chapter

8

Regional Economic Integration

Learning Objectives

In this chapter, you will learn about:

1. Regional integration and economic blocs
2. Types of regional integration
3. Leading economic blocs
4. Why countries pursue regional integration
5. Success factors for regional integration
6. Drawbacks and ethical dilemmas of regional integration
7. Management implications of regional integration

The European Union

At the end of World War II, Europe was economically and physically devastated. The war resulted in the destruction of much of Europe's industry and infrastructure. Soon after, at the onset of the Cold War between the United States and the Soviet Union, the European continent was physically and politically divided between Western and Eastern Europe. Many Europeans feared for their future.

To help address these concerns and generally promote peace and harmony in Europe, six western European countries—Belgium, France, Italy, Luxemburg, the Netherlands, and West Germany—formed an alliance in 1957, the European Economic Community. Its successor is the European Union (EU), which was established in 1992 and today includes 27 countries. Because the original bloc was founded in 1957, the EU in 2007 celebrated its 50th anniversary, making it one of the world's oldest regional economic blocs. A regional economic integration bloc (economic bloc) is an alliance of two or more countries that agree to eliminate tariffs and other restrictions to the cross-border flow of products, services, capital, and, occasionally, labor. Presently, the EU is the world's most advanced and largest economic bloc, with nearly a half billion people and about $14 trillion in annual GDP.

While the EU's original members were all Western European nations, it now includes Eastern European countries as well. Thirteen EU countries have adopted the

euro as their common currency, helping to lower business transaction costs and increase the transparency of pricing throughout the European area.

Trade and investment within Europe have become much easier since the 1950s. The member states allow investors from other member countries to freely establish and conduct business and transfer capital and earnings. Gradual elimination of bureaucracy at Europe's national borders has cut delivery times and reduced transportation costs. For example, the EU eliminated the need for volumes of customs clearance documents.

The EU is home to the headquarters of some of the world's most important firms. One such firm is Allianz, an insurance company founded in Germany. Allianz offers a range of insurance products and services, including life, health, and casualty insurance. In terms of market targeting and strategy development, Allianz management at one time viewed Europe as a collection of disparate countries. Since the creation of the EU, however, Allianz treats Europe increasingly as one large marketplace. Management attempts to devise pan-European strategies, an approach that reduces costs and increases the efficiency of Allianz's operations throughout Europe.

Development of the EU has allowed Allianz to internationalize faster than other insurers. The firm is present in all the new EU countries—such as Poland, Hungary, and the Czech Republic—which are proving to be among Allianz's most profitable markets. In 2006, Allianz changed its legal status from a German company to that of a Societas Europaea (SE), a company based and regulated in the EU as a whole. The legal groundwork for SE status was put in place in 2004, with passage of EU legislation that allows such firms to operate seamlessly across all 27 EU countries. By transforming into a European firm, Allianz is becoming more European than German.

Today, the EU is at a crossroads. Member countries signed the European Constitution in 2004—a treaty that aimed to improve the functioning of the EU's governing institutions. The goal of the constitution is to clarify the distribution of powers and legitimize the EU's federal authority, in much the same way the U.S. Constitution did for the United States. However, in a referendum held in 2005, France and the Netherlands rejected the constitution, which caused other countries to postpone or halt ratification. At present, the constitution's future and longer-term political integration of the EU are in limbo. Meanwhile, in the decade through 2007, performance of the EU economy was sluggish. GDP growth and productivity stagnated and the unemployment rate hovered between 8 and 12 percent. Many Europeans are dissatisfied with the EU and are opposed to the entry of additional countries into the bloc.

The challenges facing the EU today might be typical of economic blocs in the most advanced stages of development. Nevertheless, economic blocs have become typical of the emerging landscape of international trade and investment. Today, there are roughly 200 agreements for regional trade integration around the world, some more active than others. Such alliances represent a long-term trend and are likely a stepping-stone to the emergence of worldwide free trade.

Sources: *Economist*. (2005). "Business: Limited appeal; Pan-European companies." Sept 17, p.72; *Economist*. (2007). "Fit at 50? A Special Report on the European Union." March 17, Special Section; European Commission. *The Internal Market—Ten Years without Frontiers*. Retrieved from *www.ec.europa.eu*; *Hoovers.com*. (2007). Corporate profile of Allianz at *www.hoovers.com*; U.S. Commercial Service. (2006). *Doing business in the European Union*. Washington, DC: U.S. and Foreign Commercial Service and U.S. Department of State.

Regional Integration and Economic Blocs

Regional economic integration The growing economic interdependence that results when two or more countries within a geographic region form an alliance aimed at reducing barriers to trade and investment.

The opening vignette highlights one of the most remarkable features of contemporary international business: the worldwide trend to **regional economic integration**. Also known as *regional integration*, regional economic integration refers to the growing economic interdependence that results when two or more countries within a geographic region form an alliance aimed at reducing barriers to trade and investment. Since the end of World War II, most nations have sought to collaborate, with the aim of achieving some degree of economic integration. It is estimated that about 40 percent of world trade today is under some form of preferential trade agreements signed by groups of countries. The trend is based on the premise that, by cooperating, nations within a common geographic region connected by historical, cultural, linguistic, economic, or political factors can gain mutual advantages.[1] The free trade that results from economic integration helps nations attain higher living standards by encouraging specialization, lower prices, greater choices, increased productivity, and more efficient use of resources.

To better understand regional integration, think of international business as existing along a continuum where, at one extreme, the world operates as one large free-trade area in which there are no tariffs or quotas, all countries use the same currency, and products, services, capital, and workers can move freely among nations without restriction. At the other extreme of this continuum is a world of prohibitive barriers to trade and investment where countries have separate currencies and have very little commercial interaction with each other. Regional integration is an attempt to achieve freer economic relations. Two of the most well-known examples of this trend are the European Union (EU) and the North American Free Trade Agreement area (NAFTA). The EU is composed of 27 member countries in Europe. NAFTA is composed of Canada, Mexico, and the United States.

Regional integration results from the formation of a **regional economic integration bloc**, or simply, an economic bloc, a geographic area that consists of two or more countries that agree to pursue economic integration by reducing tariffs and other restrictions to cross-border flow of products, services, capital, and, in more advanced stages, labor. (In this text, we follow the convention of using the French term, “bloc,” instead of “block.”) At minimum, the countries in an economic bloc become parties to a **free trade agreement**, a formal arrangement between two or more countries to reduce or eliminate tariffs, quotas, and other barriers to trade in products and services. The member nations also undertake cross-border investments within the bloc.

Regional economic integration bloc A geographic area consisting of two or more countries that have agreed to pursue economic integration by reducing barriers to the cross-border flow of products, services, capital, and, in more advanced states, labor.

Free trade agreement A formal arrangement between two or more countries to reduce or eliminate tariffs, quotas, and barriers to trade in products and services.

More advanced economic blocs, such as the EU, permit the free flow of capital, labor, and technology among the member countries. The EU is also harmonizing monetary and fiscal policies and gradually integrating the economies of its member nations. For example, in light of the faster pace of economic activity in the EU, the European Central Bank recently tightened its monetary policy by raising interest rates on the money that it loans to European banks, in an effort to reduce inflation. Cross-border merger and acquisition deals increased markedly between Austria, France, the United Kingdom, the Netherlands, and other member countries in recent years.

Why would a nation opt to be a member of an economic bloc instead of working toward a system of worldwide free trade? The primary reason is that such blocs involve a smaller number of countries and, therefore, are much easier to negotiate than a system of worldwide free trade composed of all the nations in the world. This helps explain why roughly 200 economic integration agreements have been negotiated, presenting both opportunities and challenges to internationalizing firms.

Note that the proponents of free trade on a global scale are disappointed about the proliferation of regional trade agreements. Since 1947, the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO) have achieved great success in fostering economic integration on a *global* scale. The WTO recognizes that regional integration can play an important role in liberalizing trade and fostering economic development. However, existing WTO rules have been less effective in dealing with groups of countries, and the world body has failed to ensure compliance with WTO rules by all members of an economic bloc. Slow progress to liberalize trade, especially in agricultural products, has prompted many developing countries to seek alternatives to the multilateral trading system favored by the WTO. Today, the WTO remains in negotiations with economic blocs, with the aim of exercising better control over their evolution and of minimizing risks associated with regional economic integration.[2]

Types of Regional Integration

Regional integration involves processes by which distinct national economies become economically linked and interdependent through greater cross-national movement of products, services, and factors of production. Economic integration allows member states to use resources more productively. The total output of the integrated area becomes greater than that achievable by individual states.

Exhibit 8.1 identifies five possible levels of regional integration. Regional integration is best viewed as a continuum, with economic interconnectedness progressing from a low level of integration—the free trade area— through higher levels to the most advanced form of integration—the political union. The *political union* represents the ultimate degree of integration among countries, which has not yet been achieved. The **free trade area** is the simplest and most common arrangement, in

Free trade area A stage of regional integration in which member countries agree to eliminate tariffs and other barriers to trade in products and services within the bloc.

