



Economics of European Integration

Course 2022-23

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Baobab is the web of Jean Monnet Chair

- ▶ Where are allocated the course resources?:
 - ▶ <https://baobab.uc3m.es/monet/monnet/spip.php?rubrique24>
- ▶ Course slides are downloadable at
 - ▶ <https://baobab.uc3m.es/monet/monnet/spip.php?rubrique25>
 - ▶ Compulsory reading is downloadable in this link from the slides of each lesson.
 - ▶ Compulsory reading hard copy is available “clave 2” for the course 2020-21 from “reprgrafía” ground floor building 9.

Complementary readings

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- ▶ readings to help writing the course essay are also downloadable from this link:
 - ▶ Monetary and fiscal policy in the European Union readings:
<https://baobab.uc3m.es/monet/monnet/spip.php?rubrique108>
 - ▶ Brexit or BINO (Brexit In Name Only)?:
<https://baobab.uc3m.es/monet/monnet/spip.php?rubrique116>
 - ▶ CAP reform and the multiannual financial framework 2014-20 and 2020-26:
<https://baobab.uc3m.es/monet/monnet/spip.php?rubrique91>
 - ▶ Deepening the European Monetary Union. Banking Union:
<https://baobab.uc3m.es/monet/monnet/spip.php?rubrique121>
 - ▶ Environmental policy in the EU / Política Ambiental Europea:
<https://baobab.uc3m.es/monet/monnet/spip.php?rubrique74>
 - ▶ Euro-Area Debt Crisis: Debate readings:
<https://baobab.uc3m.es/monet/monnet/spip.php?rubrique55>
 - ▶ Food price stability and food security:
<https://baobab.uc3m.es/monet/monnet/spip.php?rubrique99>
 - ▶ Lisbon Strategy and the infrastructures and R & D + i policy:
<https://baobab.uc3m.es/monet/monnet/spip.php?rubrique94>
- ▶ More verbal information during the reduce classes will insist on this information. Also in the folder of Aula Global will find the last reading about hot topics.

Grading

- ▶ Grading rules are at
 - ▶ <https://baobab.uc3m.es/monet/monnet/spip.php?rubrique41>
- ▶ **Please before start writing your papers read the instructions carefully for written homework and research paper at**
 - ▶ <https://baobab.uc3m.es/monet/monnet/spip.php?article144>

What is Economics of Integration?

- ▶ **Countries** -> regional economic association.
 - ▶ Meaning trade liberalization for member countries
- ▶ **Market integration** -> and enhanced competition by trade liberalization
 - ▶ Market integration drives to
 - ▶  scale economies
- ▶ The origin of the EU were to reach **bigger markets** for the European companies allowing to **compete with the US companies**

Forms of economic integration:

- 1) **Free Trade Area** (FTA)
 - Free trade between the members
- 2) **Custom Union** (CU)
 - FTA + common external tariffs (CET) on trade with non-members
- 3) **Common Market** (CM)
 - CU + free mobility of factors of production
- 4) **Economic Union** (EU)
 - CM + common economic policy

One government

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SCHEME	Free intra-scheme trade	Common commercial policy	Free factor mobility	Common monetary and fiscal policy	One government
Free trade area	Yes	No	No	No	No
Customs union	Yes	Yes	No	No	No
Common market	Yes	Yes	Yes	No	No
Economic union	Yes	Yes	Yes	Yes	No
Complete economic & political integration	Yes	Yes	Yes	Yes	Yes

Objectives of the economic integration

- ▶ External economies (maximize the gains)
- ▶ External diseconomies (minimize the losses)



The members adopt either cooperative policies (internalize the externalities- advance economic integration) or non-cooperative policies (looser form of integration- FTA)

The process of economic integration

Integration increases

- ▶ **the interdependence** between the members increases
 - ▶ the need for **cooperation** is intensified.
- ▶ During the economic integration the member states voluntarily choose to restrict/ replace their national objectives and policies and undertake it in a **common level of union**.



Integration is a process during which the **sovereign** power of the member states is progressively **diminished**.

The objectives of economic integration

- ▶ Association between states aim at the realization of a **benefit**
- ▶ All economic associations always have **positive and negative** economic implications  trade liberalization and enhanced competition in an enlarged market.
- ▶ The objectives of the union can be reached efficiently **only** with the **sacrifice of national sovereignty** in order to achieve a collective goal.

