies, in particular macroeconomic polices.
The final stage of economic integration is a Monetary Union, where this is the strongest form of integration, where monetary policies are centralised. There is extended macroeconomic policy coordination to the monetary field, and the degree of monetary union can differ from a system of semi fixed exchange rates to the adoption of a single currency (The Euro).

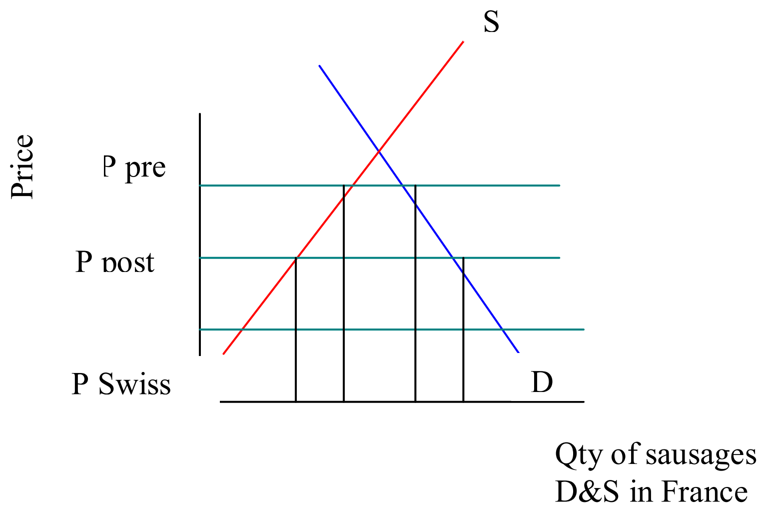
2. The effects of economic integration upon the economies of Europe may be analysed in two ways, through the static gains and the dynamic gains.
   The static gains of economic integration are mainly through trade creation and trade diversion.



Before there is trade creation, the import price, which had to be paid by French firms before the formation of the Franco-German group, was 0P Pre. This price has an import duty on it. French domestic supply is 0Qs1 and domestic demand is oQd1. French imports are therefore equal to 0Qd1 - 0Qs1.
With economic integration, trade barriers are removed, and hence the import duty is removed from the French import price. The fall in price from 0P Pre to 0P Post, shows that there will be an increase in French consumption to 0Qd2, and the domestic supply production falls to oQs2. Therefore, there has been an increase in the importation of sausages, and the difference between the original importation level and the new importation level is the trade creation resulting from economic integration.

By Shan Visram Europe Module

The decrease in price has led to an increase in the consumer surplus shown by area ABCD.



Trade diversion is where the effect of the establishment of a free trade area is to divert away from the consumption of efficiently produced goods because they happen to be produced in a country, which is located outside the free trade area.
If we take the example, and assume that after all Germany are not the most efficient, least cost effective sausage producers, and Switzerland are. Now before the establishment of the free trade area with Germany, France bought most of its sausages from Switzerland. The tariff on importing sausages from Germany or Switzerland, into France is the same.
Once the Franco-German sausage sector is formed, the import tax is removed from Germany, however the import tax from Switzerland remains because they are outside the free trade area.
There is a customs union between France and Germany, and the effect of tariff removal on German sausages is to increase the relative price on Swiss sausages
Before the customs union P pre is the cheapest import price available. French consumption is equal to 0Qd1, and domestic French production is 0Qs1 and imports (from switzerland) are given by oQd1 minus 0Qs1.
Once the trade relationship is established with Germany, the tariff on German sausages is removed and the import price falls to Ppost.

This therefore leads to an increase is consumer surplus, through access to cheaper imports. Consumer surplus is equal to area= a+b+c+d.

The dynamic gains to economic integration are there is going to be increased specialisation, as countries will use comparative advantage to gain the maximum advantage through trade with another country.
There will also be economies of scale, where firms' costs will decrease in the LR.

However, the costs of integration will be increases in world prices, and reductions in competitiveness. Therefore, there is going to be increased in the number of industries who are oligopolies and monopolies. Therefore, goods could reduce in quality, as there are no other substitutes and consumer will have to pay high prices for low quality goods.