Level of Integration	*Free Trade Area*	*Customs Union*	*Common Market*	*Economic and (sometimes) Monetary Union*	*Political Union*
Members agree to eliminate tariffs and non tariff trade barriers with each other but maintain their own trade barriers with non member countries. *Examples: NAFTA, EFTA, ASEAN, Australia and New Zealand Closer Economic Relations Agreement (CER)*	✔				
Common external tariffs *Example: MERCOSUR*	✔	✔			
Free movement of products, labor, and capital *Example: Pre-1992 European Economic Community*	✔	✔	✔		
Unified monetary and fiscal policy by a central authority *Example: The European Union today exhibits common trade, agricultural, and monetary policies*	✔	✔	✔	✔	
Perfect unification of all policies by a common organization; submersion of all separate national institutions *Example: Remains an ideal; yet to be achieved*	✔	✔	✔	✔	✔

Exhibit 8.1 Five Potential Levels of Regional Integration among Nations

which member countries agree to gradually eliminate formal barriers to trade in products and services within the bloc, while each member country maintains an independent international trade policy with countries outside the bloc. NAFTA is an example. The free trade area emphasizes the pursuit of comparative advantage for a group of countries rather than individual states. Governments may impose local content requirements, which specify that producers located within the member countries provide a certain proportion of products and supplies used in local manufacturing. If the content requirement is not met, the product becomes subject to the tariffs that member governments normally impose on nonmember countries.

Customs union A stage of regional integration in which the member countries agree to adopt common tariff and nontariff barriers on imports from nonmember countries.

The next level of regional integration is the **customs union**, which is similar to a free trade area except that the member states harmonize their trade policies toward nonmember countries. Unlike a free trade area, in which individual countries have their own external trade policies, the members of a customs union adopt *common* tariff and nontariff barriers on imports from nonmember countries. MERCOSUR, an economic bloc consisting of Argentina, Brazil, Paraguay, and Uruguay, is an example of this type of arrangement. Use of a common tariff system means that an exporter outside MERCOSUR faces the *same* tariffs and nontariff barriers by *any* MERCOSUR member country. Determining the most appropriate common external tariff is challenging, because member countries must agree on the tariff level. In addition, governments must agree on how to distribute proceeds from the tariff among the member countries.

At the next stage of regional integration, member countries may establish a **common market** (also known as a single market), in which trade barriers are reduced or removed, common external barriers are established and products, services, and *factors of production* such as capital, labor, and technology are allowed to move freely among the member countries. As with a customs union, the common market also establishes a common trade policy with nonmember countries. The EU is a common market. It has gradually reduced or eliminated restrictions on immigration and the cross-border flow of capital. A worker from an EU country has the right to work in other EU countries, and EU firms can freely transfer funds among their subsidiaries within the bloc.

Common market A stage of regional integration in which trade barriers are reduced or removed, common external barriers are established, and products, services, and factors of production are allowed to move freely among the member countries.

Common markets are hard to create because they require substantial cooperation from the member countries on labor and economic policies. Moreover, because labor and capital can flow freely inside the bloc, benefits to individual members vary, because skilled labor may move to countries where wages are higher and investment capital may flow to countries where returns are greater. In the EU, for example, Germany has seen a sharp influx of workers from Poland and the Czech Republic, because workers from the latter countries can earn substantially higher wages in Germany than they can in their home countries.

An **economic union** is a stage of regional integration in which member countries enjoy all the advantages of early stages, but also strive to have common fiscal and monetary policies. At the extreme, each member country adopts identical tax rates. The bloc aims for standardized monetary policy, which requires establishing fixed exchange rates and free convertibility of currencies among the member states, in addition to allowing the free movement of capital. This standardization helps eliminate discriminatory practices that might favor one member state over another. Through greater mobility of products, services, and production factors, an economic union enables firms within the bloc to locate productive activities in member states with the most favorable economic policies.

Economic union A stage of regional integration in which member countries enjoy all the advantages of early stages, but also strive to have common fiscal and monetary policies.

The EU has made great strides toward achieving an economic union. For example, 13 EU countries have established a *monetary union* in which a single currency, the euro, is now in circulation. Monetary union and the euro have greatly increased the ease with which European financial institutions establish branches across the EU and offer banking services, insurance, and savings products.

Economic unions have additional characteristics. To achieve greater economic integration, member countries strive to eliminate border controls, harmonize product and labeling standards, and establish regionwide policies for energy, agriculture, and social services. An economic union also requires its members to standardize laws and regulations regarding competition, mergers, and other corporate behaviors. To facilitate free trade in services, member countries harmonize procedures for licensing of professionals so that a doctor or lawyer qualified in one country can practice in any other country.

In describing an economic union, the United States provides a good analogy. Imagine that each of the fifty states is like an individual country, but joined together in a union. The members have a common currency and a single central bank with a uniform monetary policy. Trade among the members takes place unobstructed and both labor and capital move freely among them, in pursuit of optimal returns. The federal government applies a uniform tax and fiscal policy. However, just as would occur in an economic union, the individual U.S. states also govern themselves in such areas as education, police protection, and local taxes, thereby maintaining some local autonomy. Nevertheless, the analogy only goes so far. The United States *is* a country and, unlike a real economic union, the U.S. states cannot withdraw from the union.

Leading Economic Blocs

Examples of regional integration can be found on all continents. Leading economic blocs are illustrated in Exhibit 8.2 on pages 230–231. In this section, we discuss notable blocs in Europe, the Americas, Asia, the Middle East, and Africa.

Europe has the longest experience with regional integration and is home to several economic blocs. The most important of these are the European Union and the European Free Trade Association. Exhibit 8.3 on page 232 shows these two blocs in detail.

The European Union (EU)

Exhibit 8.4 highlights the notable features of the member countries in the European Union—the world's most integrated economic bloc. "PPP terms" in the exhibit refers to *purchasing power parity* (PPP), which means that per capita GDP figures have been adjusted for price differences. The EU traces its roots to the years following World War II, when six war-weary countries—Belgium, France, Germany, Italy, Luxembourg, and the Netherlands—sought to promote peace and prosperity through economic and political cooperation (www.europa.eu). These countries signed the Treaty of Rome in 1957, eventually leading to the formal creation of the EU in 1992. The EU has taken the following steps toward becoming a full-fledged economic union:

- *Market access.* Tariffs and most nontariff barriers have been eliminated for trade in products and services, and rules of origin favor manufacturing that uses parts and other inputs produced in the EU.
- *Common market.* The EU removed barriers to the cross-national movement of production factors—labor, capital, and technology. For example, an Italian worker now has the right to get a job in Ireland and a French company can now invest freely in Spain.
- *Trade rules.* The member countries have largely eliminated customs procedures and regulations, which streamlines transportation and logistics within Europe.
- *Standards harmonization.* The EU is harmonizing technical standards, regulations, and enforcement procedures that relate to products, services, and commercial activities. Thus, where British firms once used the imperial measurement system (that is, pounds, ounces, and inches), they have converted to the metric system, used by all the EU. Where German merchants once had a unique standard for the quality of meat and produce, they now follow procedures prescribed by the EU.

In the long run, the EU is seeking to adopt common fiscal, monetary, taxation, and social welfare policies. The 2002 introduction of the euro—the EU's common currency and now one of the world's leading currencies—simplified the process of cross-border trade and enhanced Europe's international competitiveness. Its introduction eliminated exchange rate risk in much of the bloc and forced member countries to improve their fiscal and monetary policies. Psychologically, the single currency allows consumers and businesses to think of Europe as a single national entity. Instituting the euro meant that national governments had to cede monetary power to the European Central Bank, which is based in Luxembourg and oversees EU monetary functions.

The EU has four additional institutions that perform its executive, administrative, legislative, and judicial functions. The *Council of the European Union*, based in Brussels, is the EU's main decision-making body. Composed of representatives from each member country, it makes decisions regarding economic policy, budgets, and foreign policy, as well as admission of new member countries. The *European Commission*, also based in Brussels, is similarly composed of delegates from each member state and represents the interests of the EU as a whole. It proposes legislation and policies and is responsible for implementing the decisions of the *European Parliament* and the Council of the EU. The European Parliament consists of elected representatives that hold joint sessions each month. By common agreement, the Parliament meets in three different cities (Brussels, Luxembourg, and Strasbourg, France) and can have up 732 total representatives. The Parliament has three main functions: (1) form EU legislation, (2) supervise EU institutions, and (3) make decisions about the EU budget. Finally, the *European Court of Justice*, based in Luxembourg, interprets and enforces EU laws and settles legal disputes between member states.[3]

The Global Trend feature discusses specific challenges of integrating new member states into the EU. Since 2004, 12 new states have joined the EU. The more recent addition of Bulgaria and Romania brings the total number of member countries to 27. The new member countries are important, low-cost manufacturing sites for EU firms.[4] For example, Peugeot and Citroën now produce cars at a plant in the Czech Republic. At full capacity, the factory turns out 300,000 vehicles per year. South Korea's Hyundai now produces the Kia brand of cars at a plant in

GLOBAL TREND

Integrating Eastern Europe and Turkey into the EU

Germany's per capita GDP is $32,684. By comparison, Romania's is $10,152, Bulgaria's is $10,844, and Poland's is $14,609 (all are 2007 figures). These Eastern European countries, with their low-wage workers, make excellent manufacturing sites for firms from Western Europe and elsewhere. Just as these and other Eastern European countries have recently joined the European Union (EU), officials in Germany, France, and other long-established EU members fear losing jobs and investment to the new EU members. These same officials are reluctant to allow other low-wage countries, such as Turkey or the Ukraine, to join the EU.