Economic integration between developed countries

1. The essential requirements for an increasing economic integration are:

- ▶ Comparable levels of economic development;
- ▶ Similar but potentially complementary structures in production and demand;

There are static effects (immediate general benefits) and dynamic effects (accelerate development and raise welfare).

The economic integration will stimulate **research and development**, inducing **innovation** and **technical change**  **faster economic growth.**

Integration among developing countries

- ▶ The economic integration is not based on static benefits, it aims at the potential dynamic effects and the expectation that closer cooperation will foster regional markets.
- ▶ The objective of their integration is the acceleration of their development by:
 - ▶ enlarging the market
 - ▶ pooling resources essential for economic growth
 - ▶ Avoiding unnecessary and uneconomic duplication in capital investment
- ▶ Integration between developing countries contains also elements of self-destruction, for that reason the economic association rarely survive for a long time.
 - ▶ Example: East Africa Common Market (EACM), Central American Common Market (CACM).

Economic disintegration

Back to protectionism?

- ▶ Grexit -> A number of economist defended the option of exit the UE to solve the debt crisis of Greece.
 - ▶ Finally Greece government opted to remain
- ▶ The conservative prime minister approve a referendum to end with cyclical claims of the conservatives Eurosceptics
 - ▶ The Brexit option won, for a narrow margin and the UK sent out the EU in 2020
 - ▶ A number of issues remains.

Trade creation

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Definition of trade creation

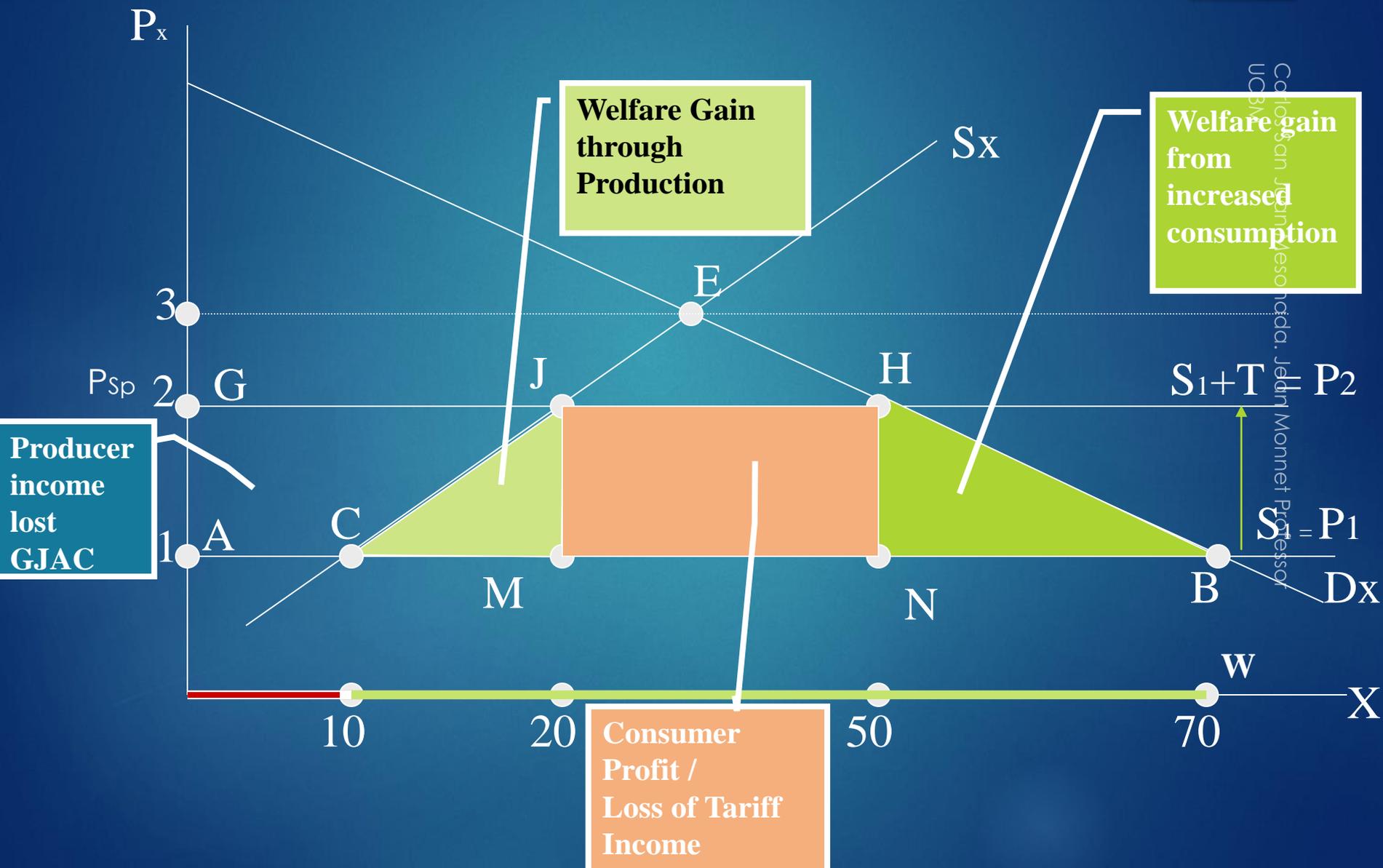
- ▶ Trade creation refers to the increase in economic welfare from joining a free trade area, such as a customs union.
- ▶ Trade creation will occur when there is a reduction in tariff barriers, leading to lower prices.

