REGIONAL AND GLOBAL ECONOMIC INTEGRATION: IMPLICATIONS FOR GLOBAL BUSINESS

William J. Kehoe, University of Virginia

Abstract

In an era of nations seeking ways to enhance international trade through economic integration, this paper examines the concepts of regional and global economic integration and the various facilitating organization such as NAFTA, the European Union, and the World Trade Organization. The paper posits implications for global business given the emergence of economic integrative agencies. The European Union presents interesting implications for global business, implications that are profound in pricing.

INTRODUCTION

This manuscript is part of an on-going research stream in economic integration, specifically focused on a critical examination of NAFTA and the euro area (examples of regional economic integration) as well as on an examination of the World Trade Organization (an example of global economic integration). More specifically, the research in this manuscript examines the structure of NAFTA and its operations, the progress in the euro-area expansion, the role and processes of the WTO in facilitating economic integration, and managerial and policy implications of such global and regional economic integration. NAFTA, the European Union, and the WTO are multilateral integrative entities that impact significantly on global business. There is a need for critical evaluative research on the impact of these entities on business. This manuscript contributes to an understanding of NAFTA, the EU, the WTO and their impact on global business.

CONCEPT OF REGIONAL ECONOMIC INTEGRATION

The concept of regional economic integration implies that nations of a geographic region come together in some type of partnership to foster trade and development. Regional economic integration can be manifest as a free trade area, a customs union, a common market, an economic union, or in its most extreme form, as a political union. NAFTA, discussed below, is an example of a free trade area, while the European Union (EU) evolved from a common market form of regional economic integration (i.e., the European Common Market) to an economic union.

Free Trade Area: There are two distinguishing characteristics of a free trade area. The first characteristic is the liberalization of trade regulation for members. Second, the removal of trade barriers placed against members. This includes the removal of tariffs, quotas, and various non-tariff barriers, or a pledge to remove such trade barriers by a date certain in the future.

Customs Union: A customs union adds a third characteristic to the two characteristics of a free trade area, namely the imposition of a common tariff on nonmember countries. This means that the member countries of a customs union pledge to liberalize trade regulations, remove trade barriers placed against members, in addition to agreeing to impose a common tariff against nonmember countries. For example, all members of a customs union might agree to have a ten percent tariff against nonmember countries, while previously each country had different and unique tariff levels. Imposition of a common tariff implies a convergence of trade policy across member countries and, through such trade policy convergence, a pooling of national sovereignty.
Common Market: A common market encompasses all characteristic of a free trade area and of a customs union, while adding mobility of factors of production as a fourth distinguishing characteristic. Included is mobility of capital, labor, and technology. Mobility of labor requires that the member countries develop a common visa policy and a common position on residency. Additionally, the member countries will develop common policies to harmonize standards, have mutual recognition or acceptance of each others standards, or agree on minimum standards. Examples of standards requiring common policies include standards on subsidies, standards on health and safety, anti-trust standards, and professional licensing standards, to name a few.
Economic Union: An economic union brings a fifth distinguishing characteristic to the four characteristic discussed in the previous paragraphs. That characteristic is to seek economic integration through harmonizing fiscal and monetary policies, creating a common currency, and establishing a super-national governing authority. For example, a super-national governing authority is the European Parliament established by the European Union countries.
Political Union: A political union is the ultimate step along the regional economic integration path. A political union brings full economic and political unification to members of an economic union. The question whether or not there will be a United States of Europe sometime in the tomorrow's beyond, is an example of a situation of an economic union (i.e., the European Union) maturing toward full economic and political unification (not likely to occur anytime soon).

EXAMPLES OF REGIONAL ECONOMIC INTEGRATION

Two examples of regional economic integration are examined. First, the North American Free Trade Agreement (NAFTA) is presented as an example of a free trade area. Second, the European Union (EU) is presented as an example of an economic union.