In population terms, Turkey (with 71 million people) is about the same size as the 12 Eastern European countries that joined the EU since 2004. However, Turkey poses additional challenges because of cultural differences, its Islamic heritage, and historically high inflation. Some oppose Turkey joining the EU because the country is seen as too remote from current EU countries in cultural and geographic terms. Successive Turkish governments have long sought EU membership, in part because it will help maintain economic reform in their country.

Proponents of EU enlargement are optimistic. They argue that low wages in the bloc's newest members are more an opportunity than a threat. Why? One reason is that Poland, Hungary, and other recent entrants are attracting substantial business investment that might go to China and other low-wage countries on the opposite side of the world.

The Eastern European countries will not maintain their low-cost labor advantages indefinitely. These satellites of the former Soviet Union are much richer today than they were after the collapse of communism in 1989, when Poland's per capita GDP was just $2,000. Starting from a much lower income level, these countries are relatively new to free-market economics and, as such, are growing their economies far faster than their affluent Western EU neighbors. The reason relates partly to the incremental value of inward investment in poorer countries versus richer countries. The profitability of using additional capital or better technology is greater in an emerging market like Poland than in a high-income country like Germany. For example, while replacing an existing computer with a new, faster computer has a relatively small payoff for a German firm, installing a new computer in a Polish firm where records are kept by hand has an enormous payoff.

Rapid economic growth spurred by affiliation with the European Union implies that the newest EU members may reach economic parity with the rest of Europe within a few decades, a short time span in the life of a nation. When that day arrives, Germans, French, British, and other venerable members of the EU bloc will no longer worry about the competitive threat of their new low-wage neighbors.

Sources: *Business Week*. (1999). "How Far, How Fast? Is Central Europe Ready to Join the EU," Nov. 8, pp. 64–66; *Economist*. (2005). "Transformed: EU Membership has Worked Magic in Central Europe." June 25, pp. 6–8; *Economist*. (2004). "The Impossibility of Saying No." Sept. 18, 30–32; *Financial Times*. (2005). "Why Turks are Changing Tack on Foreign Ownership." June 28. Special report.

Exhibit 8.2

The Most Active Economic Blocs


C OCEAN
NORWAY
SWEDEN
FINLAND
ESTONIA
LATVIA
LITHUANIA
RUSSIA
NMARK
NDS
ERMANY
POLAND
BELARUS
UKRAINE
CZECH REP.
SLOVAKIA
URG
AUSTRIA
HUNGARY
MOLDOVA
SLOVENIA
CROATIA
ROMANIA
BOSNIA-HERZEGOVINA
SERBIA AND MONTENEGRO
BULGARIA
MACEDONIA
ITALY
ALBANIA
GREECE
TURKEY
GEORGIA
ARMENIA
AZERBAIJAN
CYPRUS
UNISIA
R U S S I A
KAZAKHSTAN
MONGOLIA
UZBEKISTAN
KYRGYZSTAN
TURKMENISTAN
TAJIKISTAN
NORTH KOREA
SOUTH KOREA
JAPAN
SYRIA
LEBANON
IRAQ
ISRAEL
JORDAN
IRAN
AFGHANISTAN
C H I N A
KUWAIT
PAKISTAN
NEPAL
BHUTAN
LIBYA
EGYPT
QATAR
UNITED ARAB EMIRATES
SAUDI ARABIA
OMAN
BANGLADESH
INDIA
MYANMAR (BURMA)
LAOS
TAIWAN
PACIFIC OCEAN
IGER
CHAD
SUDAN
ERITREA
YEMEN
THAILAND
VIETNAM
CAMBODIA
PHILIPPINES
ERIA
DJIBOUTI
SOMALIA
CENTRAL AFRICAN REPUBLIC
ETHIOPIA
AMEROON
SRI LANKA
BRUNEI
MALAYSIA
SINGAPORE
CONGO REPUBLIC
ABON
UGANDA
KENYA
CONGO DEMOCRATIC REPUBLIC (ZAIRE)
RWANDA
BURUNDI
INDIAN OCEAN
INDONESIA
PAPUA NEW GUINEA
SOLOMON ISLANDS
TANZANIA
ANGOLA
ZAMBIA
MALAWI
MOZAMBIQUE
VANUATU
FIJI
NAMIBIA
ZIMBABWE
MADAGASCAR
MAURITIUS
RÉUNION
BOTSWANA
NEW CALEDONIA
AUSTRALIA
SWAZILAND
SOUTH AFRICA
LESOTHO
NEW ZEALAND
The most active economic blocs
EU
EFTA
NAFTA
MERCOSUR
CARICOM
CAN
ASEAN
APEC
CER

Exhibit 8.3

Economic Integration in Europe

Slovakia, while Japan's Suzuki makes cars in Hungary. Output of automobiles in the eastern region is growing rapidly.[5] Most of the newest EU entrants are one-time satellites of the former Soviet Union, and have economic growth rates far higher than their 15 Western European counterparts. They are poised to achieve per capita income levels similar to the EU's wealthier countries within a few decades. However, their ascension poses special challenges. Less-developed economies such as Romania, Bulgaria, and Lithuania may require decades of developmental aid to catch up.[6]

The EU faces other challenges as well. There is a tension in Europe between the forces for regional integration and the forces for retaining national identity. EU countries recognize that relinquishing autonomy in certain key areas and combining resources across national borders are necessary steps. However, some EU members, particularly Britain, are reluctant to surrender certain sovereign rights. They insist on maintaining their ability to set their own monetary and fiscal policies, and to undertake their own national military defense.

Finally, the Common Agricultural Policy (CAP) has long been a fixture of the European bloc. The CAP is a system of agricultural subsidies and programs that guarantees a minimum price to EU farmers and ranchers.

Members	*Population (millions)*	*GDP (U.S.$, billions, PPP terms)*	*GDP per capita (U.S.$; PPP terms)*	*Exports as a percentage of GDP*
Austria	8	$299	$36,189	29%
Belgium	10	353	33,908	52
Bulgaria	8	83	10,844	16
Cyprus	1	20	23,419	7
Czech Republic	10	210	20,539	44
Denmark	5	204	37,398	26
Estonia	1	26	19,243	36
Finland	5	179	34,162	29
France	63	1,988	31,377	17
Germany	83	2,699	32,684	26
Greece	11	274	24,733	3
Hungary	10	190	18,922	42
Ireland	4	192	45,135	53
Italy	59	1,791	30,383	17
Latvia	2	34	15,062	21
Lithuania	3	57	16,756	36
Luxembourg	0.5	35	76,025	28
Malta	0.4	8	21,081	44
The Netherlands	17	550	33,079	44
Poland	38	557	14,609	24
Portugal	11	218	20,673	18
Romania	22	219	10,152	51
Slovakia	5	101	18,705	67
Slovenia	2	49	24,459	38
Spain	42	1,203	28,810	16
Sweden	9	297	32,548	30
United Kingdom	61	2,004	32,949	14
	Total: 491	Total: $13,840		

Exhibit 8.4 Key Features of the European Union Member Countries, 2007

SOURCE: International Monetary Fund at www.imf.org

Original goals of the CAP were to provide a fair living standard for agricultural producers and food at reasonable prices for consumers. In reality, however, the CAP has increased food prices in Europe and consumes over 40 percent of the EU's annual budget. It complicates negotiations with the World Trade Organization for reducing global trade barriers. The CAP imposes high import tariffs that unfairly affect exporters in developing economies, such as Africa, that rely heavily on agricultural production. The EU has been working in recent years to reform the CAP, but progress has been slow. Meanwhile, entry into the EU of new member countries since 2004 has increased the number of bloc farmers from 7 to 11 million and increased crop production by 10 to 20 percent.

European Free Trade Association (EFTA)

The second largest free trade area in Europe is the European Free Trade Association (EFTA; see www.efta.int), which was established in 1960 by Austria, Britain, Denmark, Norway, Portugal, Sweden, and Switzerland. However, most of these countries eventually left the EFTA to join the EU. The current EFTA members are Iceland, Liechtenstein, Norway, and Switzerland. The bloc promotes free trade and strengthens economic relations with other European countries and the world. The EFTA Secretariat, headquartered in Geneva, has negotiated trade agreements with several non-European countries. EFTA members cooperate with the EU via bilateral free trade agreements, and, since 1994, through the European Economic Area arrangement, which allows for free movement of people, products, services, and capital throughout the combined area of the EFTA and the EU.

North American Free Trade Agreement (NAFTA)

Consisting of Canada, Mexico, and the United States, NAFTA is the most significant economic bloc in the Americas (see www.nafta-sec-alena.org). Exhibit 8.5 highlights key features of the NAFTA countries. The concept suggests that, in the long run, exchange rates should move toward levels that would equalize the prices of an identical basket of goods and services in any two countries. Since prices vary greatly among countries, economists adjust ordinary GDP figures for differences in purchasing power. Adjusted per capita GDP more accurately represents the amount of products that consumers can buy in a given country, using their own currency and consistent with their own standard of living.

