International Business

Economic Integration and Trade Relations

Contributors: By: Gabriele Suder
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Economic Integration and Trade Relations

International trade relations constitute an essential part of relations between states or market groups as parts of a state's potential of power and cooperation policies. These relations are part of International Relations, and are characterized by a multitude of decision-making bodies. Often, this phenomenon of complexity is described as 'polycentric'; some even speak of the 'anarchy of politics' in the political economy. (In contrast, the state is built on a monocentric basis.) Business evolves in this environment, and is regulated by it.

Organizations such as the Organization for Economic Cooperation and Development (OECD) provide the most advanced economies with knowledge and a forum to discuss economic problems and solutions.

World trade is based on a multilateral non-discriminatory trading system, in the past governed primarily by industrialized countries that emphasize World Trade Organization and other multinational trade associations' normalization (setting rules, norms, and standards of conduct on an international level). By the theory (see section 2.2), trade expands by reciprocal tariff reduction and liberalization.

'What is *Liberalization* in this Context?'

Trade liberalization reduces or abolishes restrictions to trade and investments from outside the country or market grouping, and aims for free trade between trade partners. Since the working of GATT (the General Agreement on Tariffs and Trade, 1947–1995) and WTO (the World Trade Organization, since 1995), essential quantitative barriers to trade, i.e. *tariffs* and *non-tariff barriers* (quotas, licences and technical specifications, among other restrictions), have greatly been reduced or abolished (dismantled). Developing countries liberalize trade regimes to access triad advantages, as the performance of free trade economies has been found to be superior to that of inward-focused economies.

> Export-oriented economies such as those of Taiwan and South Korea have experienced formidable economic growth. The same goes for an international firm's performance versus that of locally focused firms. On the negative side, it has been argued that free trade can contain major risks for underdeveloped and developing economies because of a power imbalance with advanced economies' political and corporate authorities.

Trade relations are considered a voluntary exchange of assets. States or groups engage in these relations because of benefits that the trading partners obtain by an optimal allocation of resources (following the theory of comparative advantage explained in section 2.2). At times, resources may not be allocated optimally, for example because of competitive or technological change, or unfair trade practices. On welfare grounds, this may explain and even justify the application of restrictions on trade. These restrictions on trade are used for a reallocation of resources for the mutual benefit of all trading parties (Julius DeAnne, 1990), and for reducing the harm done to certain industries caused by distortions of trade. But the line between welfare and protectionism is fine. It is the aim of the GATT, then since 1995 established as the

WTO, to provide a forum for the promotion of non-discriminatory international trade between its participants, mainly via periodic trade rounds and dispute-settlement mechanisms. In this, negotiations are to reduce or abolish restrictions on trade (mainly via the mostfavoured-nations clauses that provide states with preferential trading conditions among each other), to homogenize trade documentation procedures, and to provide for legislation on trade. WTO negotiations increasingly deal with services, and have moved to give more power to developing countries.

The protectionist means that are quotas, tariffs, and qualitative restrictions (see section 2.3) serve as main tools in trade disputes, next to propaganda and similar means. The liberalization from such protectionism typically stimulates international business, trade and investment. On the contrary, trade disputes and protectionist measures typically slow down bilateral relations (between two states or groups) or multilateral relations (between more than two partners), and need to be settled on a bilateral or multilateral level.

One of the favourite teaching cases for trade disputes is one dealing with what was named 'The Banana War'. This is an example of a US case brought to the WTO against the EU discriminatory import policy for bananas from former colonies, i.e. 71 African, Caribbean and Pacific countries. This case is mentioned in all major IB textbooks in one form or another.

The quality of trade relations is measured mainly by the *balance of payment (BoP)*, i.e. a nation's trade deficit or surplus with its trade partners. This BoP is an accounting record of the transactions between a country and the rest of the world over a given period of time. It is comparable to a company's sources-and-uses-of-funds statement. The *current account*, the *capital account*, and the official transactions account are the principal parts of this statement.