NAFTA: NAFTA combined the United States with its largest (Canada) and third largest (Mexico) trading partners. Under Article 102 of the NAFTA Agreement (NAFTA Agreement Objectives, 2006), Canada, Mexico and the United States agreed to work cooperatively to "eliminate barriers to trade in, and facilitate the cross border movement of, goods and services between the territories of the Parties; promote conditions of fair competition in the free trade area; increase substantially investment opportunities in their territories; provide adequate and effective protection and enforcement of intellectual property rights in each Party's territory; create effective procedures for the implementation and application of this Agreement, and for its joint administration and the

resolution of disputes; and establish a framework for further trilateral, regional and multilateral cooperation to expand and enhance the benefits of this Agreement."

NAFTA is a congressional-executive agreement (Kirgis, 1997) approved by the U.S. Congress and entered into by the U. S. President. Upon enactment of NAFTA, the ttariffs levied by the three countries against each other either were eliminated immediately or phased out over periods of up to fifteen years. Limits on investments were removed with investors from any of the three countries treated equally, currency freely transferred at market rates, and performance requirements such as maintaining export levels and trade balancing being eliminated. Trade in services was liberalized and equal treatment was expected for service providers and professionals in each country. Transportation regulations were liberalized so that by 2000 commercial buses and trucks have almost unlimited access to the NAFTA countries. Protection of intellectual properties was strengthened, including protection of literary works, recordings, computer programs, and product and process patents.

NAFTA facilitates comity through a trilateral trade commission to resolve disputes, review and prevent dumping of products across national markets, and to enable a country to reinstate pre-NAFTA duties for a period up to three years, on a one-time only basis, if domestic industries are injured as a result of an import surge from another NAFTA country. Offices of the NAFTA Secretariat (NAFTA Secretariat, 2006), located in Ottawa, Mexico City, and Washington, D.C., work to resolve trade disputes in a fair, impartial, and timely manner, thereby contributing to comity among the member countries.

European Union (EU): The European Union, with many NAFTA-like features, has a particularly significant feature - the euro currency. On January 1, 1999, eleven member states of the fifteen-member European Union - Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Holland, Portugal, and Spain - launched a new currency - the euro (Stecklow, 1999). At its introduction on January 1, 1999, the euro was authorized for non-cash transactions in the euro-eleven countries, meaning that the euro was authorized for equity & debt trading, bank transactions, business-to-business transactions, and for payments by check, credit card and/or bank transfer.

Having operated on a non-cash basis for several years, the euro moved to the next phase in its emergence when, on January 1, 2002, euro bank notes and coins were placed in circulation in the euro countries and the national currencies were phased out of circulation beginning on July 1, 2002. The euro transformed Europe (Warner, 1998) from "a jigsaw of costly, protected markets into a vigorously competitive economic bloc," thereby enhancing international trade and comity in the area.

GLOBAL ECONOMIC INTEGRATION – WTO

Founded on January 1, 1995, the World Trade Organization's (WTO) prime objective was to strengthen the world trading system and be more effective than the General Agreement on Tariffs and Trade (GATT), the organization it replaced (WTO & GATT,2006). As stated on its website (WTO About, 2006), "the World Trade Organization is the only global international organization dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments. The goal is to help

producers of goods and services, exporters, and importers conduct their business." The WTO seeks to strengthen the world's trading system and, as a permanent organization, to be more effective in fostering comity than the provisional GATT organization which it replaced.

The WTO is based in Geneva and organized with a Ministerial Conference as its highest authority. Meeting at least every two years, the Ministerial Conference is composed of representatives of all WTO member nations. A General Council administers the WTO, implements its ministerial decisions, and acts, by convening in two particular forms, as a Dispute Settlement Body and as a Trade Policy Review Body (WTO Structure, 2006). The General Council establishes subsidiary units to accomplish the work of the WTO, including a Council on Trade in Goods, a Council on Trade in Services, and a Council on Trade-Related Aspects of Intellectual Property Rights. Reporting to each of these Councils are committees, negotiating groups, and working parties (WTO Structure, 2006). Decision making in the WTO is by consensus. When consensus is not possible, decisions are carried on a two/third majority vote on a one country, one vote basis (WTO Decisions, 2006). WTO Ministerial Conferences to date include:

First WTO Ministerial Conference, Singapore, December 9 to 13, 1996. The first conference since the WTO entered into force on January 1, 1995, this meeting was attended by representatives from 120 nations. The primarily focus was on examining the implementation progress of Uruguay Round agreements.