Members	*Population (millions)*	*GDP (U.S.$ billions, PPP terms)*	*GDP per capita (U.S.$; PPP terms)*	*Exports as a percentage of GDP*
Canada	33	$1,225	$37,321	29%
Mexico	108	1,192	10,993	18
United States	302	13,678	45,257	6
	Total: 443	Total: $16,095		

Exhibit 8.5 North American Free Trade Agreement (NAFTA), 2007

SOURCE: International Monetary Fund at www.imf.org

Comparable in size to the EU, NAFTA was launched in 1994. Its passage was smoothed by the existence, since the 1960s, of the *maquiladora* program. Under this program, U.S. firms have been able to locate manufacturing facilities in an area just south of the U.S. border and access low-cost labor and other advantages in Mexico without having to pay significant tariffs.

For its member countries, the NAFTA agreement increased market access. The agreement eliminated tariffs and most nontariff barriers for products and services traded in the bloc, and made it possible for member country firms to bid for government contracts. NAFTA established trade rules and uniform customs procedures and regulations, while prohibiting the use of standards and technical regulations as trade barriers. The member countries agreed to rules for investment and intellectual property rights. NAFTA also provides for dispute settlement in areas such as investment, unfair pricing, labor issues, and the environment.

What did NAFTA accomplish for its members? Since the bloc's inception, trade among the members has more than tripled and now exceeds one trillion dollars per year. In the early 1980s, Mexico's tariffs averaged 100 percent and gradually decreased over time, eventually disappearing under NAFTA. In the 10 years following NAFTA's launch in 1994, U.S. exports to Mexico grew from about $40 billion to more than $110 billion. U.S. exports to Canada nearly doubled, to nearly $200 billion. Canada's exports to Mexico and the United States also more than doubled. In 1994, Mexican exports to the United States averaged about $50 billion per year, compared to over $160 billion by 2005.[7]

Mexico benefited greatly from NAFTA. Access to Canada and the United States helped launch numerous Mexican firms in industries such as electronics, automobiles, textiles, medical products, and services. For instance, Mexico gave birth to a $100 million-per-year dental supply industry, in which entrepreneurs export labor-intensive products such as braces, dental wax, and tools used in dental work to the United States. Annual foreign investment in Mexico rose from $4 billion in 1993 to nearly $20 billion by 2006 as United States and Canadian firms invested in their southern neighbor. In the years following NAFTA's passage, Mexico's per capita income rose substantially, to about $11,000 in 2007, making Mexico the wealthiest country in Latin America in terms of per capita income.[8]

Compared to the days before NAFTA, the member countries now trade more with each other than with former trading partners outside the NAFTA zone. Both Canada and Mexico now have some 80 percent of their trade with, and 60 percent of their FDI stocks in, the United States.[9] By increasing Mexico's attractiveness as a manufacturing location, firms like Gap Inc. and Liz Claiborne moved their factories from Asia to Mexico during the 1990s. IBM shifted much of its production of computer parts from Singapore to Mexico.

NAFTA also stimulated some restructuring in the North American labor market. Falling trade barriers triggered job losses in the North as factories were "exported" to Mexico to profit from its low-cost labor. Nevertheless, increased purchasing power of Mexican consumers meant that they could afford to buy imports from Canada and the United States. As part of the accord, the member countries were also required to strengthen their labor standards. Workers in the NAFTA zone gained the right to unionize. The accord helped to improve working conditions and compliance with labor laws. NAFTA also includes provisions that promote sustainable development and environmental protection.

Let's turn now to a collection of lesser known economic blocs, often composed of developing economies. Compared to the EU or NAFTA, the remaining blocs are less stable and have been less successful. These blocs are located in Latin America, Asia, the Middle East, and Africa.

Members	*Population (millions)*	*GDP (U.S.$ billions, PPP terms)*	*GDP per capita (U.S.$; PPP terms)*	*Exports as a percentage of GDP*
Argentina	39	$599	$15,509	6%
Brazil	189	1,758	9,286	5
Paraguay	6	32	5,264	9
Uruguay	3	38	12,012	4
Venezuela	28	182	6,614	18
Bolivia *	10	28	2,858	7
Chile *	17	225	13,588	12
Colombia *	48	380	7,975	5
Ecuador *	14	62	4,591	13
Peru *	29	190	6,609	6
	Total: 383	Total: $3,494		

* Associate members

Exhibit 8.6 El Mercado Comun del Sur (MERCOSUR), 2007

SOURCE: International Monetary Fund at www.imf.org

El Mercado Comun del Sur (MERCOSUR)

Established in 1991, MERCOSUR, or the *El Mercado Comun del Sur* (the Southern Common Market) has, become the strongest economic bloc in South America (see www.mercosur.int). Exhibit 8.6 provides the membership and key features of the MERCOSUR bloc. The four largest members alone—Argentina, Brazil, Paraguay, and Uruguay—account for some 80 percent of South America's GDP. Within its borders, MERCOSUR established the free movement of products and services, a common external tariff and trade policy, and coordinated monetary and fiscal policies. An additional priority is the construction of reliable infrastructure—roads, electricity grids, and gas pipelines—across a landmass larger than Mexico and the United States combined. MERCOSUR eventually aims to become an economic union.

MERCOSUR's early progress was impressive. It attracted much investment from nonmember countries, particularly in the auto industry. During its first six years, trade among the member countries tripled.[10] In addition to its regular members, MERCOSUR also has five associate members, which have access to preferential trade but not to the tariff benefits of full members. MERCOSUR has trade agreements with various nations outside the bloc. Some predict that MERCOSUR will be integrated with NAFTA and the Dominican Republic-Central American Free Trade Agreement (DR-CAFTA) as part of the proposed Free Trade Area of the Americas (FTAA), bringing free trade to the entire western hemisphere. If implemented, this integration would bring free trade to the entire western hemisphere.

The Caribbean Community (CARICOM)

Composed of roughly 25 member and associate member states around the Caribbean Sea, CARICOM was established in 1973 to lower trade barriers and institute a common external tariff (see www.caricom.org). However, the bloc has met with little success in stimulating economic development. Problems have resulted due to economic difficulties of the individual members and their inability to agree on basic issues. In recent years, the bloc has made much progress toward establishing the Caribbean Single Market, a common market that allows for a greater degree of free movement for products, services, capital, and labor, and gives citizens of all CARICOM countries the right to establish businesses throughout the region.

Comunidad Andina de Naciones (CAN)

Long called the Andean Pact, the Comunidad Andina de Naciones (CAN) was established in 1969 and includes Bolivia, Colombia, Ecuador, Peru, and Venezuela (see www.comunidadandina.org). The CAN countries have a population of 120 million and a combined GDP of $260 billion. CAN is expected to merge with MERCOSUR to form a new economic bloc that encompasses all of South America. The pact achieved little progress in its first 20 years, with intra-bloc trade reaching only 5 percent of the bloc members' total trade.[11] This low trade rate is partially due to geography: The Andes mountain range makes cross-border land transportation costly and cumbersome.

Association of Southeast Asian Nations (ASEAN)

One of the few examples of economic integration in Asia, ASEAN was created in 1967 with the goal of maintaining political stability and promoting regional economic and social development (see www.aseansec.org). Subsequently, ASEAN created a free trade area in which many tariffs were reduced to less than 5 percent. However, further regional integration has been slowed by large economic differences among the member countries. For instance, oil-rich Brunei has a per capita income of over $26,000, while Vietnam's is less than $4,000. The mass movement of workers from poor to prosperous countries that would likely result with further ASEAN integration reduces the likelihood that this bloc will become a common market or an economic union. In the long run, ASEAN aims to incorporate international trading powerhouses like Japan and China, whose membership would accelerate the development of extensive trade relationships. Exhibit 8.7 profiles the ASEAN. Note that Singapore's exports as a percent of its GDP exceed 100 percent. The reason is that Singapore is an entrepôt nation, an import-export platform for Asia, trading far more goods than it manufactures.

Asia Pacific Economic Cooperation (APEC)

Originally suggested by Australia, APEC aims for greater free trade and economic integration of the Pacific Rim countries. It incorporates 21 nations on both sides of the Pacific, including Australia, Canada, Chile, China, Japan, Mexico, Russia, and the United States (www.apec.org). Its members account for 85 percent of total regional trade, as well as one-third of the world's population and over half its GDP. APEC aspires to remove trade and investment barriers by 2020. Nevertheless, APEC has accomplished little. Progress has been slowed by economic and political turmoil in some member countries, as well as failure to agree on foundational issues. Members have varying national economic priorities, and the composition of less affluent Asian countries alongside strong international traders like Australia, Japan, and the United States makes it difficult to achieve agreement on a range of issues.