Effects of trade creation

- ▶ This switch to lower cost producers will lead to an increase in consumer surplus and economic welfare.
- ▶ But in our next graph we refers to the case in which a country joint a Customs Unions with a lower tariff than before integration.

TRADE CREATION after integration in a free trade area

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Trade diversion

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Trade diversion

- ▶ Trade diversion occurs when tariff agreements cause imports to shift from low-cost countries to higher-cost countries.
- ▶ Trade diversion is considered undesirable because it concentrates production in countries with a higher opportunity cost and lower comparative advantage.
- ▶ Trade diversion may occur when a country joins a free trade area with a common external tariff (or Common Market).

Example: Spain joint the EU

- ▶ Suppose that the international Price of Lamb is $S_1 = P_w$
- ▶ But with the Spanish tariff consumers pay $P_w + T_{sp}$
- ▶ Suppose Australia export lamb at the international Price P_w
- ▶ Suppose the UE place a tariff T_{EU} on the import of lamb to all countries equally.
- ▶ There is an equal tariff to European countries and so an equal tariff for imports from Australian.
- ▶ Member States do not pay tariff in the internal market, so imports are duty free.

Trade diversion

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Joining the customs union

- ▶ After the integration of Spain in the EU consumers will pay a price $P_U = P_W + TEU$
- ▶ Now Spanish consumers may import lamb from France duty free diverting trade from Australia to France
 - ▶ France or other ME of the EU
- ▶ **Consumers gain** an increase in consumer surplus of areas **Transfer from producers to consumers plus the Welfare gain triangles plus the Tariff transfer from the government to consumers**
 - ▶ Consumers will pay a price of P_1 , $P_w + TEU$ and total quantity of lamb will be Q_4
 - ▶ **Consumers gain** area between 1 and 1.5 = $GG'HB'$

Welfare effects

- ▶ Spanish producers **sell less** they only sell 15, as we now import more 60 – 15.
 - ▶ Producers lose $GG'JJ'$
- ▶ **The government loses tariff area: Tariff transfer from the government to consumers**
 - ▶ Other taxes may increase to compensate the loss of income from tariff
- ▶ The net gain is **Trade creation – Trade diversion**

Trade diversion

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Joining custom unions from a position of free trade

- ▶ The above analysis suggests the UK had equal tariffs to all countries, such as Australia. However, before joining the EU, the **UK had free trade agreements** with countries in the **Commonwealth**, such as New Zealand and Australia.
- ▶ When the UK joined the EU, it had to implement an EU wide common external tariff of imports from outside the EU.
- ▶ The effect was to make Australian and NZ agriculture **more expensive** than previously. Therefore we switched imports from New Zealand to European countries. Prices rose for consumers for items like butter.
- ▶ Consumers in UK tend to lose out because they pay higher prices from the less efficient producer.

Overall welfare effects

- ▶ Australian farmers lose out. Exports fall.
- ▶ EU farmers gain
- ▶ The **global economy loses out** because we have shifted from low-cost producers – Australia – to relatively high-cost producers the EU.
- ▶ By joining the EU, the UK gained from new free trade agreements within Europe. The big losers were New Zealand and Australia who lost trade to the UK.
- ▶ **Brexit** may not change the situation if the UK remains in the EU Internal Market.