- The *current account* gives the monetary value of the international transactions in physical goods, in services, and in unilateral transfers such as gifts or aid.
- The *capital account* shows long-term and short-term transactions like certificates of deposit and foreign exchange. Internally traded goods rank among the largest categories in most nations' balance of payments. Because employment and standards of living appear so closely tied to these inflows and outflows, there is much debate about why particular countries find comparative advantages in certain goods and have different advantages and disadvantages. For example, countries like China and India, first known for inexpensive products, start to compete internationally in high technology products and raise a highly controversial, large amount of trade surplus with their trade partners.

The power of actors (states, market groups, organizations) in the international environment to achieve their objectives depends in general on their geographic position, the natural resources, economic strength and industrial capacity, and the international situation. Other factors may also be the military potential, size of the population, national character and morale, the quality of diplomacy, and the legitimacy of government.

Many of these factors have their importance reduced in the globalized world due to economic interdependence, liberal and democratic values, and the experience of history.

A List of Useful Variables that Influence the Quality of Trade Relations

A. External variables:
   - External demands
   - Global trends and events
   - Policy changes
   - Policy initiatives
B. Structural variables:
   - Domestic socio-economic system
   - Stability
   - Political legitimacy
   - Working of economies
C. Community variables:
   - Attitudes, norms, standards
   - Policies of national administrations
   - Interest groups and associations
   - Formation of supra-national coalitions
D. Institutional variables:
   - Formal and informal initiatives
   - Negotiations and consultations
   - Cooperation structures
E. Policy variables:
   - Objectives
   - Perceptions
   - Evaluations
   - Strategies
F. Sociological variables:
   - Motivation
   - Qualifications of staff
   - Cultural and political perceptions
G. Incidental variables:
   - Bilateral bargaining

‘What is the Impact of Enhanced Trade Relations between Two or More Countries on Corporations' Performance?’

Trade relations increase the options that firms have to obtain important and possibly less expensive resources and to enter markets that potentially increase revenue and profit. This may be a question of survival in highly competitive sectors, for small innovative companies and for small countries that are dependent on others to see their economy grow. Firms can enhance their competitive advantage through internationalization (We will review internationalization tools and strategies in section 2.6 in detail.) Porter's diamond model (mentioned briefly in section 2.2) names four main conditions that influence a firm's competitive advantage, i.e. factor conditions, demand conditions, related and support industries and firm strategy, structure and rivalry. Also, the model includes two external variables, i.e. chance events such as benefits stemming from innovations and governmental policy such as changes in regulations or policy plans that after factor endowments. This helps in analysing strategies that are employed in ‘triad’ and other advanced economies. It also illustrates that national responsiveness and local knowledge are key to international

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performance.

Pitfall

Be careful – while Porter's diamond model applies well to advanced economies' strategies, it is not entirely suitable for the analysis of smaller economies.

‘Why and how do Corporations then Profit from Trade Relations?’

The quality of trade relations has a significant influence on the *foreign direct investment (FDI*) activities of international corporations. FDI means that firms invest outside their home country, and thus own/control foreign assets. FDI is therefore a much stronger engagement in the international community than international trade that consists of export and import activities only. Over the past three decades, most FDI activity was confined to the triad countries.

The Triad denominates the three major trade and investment partners in the world economy, i.e. the USA, the European Union, and Japan (the definition is currently being enlarged to include Asia, in particular China and India).

Taking it *Further*

About 80 percent of FDI takes place among triad countries and within their market groupings. Non-triad countries most successfully invest in triad-driven groupings. Economic integration drives FDI activity and performance of corporations that engage in it. Note that FDI is different from portfolio investment, defined as the purchase of financial securities in other organizations for a financial gain when these marketable assets are sold.

In this, trading blocs are the preferential economic arrangement among a group of countries. They may take the shape of:

- free trade areas
- customs unions
- common markets
- economic unions.