Members	Population millions	GDP (U.S.$ billions, PPP terms)	GDP per capita (U.S.$; PPP terms)	Exports as a percentage of GDP
Brunei	0.4	$10	$26,098	52%
Cambodia	15	41	2,673	6
Indonesia	225	1,146	5,097	8
Laos	6	15	2,402	3
Malaysia	27	341	12,703	47
Myanmar (Burma)	58	105	1,814	3
Philippines	88	474	5,409	9
Singapore	5	140	31,165	130
Thailand	66	626	9,427	16
Vietnam	86	300	3,503	10
	Total: 576	Total: $3,198		

Exhibit 8.7 Association of Southeast Asian Nations (ASEAN), 2007

SOURCE: International Monetary Fund at www.imf.org

Australia and New Zealand Closer Economic Relations Agreement (CER)

In 1966, Australia and New Zealand reached a free trade agreement that removed 80 percent of tariffs and quotas between the two nations, but was relatively complex and bureaucratic. In 1983, the Closer Economic Relations Agreement (CER) sought to accelerate free trade, leading to further economic integration of the two nations. The CER gained importance when Australia and New Zealand lost their privileged status in the British market as Britain joined the EU. Many believe the CER has been one of the world's most successful economic blocs. In 2005, the members began negotiating a free trade agreement with the ASEAN countries, a move that would further reduce Australia and New Zealand's dependence on trade with Britain.

Economic Integration in the Middle East and Africa

The Middle East and North Africa comprise a collection of primarily Islamic countries where oil is often the driving economic force. The Middle East's primary regional organization is the Gulf Cooperation Council (GCC; see www.gcc-sg.org.htm). Established in 1981 to coordinate economic, social, and cultural affairs, the GCC consists of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. Specific GCC initiatives include coordination of the petroleum industry, abolition of certain tariffs, and liberalization of investment, as well as harmonization of banking, financial, and monetary policies. The GCC also wants to establish an Arab common market and increase trade ties with Asia. Although largely focused on political issues, the GCC has spawned agreements that allow its citizens to travel freely among, and establish businesses in, other member nations.

Elsewhere in the Middle East, efforts have been made for regional economic integration, such as the Arab Maghreb Union (composed of Algeria, Libya, Mauritania, Morocco, and Tunisia) and the Regional Cooperation for Development (RCD; composed of Pakistan, Iran, and Turkey). The Maghreb

Union is still struggling to become a viable economic bloc. The RCD was dissolved in 1979 and replaced by the Economic Cooperation Organization (ECO). The ECO is an international organization that now includes ten Middle Eastern and Asian countries, seeking to promote trade and investment opportunities in the region. Such regional groups are very early attempts at regional integration that may foster the development of inter-Arab trade and investment. Another grouping, the Arab League, is a longstanding political organization with 21 member states and a constitution that requires unanimous agreement in any decision making. It has been relatively unsuccessful in fostering regional economic development.

These workers harvest table grapes growing in Robertson, South Africa. External tariffs of NAFTA and the EU hinder African agricultural exports to Europe and North America.

Africa would like better access to European and North American markets for sales of farm and textile products. African countries believe they can gain clout to negotiate free trade with the developed world by forming economic blocs through regional integration. To this end, the continent has established at least nine economic blocs. Most notable are the Southern African Development Community, the Economic Community of West African States, the Economic Community of Central African States, and, most recently, the African Union for Regional Cooperation. However, these groups have not had much impact on regional trade. This failure is partially due to political turmoil and misunderstandings about free trade, as well as underdeveloped economic and transportation systems. Political instability, civil unrest and war, military dictatorships, corruption, and infectious diseases have prevented economic development in many African countries.

Why Countries Pursue Regional Integration

Economic integration contributes to corporate and industrial growth, and hence to economic progress, better living standards, and higher tax revenues for the member countries. Nations seek at least four objectives in pursuing regional integration.

Expand market size. Regional integration greatly increases the scale of the marketplace for firms inside the economic bloc. For example, while Belgium has a population of just 10 million, the absence of trade barriers with other countries in the EU gives Belgian firms easier access to a total market of roughly 490 million buyers. In a similar way, management at Allianz, the German insurance firm featured in the opening vignette, has come to view Europe as one large marketplace. When NAFTA was formed, Canadian firms gained access to the much larger markets of Mexico and the United States. In this way, consumers also gain access to a greater selection of products and services.

Achieve scale economies and enhanced productivity. Expansion of market size within an economic bloc gives member country firms the opportunity to increase the scale of operations in both production and marketing. This leads to greater concentration and increased efficiency in these activities. For instance, where a German firm may be only moderately efficient when producing 10,000 units of a product strictly for the German market, it greatly increases its efficiency by producing 50,000 units for the much larger EU market. Internationalization inside the bloc helps firms learn to compete more effectively outside the bloc as well. The firms enjoy additional benefits through increased access to factors of production that now flow freely across

Members of MERCOSUR, which include Argentina, Brazil, Paraguay, and Uruguay—seek to expand market size, achieve scale economies, attract foreign direct investment, and build defensive and political posture.

national borders within the bloc.[12] Labor and other inputs are allocated more efficiently among the member countries. More efficient use of resources should lead to lower prices for consumers.

Attract direct investment from outside the bloc. Compared to investing in stand-alone countries, foreign firms prefer to invest in countries that are part of an economic bloc because factories that they build within the bloc receive preferential treatment for exports to other member countries. For example, many non-European firms—including General Mills, Samsung, and Tata—have invested heavily in the EU to take advantage of Europe's economic integration. By establishing operations in a single EU country, these firms gain free trade access to the entire EU market.

Acquire stronger defensive and political posture. One goal of regional integration is to give the member countries a stronger defensive posture relative to other nations and world regions. This was one of the motives for creating the European Community (the precursor to the EU), whose members sought to strengthen their mutual defense against the expanding influence of the former Soviet Union. Today, some view the EU as a means for Europe to counterbalance the power and international influence of the United States. Forming an economic bloc also allows countries to obtain greater bargaining power in world affairs and thereby political power. For example, the EU enjoys greater influence with the World Trade Organization in trade negotiations than any individual member country. Broadly speaking, countries are more powerful when they cooperate together than when they operate as individual entities.

Success Factors for Regional Integration

Experience with regional economic integration suggests that the most successful economic blocs tend to possess the following characteristics.

Economic similarity. The more similar the economies of the member countries, the more likely the economic bloc will succeed. Significant wage rate differences means that workers in lower-wage countries will migrate to higher wage countries. Significant economic instability in one member can quickly spread and harm the economies of the other members. For instance, a severe recession in one country increases the likelihood that others also experience an economic slowdown. Compatibility of economic characteristics is so important that the EU requires its current and prospective members to meet strict membership conditions, ideally low inflation, low unemployment, reasonable wages, and stable economic conditions.

Political similarity. Similarity in political systems enhances prospects for a successful bloc. Countries that seek to integrate regionally should share similar aspirations and a willingness to surrender national autonomy for the larger goals of the proposed union. In the EU, for example, Sweden has encountered difficulties in revising its fiscal policy to be more in line with other EU member countries. Sweden has attempted to lower its corporate income tax rate and other taxes to improve the country's attractiveness as a place to do business in the larger EU marketplace.

Similarity of culture and language. Cultural and linguistic similarity among the countries in an economic bloc provides the basis for mutual understanding and cooperation. This partially explains the success of the MERCOSUR bloc in Latin America, whose members share many cultural and linguistic similarities. Following the passage of NAFTA, it was easier for Canadian firms to establish trade and investment relationships in the United States than in Mexico because of the similarities between the two northern countries.

Geographic proximity. Most economic blocs are formed by countries within the same geographic region; hence the name, *regional integration.* Close geographic proximity of member countries facilitates transportation of products, labor, and other factors of production. Also, neighboring countries tend to be similar in terms of culture and language.

While the four types of similarities enhance the potential for successful regional integration, economic interests are often the most important factor. Dissimilarity in one area can be overcome by similarity in the other areas. This was demonstrated in the EU, whose member countries, despite strong cultural and linguistic differences, are able to achieve common goals based on pure economic interests.

Drawbacks and Ethical Dilemmas of Regional Integration

Regional integration is not a uniformly positive trend. The changes that result from regional integration can threaten firms and other constituents. Regional integration can give rise to ethical and moral concerns. These include:

Trade diversion. At least in the short run, regional integration gives rise to both trade creation *and* trade diversion. *Trade creation* means that trade is generated among the countries inside the economic bloc. This occurs because, as trade barriers fall within the bloc, each member country tends to favor trade with countries inside the bloc over trade with countries outside the bloc. At the same time, once the bloc is in place, member countries will discontinue some trade with nonmember countries, leading to *trade diversion.* The aggregate effect is that national patterns of trade are altered—more trade takes place inside the bloc, and less trade takes place with countries outside the bloc.

For example, suppose that before the formation of NAFTA, Canada and the United States were each self-sufficient in the production of wine. Suppose further that neither country imported wine from the other because of a 100 percent tariff. Now suppose that after the formation of NAFTA and elimination of the tariff, Canada began importing wine from the United States. This is an example of trade creation. Prior to NAFTA Canada had imported all its wine from France because Canada's tariff on wine imports from France was only 50 percent, making French wine cheaper than U.S. wine. Suppose that NAFTA's launch eliminated the higher U.S. tariff and made U.S. wine cheaper than French wine. Canada may then discontinue its wine imports from France in favor of imports from the United States. This is an example of trade diversion. Policymakers worry that the EU, NAFTA, and other economic blocs could turn into economic fortresses resulting in a decline in trade *between* blocs that exceeds the gains from trade *within* the blocs.