Second WTO Ministerial Conference, Geneva, May 18 to 20, 1998. This conference reaffirmed the importance of a multilateral, rule-based trading system as well as reaffirming the agreements made during the first ministerial conference.

Third WTO Ministerial Conference, November 30 to December 3, 1999, Seattle. This conference is remembered for its anti-globalization protests and for rioting in the streets of Seattle by anti-globalization protestors. During the conference a divergence of opinion emerged among the member nations about various trade issues, none of which were resolved.

Fourth WTO Ministerial Conference, November 9 to 14, 2001, Doha, Qatar. This conference initiated the Doha Development Agenda.

Fifth WTO Ministerial Conference, September 10 to 14, Cancún, Mexico. This conference reviewed progress under the Doha Development Agenda and outlined the work yet remaining.

Sixth WTO Ministerial Conference, December 13 to 18, 2005, Hong Kong, China. The objective of this conference was primarily to enable the four-year old Doha Development Agenda to find common ground for a 2006 conclusion.

IMPLICATIONS for GLOBAL BUSINESS

The global business arena is one in which firms interact increasingly with global and regional economic integration entities. This increased interaction adds a level of complexity in doing international business. It also brings business firms under the scrutiny of global and regional regulators as well as scrutiny from host-country regulators. For example, Microsoft currently is experiencing increased scrutiny and is facing antitrust litigation in the European Union. The EU drafted a 302-page antitrust

order against Microsoft over the perceived unwillingness of Microsoft to share technical information with European competitors. The EU is threatening Microsoft with a fine of $2.4 million/day for noncompliance with its antitrust order (Staff Report, 2006).

In addition to complexity and increased scrutiny, global and regional economic integration brings other challenges for business firms. In the case of the European Union and the emergence of the euro currency, the challenges are particularly interesting. The euro is bringing transparency to European business. Prices and wages in the EU member countries now are transparent, meaning that disparities in prices, costs, wages, taxes and the like across countries, previously cloaked by currency fluctuations, now are easily comparable from one country to another. Increased transparency has implications for global business, implications that are profound in pricing.

Low-Price Seeking: Transparency implies that it will be easier for consumers to perform cross-country price comparisons. Given ease of price comparisons, some form of price arbitrage may arise as consumers seek a product at its lowest price, no matter its country location. For example, Zachary (1999) reported on an European Consumers' Organization study that found that European pay 39.2 euros for a Swatch watch in Belgium as compared to 25.7 euros for the same watch in Italy. As this price discrepancy became apparent, consumers elected to buy the product at its lowest price in Italy, rather than in their home countries either by traveling to Italy to purchase the watch, ordering by mail from a retailer in Italy, or, ordering through electronic commerce.

Downward Shift in Prices: As consumers undertake cross-country price comparisons and shift their purchase locus to a lowest price country, a downward shift in prices likely occurs. Purchasing power parity and the law of one price explain an expectation of a downward shift in prices. While these concepts generally apply in situations of different currencies across countries, they have applications in a situation of nations switching from individual national currencies to a single currency such as the euro.

Purchasing power parity relates currency spot rates over time to inflation. In other words, the prices of products, when expressed in a common currency, will equalize across countries as a result of exchange rate movements. Operationally, under purchasing power parity, the price of a product in a host country, when multiplied by the currency spot rate existing between a home country and a host country should be in parity to the price in the home country. Expressed mathematically, purchasing power parity (PPP) is:
$PPP = f[(\text{price host country}) * (\text{spot rate}) = (\text{price home country})]$.

Consider an example in which the spot exchange rate between a home country currency (HC) and a host country currency (hc) is HC 0.80 = hc 1.00. A product, say a blouse, is priced HC 48.00 and hc 60.00, so that, applying the purchasing power parity formula, the prices are at parity in that $PPP = f[(60.00)*(.80) = (48.00)]$. Assume inflation in the host country increases prices there by 30%, so that the price of the blouse increases in the host country from 60.00 to 78.00. Parity no longer exists between home country and host country prices, so host country citizens are motivated to purchase the product in its home country at HC 48.00 rather than in the host country at hc 78.00. As consumers engage in arbitrage-like cross border transactions, these behaviors affect demand and price of foreign currency so that, over time, the spot exchange rate between the two countries will adjust from HC 0.80 = hc 1.00 to HC 0.61538 = hc 1.00. This adjustment brings parity at $PPP = f[(78.00)*(.61538) = (48.00)]$.