The *free trade area* is the least restrictive and loosest form of economic integration among countries. In a free trade area, all barriers to trade among member countries are removed. An example of this is the North American Free Trade Agreement (NAFTA) and ASEAN (Association of Southeast Asian Nations)'s AFTA.

Members of a *customs union* dismantle barriers to trade in goods and services among themselves. A customs union establishes a common trade policy with respect to non-members. For example, a customs union rules trade between Turkey and the European Union. Other examples are MERCOSUR, having moved from free trade area to the customs union, and the efforts of the East African Community (EAC).

A *common market* has no barriers to trade among members and has a common external trade policy. Factors of production are mobile among members. Members of a common market must be prepared to cooperate closely in monetary, fiscal and employment policies. A common market exists, for example, in CARICOM (The Central American Common Market).

The creation of a true *economic union* requires integration of economic policies in addition to the free movement of goods, services and factors of production. Under this union, members would harmonize monetary policies, taxation and government spending and a common currency would be used by all members. The establishment of transnational rules and regulations enhances economic relations and cooperation among countries, economies, business and communities. The European Union is currently the only example of a market grouping striving to attain these goals.

> “The process of monetary union goes hand in hand, must go hand in hand, with political integration and ultimately political union. EMU is, and was meant to be, a stepping stone on the way to a united Europe.”
>
> (Wim Duisenberg, former President, European Central Bank) http://www.europeanfoundation.org/quotes.html

Market grouping results in *trade creation* and *trade diversion* effects, i.e. mainly the impact of integration on import prices, competition, economies of scale (lower production costs from greater production for a vast market), and factor productivity; that is the benefits of regionalism versus nationalism. Diversion takes place when the union is strong enough that non-members decrease exports to members of a market grouping, thus advantages shift from lower-cost external producers to higher internal cost producers.

In an IB exam, you are typically asked to analyse the opportunities that may be explored by the international manager. You remember to explore the issues that strengthen the corporate fit into this enlarged, less uncertain business environment. It calls for the adaptation of:

- *the company's entry mode, i.e. firms may move quickly from exports to investments because of liberalized trade and investment conditions, and differing factor conditions in the members of the market grouping*
- *effects of change which can be an opportunity to access new resources (financial, human, natural), and the simplification of trade policy and tariff structures*
- *strategic planning: uncertainties are reduced in a market grouping in which rules are harmonized, i.e. common rules are set and accepted by the actors in the adhering countries*

- *reorganization which can streamline the firm's cross-border business to raise efficiency within the market grouping (that reduces administration, financial management and other tasks*)
- *public affairs management and lobbying which must be expanded to the decision-making authority of the market grouping.*

The purpose of enhanced trade relations and economic integration is, for international business, to increase sales and profits, enter rapidly growing markets, reduce costs, ensure the benefits of adhesion to economic blocs, and their dynamic flow of trade and investment among them (intra-regional), or its neighbouring countries (inter-regional), to protect domestic and foreign market activity, and to acquire technological and managerial know-how.

Most international business takes place on an intra-regional level. For example, only 10% of Wal-Mart's stores are located outside of North America.

Taking it *Further*

The European Union constitutes the most advanced form of economic integration. Among its goals are:

- the elimination of customs duties among member states
- the elimination of obstacles to the free flow of import and/or export of goods and services among member states
- the establishment of common customs duties and unified industrial/commercial policies regarding countries outside the community
- free movement of persons and capital within the bloc
- the acceptance of common agricultural policies, transport policies, technical standards, health and safety regulations, and educational degrees
- common measures for consumer protection
- common laws to maintain competition throughout the community and to fight monopolies or illegal cartels
- regional funds to encourage the economic development of certain countries/regions
- greater monetary and fiscal coordination among member states and certain common

monetary/fiscal policies.

Recomended Reading

HILL (2008)*Chapters 1, 6 and 8*

RUGMAN AND HODGETTs (2006)*Chapters 3, 15 and 19*

- trade
- customs union
- triads
- common markets
- free trade
- free trade area
- economic integration

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