Reduced global free trade. In more advanced stages, regional integration can give rise to two opposing tendencies. On the one hand, a country that reduces trade barriers is moving toward free trade. On the other hand, an economic bloc that imposes external trade barriers is moving *away* from *worldwide* free trade. For instance, when countries form a customs union, the members impose common external trade

The European parliament meets in Strasbourg, France, where members of the EU make decisions about regional integration, including trade barriers and fiscal and monetary policy.

barriers and some member countries' external tariffs may actually *rise* relative to the tariffs in place prior to formation of the union.[13] Suppose that Germany, the EU's largest member, once had a 10 percent tariff on imported footwear. Assume that in the process of developing a common market, the EU countries collectively imposed a 20 percent tariff on footwear imports. In effect, Germany's external tariff on footwear has increased. In this way, regional integration results in *higher* trade barriers.

We addressed the harmful effects of import tariffs. Such trade barriers shield sellers inside the economic bloc from competitors based outside the bloc. However, buyers inside the bloc are worse off because they must pay higher prices for the products that they want to consume. Tariffs also counteract comparative advantages and interfere with trade flows that should be dictated by national endowments. All told, external trade barriers imposed by economic blocs result in a net loss in well-being to all the members of the bloc. Finally, because foreign firms sell less into a bloc that imposes restrictions, they are harmed as well. When external suppliers are based in developing economies, the consequences are significant. By limiting imports from such countries, trade barriers imposed by economic blocs threaten the ability of producers in these countries to improve their poor living conditions. This is the case, for example, of agricultural tariffs imposed by the EU and NAFTA blocs. These trade barriers do the most harm to farmers and ranchers in Africa, South America, and other areas characterized by substantial poverty. Governments need to consider the ethical consequences of such barriers when drafting regional integration agreements.[14]

Loss of national identity. When nations join together in an economic bloc, increased cross-border contact has a homogenizing effect; the members become more similar to each other and national cultural identity can be diluted. For this reason, member countries typically retain the right to protect certain industries vital to national heritage or security. For example, Canada has restricted the ability of U.S. movie and TV producers to invest in the Canadian film market. This is because Canada sees its film industry as a critical part of its national heritage and fears the dilution of its indigenous culture from an invasion of U.S. movie and TV entertainment programming. By enacting specific exclusions in the NAFTA accord, Canada has ensured that Canadian TV and movie interests remain largely in the hands of Canadians.

Sacrifice of autonomy. Later stages of regional integration require member countries to establish a central authority in order to manage the bloc's affairs. Each participating country must sacrifice to the central authority some of its autonomy, such as control over its own economy. In this way, nations that join an economic bloc run the risk of losing some of their national sovereignty. Concerns about national sovereignty have been a stumbling block in the development of the EU. In Britain, critics see the passage of many new laws and regulations by centralized EU authorities as a direct threat to British self-governance. Britain is a sovereign nation and the British electorate has little control over legislative efforts by EU federal authorities in continental Europe.[15] The British have resisted joining the European Monetary Union because such a move would reduce the power that they currently hold over their own currency, economy, and monetary regime.

Transfer of power to advantaged firms. Regional integration can concentrate economic power in the hands of fewer, more advantaged firms. Development of the regional marketplace attracts new competitors, from other bloc countries or from outside the bloc, into formerly protected national markets. Foreign invaders that are larger, have stronger brands, or enjoy other advantages can overwhelm local firms in their home markets. Moreover, regional integration encourages mergers and acquisitions within the bloc, leading to the creation of larger rivals. Over time, economic power gravitates toward the most advantaged firms in the bloc. Larger firms come to dominate smaller firms. For example, critics charged that as the

DR-CAFTA accord eliminated trade barriers that had protected Central American economies, U.S. firms entered these countries to manufacture and sell products. Because U.S. firms often enjoy advantages such as large size and better resources, some have come to dominate industries in Central America.

Failure of small or weak firms. As trade and investment barriers decline, protections are eliminated that previously shielded smaller or weaker firms from foreign competition. Companies typically find themselves battling new, often better-resourced rivals. New competitive pressures particularly threaten smaller firms, which may be absorbed or go out of business. The risk can be substantial for companies in smaller bloc countries, or in industries that lack comparative advantages. For example, under NAFTA, many U.S. companies in industries covered by the accord relocated their production to Mexico, the bloc member with the lowest wage rates. As a result, numerous firms in the U.S. tomato-growing industry went out of business as the industry shifted south to Mexico.

Corporate restructuring and job loss. Many firms must restructure to meet the competitive challenges posed in the new, enlarged marketplace of regional integration. Increased competitive pressures and corporate restructuring may lead to worker layoffs or re-assigning employees to distant locations. The resulting turmoil disrupts worker lives and, occasionally, entire communities. For example, MERCOSUR was a factor in the layoff of thousands of workers in Argentina's auto parts manufacturing sector. Low-priced auto parts from Brazil flowed into the MERCOSUR countries following implementation of the MERCOSUR agreement. The intense competition forced parts manufacturers in Argentina to cut costs, leading to worker layoffs.

In addition, regional integration compels many MNEs to centralize managerial control to regional or international headquarters. During this process, national managers may need to surrender some of their power and autonomy. For example, prior to EU unification, the Ford Motor Company maintained national headquarters in each of several European countries. Following EU unification, Ford reassigned some decision-making power from country heads to its European headquarters in Dagenham, England. The company centralized product design responsibilities, brought together pan-European design teams in Dagenham, and transferred financial controls and reporting to headquarters in the United States. Restructuring can prove difficult to managers, such as the head of Ford's subsidiary in Cologne, who resigned rather than lose power.

When they negotiate regional integration agreements, national governments have a responsibility to include provisions that reduce harmful effects such as job losses and the failure of small or weak firms. For example, NAFTA included various clauses aimed at softening the effects of economic restructuring that resulted from passage of the accord. NAFTA included provisions aimed at maintaining or improving labor conditions for workers in the member countries. Firms received long phase-in periods (often 10 years or more) to adjust to falling protectionist barriers. Funds were allocated to support the retraining of workers who lost their jobs due to NAFTA.

Management Implications of Regional Integration

Regional economic integration has implications for company strategy and performance. Many firms modify their strategies to take advantage of new opportunities in the enlarged marketplace or to safeguard their positions against potential threats. Choosing appropriate strategies depends largely on the firm's current position in the regional market, the characteristics of the firm's industry, and on the market's particular rules and regulations. Regional economic integration suggests at least six implications for management.

Internationalization by firms inside the economic bloc. Initially, regional integration pressures or encourages companies to internationalize into neighboring countries within the bloc. The elimination of trade and investment barriers also presents new opportunities to source input goods from foreign suppliers within the bloc. By venturing into other countries in the bloc, the firm can generate new sales and increase profits. Internationalizing into neighboring, familiar countries also provides the firm with the skills and confidence to further internationalize to markets *outside* the bloc. For example, following the formation of NAFTA, many U.S. companies entered Canada and gained valuable international experience that inspired them to launch ventures into Asia and Europe.

Rationalization of operations. Following the creation of an economic bloc, the importance of national boundaries will decrease. Instead of viewing the bloc as a collection of disparate countries, firms begin to view the bloc as a unified whole. Managers develop strategies and value-chain activities suited to the region as a whole, rather than to individual countries. *Rationalization* is the process of restructuring and consolidating company operations that managers often undertake following regional integration. When a firm rationalizes, it reduces redundancy. The goal is to reduce costs and increase the efficiency of operations. For example, management may combine two or more factories into a single production facility that eliminates duplication and generates economies of scale. Rationalization becomes an attractive option because, as trade and investment barriers decline, the firm that formerly operated factories in each of several countries reaps advantages by consolidating the factories into one or two central locations inside the economic bloc.

As an example, prior to formation of the EU, many companies operated factories in each of numerous European countries. After the EU's launch, these firms merged their plants into one or two European countries. Companies centralized plants in the EU locations that offered the lowest-cost operations and other competitive advantages. Thus, Caterpillar, the U.S. manufacturer of earth-moving equipment, was one of many companies that shifted its focus from serving individual European countries to serving the EU region. Caterpillar undertook a massive program of modernization and rationalization at its EU plants to streamline production, reduce inventories, increase economies of scale, and lower operating costs.

Companies can apply rationalization to other value-chain functions such as distribution, logistics, purchasing, and R&D. For example, following formation of the EU, the elimination of trade barriers, customs checkpoints, and country-specific transportation regulations allowed U.S. firms to restructure their EU distribution channels to make them better suited to the greatly enlarged EU marketplace. Creation of the economic bloc eliminated the need to devise separate distribution strategies for individual countries. Instead, the firms were able to employ a more global approach for the larger marketplace, generating economies of scale in distribution.

Mergers and acquisitions. The formation of economic blocs also leads to mergers and acquisitions (M&A); that is, the tendency of one firm to buy another, or of two or more firms to merge and form a larger company. Mergers and acquisitions are related to rationalization. The merger of two or more firms creates a new company that produces a product on a much larger scale. As an example, two giant engineering firms, Asea AB of Sweden and Brown, Boveri & Co. of Switzerland, merged to form Asea Brown Boveri (ABB). The merger was facilitated by regional integration of European countries in the development of the EU economic bloc. The merger allowed the new firm, ABB, to increase its R&D activities and pool greater capital funding for major projects, such as construction of power plants and large-scale industrial equipment. In the pharmaceutical industry, Britain's Zeneca purchased Sweden's Astra to form AstraZeneca. The acquisition led to the development of blockbusters such as the ulcer drug Nexium and helped transform the new company into a leader in the gastrointestinal, cardiovascular, and respiratory areas.