In the long run, the concept of PPP implies that currency exchange rates adjust so that the cost of identical goods and services is the same in all markets and in all countries. As the introduction of the euro facilitated price comparisons and provided price transparency, prices moved toward a single price point across all countries, similar to what is implied by purchasing power parity and the law of one price. But, because the locus is one of a single currency rather than multiple currencies, there are no exchange rates to be adjusted. Instead, what is happening is a downward price pressure in all countries toward whatever is a product's lowest price point across the countries where it is sold. If 27.5 euros is the lowest price point of a Swatch watch in Europe, prices of Swatch watches in all European countries will move toward that low-price point.

Revenue/Profit Erosion: The implications of a movement toward low price points and downward pressure on prices are profound. As prices move toward a single price point across the euro countries, the movement is in a downward rather than an upward direction for reasons of consumer price arbitrage. Management recognizes the inevitability of downward price movement in European markets. For example, Salvador Gabarro, CEO of Roca Radiadores, a Barcelona-based equipment manufacturer, said about the impact of the euro on his business, "we will never, ever raise prices again" (Kamm, 1999). Or, put another way, a downward pressure on prices means, in turn, that firms likely will experience erosion in revenues and likely decreases in profits.

CONCLUSION

Globalization, in the form of globalization of production (Hill, 2005) and/or globalization of marketing (Kehoe, 1998; Johansson, 2006), presents new opportunities for trade among nations. The ability to exchange good and services globally, to export products to distant lands, the opportunity to shift production to other countries (often to least-cost locations), the advances in communication and computing technologies, all of these things define the arena of global trade. In that arena, global and regional economic-integration organizations establish the rules of the game. These organizations impact the global trade arena with increasing frequency and with profound implications for global business.

REFERENCES

Hill, Charles W. L. (2005). *International Business*. Boston, MA: McGraw-Hill/Irwin.

Johansson, Johny K. (2006). *Global Marketing.* Boston, MA: McGraw-Hill/Irwin.

Kamm, Thomas (1999), "Emergence of Euro Embodies Challenge and Hope for Europe," Wall Street Journal, January 4, pp. A1 and A4.

Kehoe, William J. (1998). "GATT and WTO: Facilitating Global Trade," *Journal of Global Business,* Spring, 67-76.

Kirgis, Frederic L. (1997). "International Agreements and U. S. Law," *ASIL Insights.* http://www.asil.org/insights/insigh10.htm.

NAFTA Agreement Objectives (2006). http://www-tech.mit.edu/Bulletins/Nafta/01.objective.

NAFTA Secretariat (2006). http://www.nafta-sec-alena.org/DefaultSite/index_e.aspx?DetailID=184.

Special Report (2003). "Special Report - World Trade," *The Economist*, 161(March 29),

63-64.
Staff Report (2006). "Microsoft Defends Itself at EU Antitrust Hearing," Wall Street Journal Online. http://online.wsj.com/article_print/SB114370415965012135.html
Stecklow, Steve (1999). "No Euros, Please – We're British." *Wall Street Journal* (January 4), A6.
Warner, Joan (1998). "The Euro: Are You Ready?" *Business Week*, (December 14), 62-63.
WTO & GATT (2006). http://www.wto.org/wto/about/facts6.htm
WTO About (2006). http://www.wto.org/english/thewto_e/whatis_e/whatis_e.htm
WTO Decisions (2006). http://www.wto.org/wtoworks_wpf.html#Decisions
WTO Structure (2006). http://wto.org/wtoworks_wpf.html#Structure
Zachary, G. Pascal (1999), "Euro Is Unlikely to End Differences in Prices Soon," Wall Street Journal, January 8, p. A 16.
Zoellick, Robert (2002). "Unleashing the Trade Winds," *The Economist*, December 7, 27-29.

Acknowledgement: The author acknowledges the support for this research received from the Faculty Research Grant Program, McIntire School of Commerce, University of Virginia.