Regional products and marketing strategy. Regional integration can also stimulate companies to *standardize* their products and services. Companies prefer to offer relatively standardized merchandise in their various markets. The reason is that it is easier and much less costly to make and sell a few product models than dozens of models. An economic bloc facilitates the streamlining and standardization of products and marketing activities because, in more advanced stages of regional integration, the member countries tend to harmonize product standards and commercial regulations, and eliminate trade barriers and transportation bottlenecks. As conditions in the member countries become similar to each other, companies can increasingly standardize their products and marketing.[16]

For example, prior to EU unification, in order to comply with varying national regulations regarding the placement of lights, brakes, and other specifications on tractors sold in Europe, J. I. Case, a manufacturer of agricultural machinery, had produced numerous versions of its Magnum model of farm tractors. Where Case once produced 17 versions of the Magnum, the harmonization of EU product standards allowed the firm to standardize its tractor, allowing it to produce only a handful of models that were, nevertheless, appropriate for serving all the EU market.[17]

Internationalization by firms from outside the bloc. Regional integration leads to the creation of large multicountry markets, which are attractive to firms from *outside* the bloc. Such foreign firms tend to avoid exporting as an entry strategy because economic blocs erect trade barriers against imports from outside the bloc. Accordingly, the most effective way for a foreign firm to enter an economic bloc is to establish a physical presence there via FDI. By building a production facility, marketing subsidiary, or regional headquarters anywhere inside a bloc, the outsider gains access to the entire bloc and obtains advantages enjoyed by local firms based inside the bloc. As an example, since formation of the EU, Britain has become the largest recipient of FDI from the United States. U.S. firms choose Britain as the beachhead to gain access to the massive EU market. In a similar way, European firms have established factories in Mexico to access countries in the NAFTA bloc.

Collaborative ventures. Regional integration creates opportunities for cooperation among firms located inside their own bloc. For example, following creation of the European Community, the precursor to the EU, firms from France, Germany, Spain, and the United Kingdom collaborated to establish Airbus Industries, the giant commercial aircraft manufacturer. The elimination of trade and investment barriers in the EU allowed Airbus to move aircraft parts, capital, and labor among the member countries from one factory to another. In a similar way, firms from outside an economic bloc also benefit from regional integration. Outsiders ease their entry into the bloc by entering joint ventures and other collaborative arrangements with companies based inside the bloc.

In 1990, there were approximately 50 regional economic integration agreements worldwide. Today there are some 200, in various stages of development. As the growth in world trade continues apace, nations want to be part of emerging opportunities. Governments continue to liberalize trade policies, encourage imports, and restructure regulatory regimes, largely through regional cooperation. Many nations belong to several free trade agreements. Economic blocs are joining with other blocs around the world. More nations are clamoring to join the EU, which has signed trade agreements with other economic blocs worldwide. Other intercontinental blocs are underway. Empirical evidence since the 1970s suggests that regional economic integration is not slowing the progress of global free trade.[18] It is more likely that global free trade will gradually emerge as economic blocs link up with each other over time. The evidence suggests that regional economic integration is gradually giving way to a system of worldwide free trade.

CLOSING CASE

Russell Corporation: The Dilemma of Regional Free Trade

Russell Corporation is a leading manufacturer of sportswear, including sweatshirts, sweatpants, and T-shirts. Owned by Berkshire Hathaway, Russell is based in Atlanta, Georgia, in the United States, and has annual revenues of around $2 billion. Its main competitors include Adidas, Nike, Benetton, and Zara. Russell runs every step of the manufacturing process: from weaving raw yarn into fabric, to dyeing, cutting, and sewing, to selling garments through retailers. Russell's brands include JERZEES, American Athletic, Brooks, Cross Creek, Huffy Sports, Russell Athletic, and Spalding. The firm sells through mass merchandisers, department stores such as Wal-Mart, and golf pro shops. Russell sells its apparel in about 100 countries and recently restructured production. The firm closed plants, moved some manufacturing abroad, and eliminated 1,700 U.S. jobs.

Management at Russell was pleased with the passage of the Dominican Republic-Central American Free Trade Agreement (DR-CAFTA) in 2005. The pact eliminated trade barriers between the United States and six Latin American countries: Guatemala, Honduras, El Salvador, Nicaragua, Costa Rica, and the Dominican Republic. Following DR-CAFTA's passage, Central American countries experienced a significant rise in foreign direct investment (FDI) from abroad. The apparel and clothing sector—consisting of firms like Russell—were among the biggest beneficiaries.

Prior to DR-CAFTA, many North American apparel companies sourced from China and other Asian nations, where production costs are low. DR-CAFTA virtually eliminated tariffs on trade between the United States, Central America, and the Dominican Republic. Now Russell can cost-effectively source raw materials in Central America, manufacture fabric in the United States, then send the fabric to its factories in Honduras for assembly. Once the garments are completed, they are re-exported to the U.S. for distribution. Without DR-CAFTA, it would not have been cost effective to make fabric in the United States, export it to Asia, have the products manufactured there and then reexported back. Under that scenario, Russell would have shifted *all* its manufacturing to China.

Background on DR-CAFTA

In the past, Central America and the Caribbean were parties to various protectionist trade arrangements, including the worldwide Multi-Fibre Agreement (MFA) of 1974. Among its provisions, the MFA shielded the North and Central American apparel industries from foreign competition by imposing strict import quotas. When the MFA expired in 2005, many countries became exposed to the full force of cheap imports from low-cost producers in Asia. China dramatically increased its apparel exports to the United States, to the detriment of U.S. and Central American producers that long had supplied Western markets. For example, Alabama was once the world center of sock manufacturing. When the MFA expired, the sock capital shifted to Datang, China. Alabama sock workers receive an average of $10 an hour, compared to 70 cents an hour in Datang.

Since the expiration of the MFA, China has been flooding the United States with apparel. In recent years, China's share of finished clothing exports to the United States, once less than 20 percent, has leaped past 50 percent in some segments. To protect its home-grown apparel industry, the United States reimposed some trade barriers against Chinese imports. The U.S. government justified this action in part because China's currency, the yuan, is considered undervalued, which makes Chinese exports artificially cheap. However, such protection of the U.S. apparel industry is only temporary. World Trade Organization rules require the U.S. government to remove the trade barriers, at which time Chinese exports to the United States will increase.

Many in the U.S. apparel industry see DR-CAFTA as perhaps the only way to compete with China. DR-CAFTA helps maintain much apparel production in the Western Hemisphere by creating a bigger apparel market in the region and granting favorable trade status to apparel producers who manufacture their products using raw material from the DR-CAFTA region.

The United States is the biggest apparel market, importing more than $9 billion worth of apparel from the DR-CAFTA countries in each of 2004, 2005, and 2006. Honduras was the biggest shipper in dollar value, and exported products such as cotton blouses, shirts, and underwear. Meanwhile, DR-CAFTA gave U.S. producers an equal footing to sell their products to Central America. For example, the region is the second largest market for U.S. textiles and yarn, which Central American manufacturers use to produce finished apparel.

The DR-CAFTA countries are part of a large and growing trade region, and the free trade agreement is helping to improve economic conditions there. Perhaps the most important long-term benefit will be foreign investment in new technologies and a better-educated regional labor force. Some see DR-CAFTA as a further step toward development of the Free Trade Area of the Americas (FTAA), a proposed agreement that would bring free trade to all or most of North, Central, and South America.

The Situation in Honduras

Russell manufactures much of its garments in Honduras, a poor Central American country with 7 million people, one quarter of whom are illiterate. Honduras has an annual per-capita GDP of about $3,000. In 2006, the country's unemployment rate was 28 percent. The Honduras currency, the lempira, has been weakening against the U.S. dollar over time. Growth remains dependent on the U.S. economy, its largest trading partner, and on reduction of the high local crime rate. Honduras sends over 73 percent of its exported goods to the United States and receives about 53 percent of its imports from that country. The Honduran government is counting on the DR-CAFTA agreement to increase trade with the United States and the Central American region.

Few countries rely on their apparel industry more than Honduras. The Honduran government used incentives to create a large cluster of apparel firms. In addition to low-cost labor, Honduras offers a generous tax package: firms pay no income tax, value-added tax, or duties. Honduran apparel manufacturers can truck their merchandise to Puerto Cortes, Central America's biggest port, in just 30 minutes. From there, it takes only 22 hours to ship the goods to Miami by container ship. Honduras' apparel sector employs over 110,000 people, or 30 percent of the country's total industrial employment. The government is investing to improve Puerto Cortes and create a Textiles and Apparel University to train future managers and supervisors. To counter Chinese competition, the apparel industry in Honduras has begun to offer the "total package"—buying fabric, and sometimes even designing the garments, as well as final assembly.

Some Honduran apparel plants employ sophisticated technologies to increase productivity and output. For example, one supplier uses computer-aided design to cut cloth before sending it to be stitched into shirts for brands such as Jockey, Ralph Lauren, and Nautica. In 2003, the stock of U.S. FDI in Honduras was $262 million and rose to $339 million the following year. However, Honduras' legal system remains weak and corruption is a problem.

Honduran apparel producers are taking steps to survive in the evolving free trade environment. Geographic proximity to the United States is a big advantage that gives producers greater flexibility to respond quickly to rapidly evolving tastes. Honduran producers can ship finished merchandise to the United States in less than 24 hours, while similar shipments from China take up to a month.

Russell's Dilemmas

Many consumers shop for athletic clothing based on price, so even slight price increases can affect sales. Unlike Nike and Adidas, Russell does not enjoy much brand loyalty. Russell must decide whether to retain its manufacturing in Honduras or move everything to China. An additional possibility is to establish production in Eastern Europe to gain access to the huge EU market. Meanwhile, Adidas and Nike are pursuing markets in China and other Asian countries. Labor costs for manufacturing apparel are similar in Central America and China. In both locations, workers earn around a dollar per hour and can produce over a hundred garments per day, from precut cloth. Labor costs are roughly $2 an hour in Eastern Europe, but producers are advantaged by being so close to the nearly 500 million consumers in the EU.

Management at Russell is keeping an eye on the proposed FTAA, which would widen access to the Latin American marketplace with its 500 million consumers. Maintaining a presence in Latin America would give Russell a favorable position for targeting new markets there. But progress on the FTAA has been slowed due to hostile public and governmental opposition from some South American countries. Governments in countries such as Bolivia and Venezuela argue that the FTAA will increase U.S. dominance in the region and harm local workers, subjecting them to sweatshop working conditions.

Meanwhile, regional integration is creating a larger market in the Western Hemisphere and new opportunities to source low-cost inputs from regional suppliers. While increased competition from China poses new challenges, the DR-CAFTA accord is helping to level the playing field. Russell management is concerned about manufacturing costs that are higher than competitors and is poised to consolidate much of its production into suppliers located close to its home market. At the same time, Russell is also contemplating new markets in the Americas and beyond.

AACSB: Reflective Thinking, Ethical Reasoning

Case Questions

1. Worldwide, China has the most absolute and comparative advantages in producing apparel. Free trade theory implies that retailers should import clothing from the most efficient country. Nevertheless, DR-CAFTA aims to promote Central American trade with the United States, and the United States has imposed quotas on imports from China. Given this, and the potential drawbacks of regional integration, would it be better to allow free trade to take its natural course? That is, would it be better to rescind DR-CAFTA and allow apparel retailers to import from the most cost-effective suppliers, wherever they are located worldwide?

2. What are the advantages and disadvantages of DR-CAFTA to Honduran firms? To Honduras as a nation? Should free trade be extended throughout Latin America through the proposed FTAA?

3. Honduras is a poor country that faces the loss of jobs in its apparel sector from growing foreign competition. What can the Honduran government do to help keep jobs in Honduras? The government can address some problems by attracting more foreign investment into Honduras. In what ways could foreign investment help? What steps could the government take to attract more FDI?
4. Russell Corporation is a smaller player than its formidable rivals, Adidas and Nike. What should Russell do to counter these firms? What should Russell do to counter the flood of low-cost athletic apparel now entering the United States from China? What strategic approaches should Russell follow to ensure its future survival and success?

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CHAPTER ESSENTIALS

Key Terms

common market, p. 227
customs union, p. 226
economic union, p. 227
free trade agreement, p. 225
free trade area, p. 225
regional economic integration, p. 224
regional economic integration bloc, p. 225

Summary

In this chapter, you learned about:

1. **Regional integration and economic blocs**

   Regional economic integration involves groups of countries forming alliances to promote free trade, cross-national investment, and other mutual goals. This integration results from **regional economic integration blocs** (or economic blocs), in which member countries agree to eliminate tariffs and other restrictions on the cross-national flow of products, services, capital, and, in more advanced stages, labor, within the bloc. At minimum, the countries in an economic bloc become parties to a **free trade agreement**, which eliminates tariffs, quotas, and other trade barriers.

2. **Types of regional integration**

   For countries that become members of an economic bloc, there are various stages of regional integration. First is the **free trade area**, in which tariffs and other trade barriers are eliminated, and that emerge when nations sign a free trade agreement. Second is the **customs union**, a free trade area in which common trade barriers are imposed on nonmember countries. Third is the **common market**, a customs union in which factors of production move freely among the members. Fourth is the **economic union**, a common market in which some important economic policies are harmonized among the member states. A true *political union* does not yet exist.

3. **Leading economic blocs**

   There are roughly 200 economic integration agreements in the world. The European Union (EU) is the most advanced of these, comprising 27 countries in Europe. The EU has increased market access, improved trade rules, and harmonized standards among its members. Europe is also home to the European Free Trade Association. In the Americas, the most notable bloc is the North American Free Trade Agreement (NAFTA). The bloc consists of Canada, Mexico, and the United States. NAFTA has reached only the free-trade-area stage of regional integration. Other economic blocs in the Americas include MERCOSUR, CARICOM, and CAN. In the Asia/Pacific region, ASEAN, APEC, and the Australia and New Zealand Closer Economic Relations Agreement (CER) are the leading blocs. Economic blocs in Africa and the Middle East have experienced only limited success.

4. **Why countries pursue regional integration**

   Regional integration contributes to corporate and industrial growth, and hence to economic growth, better living standards, and higher tax revenues for the member countries. It increases market size by integrating the economies within a region. It increases economies of scale and factor productivity among firms in the member countries and attracts foreign investors to the bloc. Regional integration also increases competition and economic dynamism within the bloc, and increases the bloc's political power.

5. **Success factors for regional integration**

   The most successful blocs consist of countries that are relatively similar in terms of culture, language, and economic and political structures. The countries should also be close to each other geographically. Countries can overcome major differences in any one of these factors if there are strong similarities in all the other factors.

6. Drawbacks and ethical dilemmas of regional integration

Regional integration simultaneously leads to *trade creation,* whereby new trade is generated among the countries inside the bloc, and *trade diversion,* in which member countries discontinue some trade with countries outside the bloc. Regional integration entails specific disadvantages. It can reduce global free trade, particularly when member countries form a customs union that results in substantial trade barriers to countries outside the bloc. When economic blocs involve many countries of various sizes, regional integration can concentrate power into large firms and large nations inside the bloc. Regional integration results in economic restructuring, which may harm particular industries and firms. When a country joins an economic bloc, it must relinquish some of its autonomy and national power to the bloc's central authority. Individual countries risk losing some of their national identity.

7. Management implications of regional integration

Regional integration leads to increased internationalization by firms inside their economic bloc. Firms reconfigure and rationalize their operations in line with the larger internal market. Management reconfigures value-chain activities on a pan-regional basis. The formation of economic blocs also leads to mergers and acquisitions because the emergence of a new, larger market favors the creation of larger firms. Managers revise marketing strategies by standardizing products and developing regional brands. Regional integration also leads firms from outside the bloc to expand into the bloc, often via direct investment and collaborations with bloc firms. But regional integration leads to competitive pressures and other challenges to firms inside the bloc, some of which may lay off workers or go out of business.

Test Your Comprehension AACSB: Reflective Thinking

1. What is a regional economic integration bloc (also called an economic bloc)?
2. What is the role of free trade agreements in the formation of economic blocs?
3. What are the different levels of economic integration?
4. Differentiate between a free trade area and a customs unions. Differentiate between a customs unions and a common market.
5. What are the world's leading economic blocs? Which blocs are most advanced in terms of regional integration?
6. Describe the major characteristics of the European Union and NAFTA.
7. Why do nations seek to join or form economic blocs? What are the advantages of such arrangements?
8. What national conditions contribute to the success of economic integration?
9. Explain the drawbacks of regional integration for nations. Explain the drawbacks for firms.
10. Distinguish between trade creation and trade diversion.
11. What strategies should companies employ to maximize the benefits of regional integration?

Apply Your Understanding

AACSB: Ethical Reasoning, Reflective Thinking, Communication

1. There are some 200 economic integration agreements in effect around the world already, far more than even a few years ago. Virtually every country is now party to one or more free trade agreements. Supporters argue that free trade is good for nations. What is the basis for their support? That is, what are the specific benefits that countries seek by joining an economic bloc? What is the main economic bloc for your country? From your perspective, what advantages has bloc membership brought to your country? What disadvantages has bloc membership produced?

2. The United States is in free trade agreements with Mexico, Canada (NAFTA), and several Central American countries (via the DR-CAFTA accord featured in the *Closing Case*), among others. Critics charge that these agreements are harmful because of the substantial wage differences with the partner countries. For example, a Mexican worker may earn one-fifth the hourly wage of a U.S. worker. Critics further argue it would be unwise for the United States to establish a common market or economic union with Latin American countries. They argue that a U.S. worker will be disadvantaged relative to a Mexican worker if he or she does not work with more or better natural resources than the Mexican, have a better skill set, and have access to better technology. What can U.S. firms do to maintain their competitiveness relative to Mexican firms, given Mexico's advantage in low wages? It is likely that some day the United States will form a common market with Mexico and other Latin American partners. In your view, what conditions should be in place before such an agreement is allowed to go forward?

3. Following implementation of free trade agreements, trade has grown *within* each of the CARICOM and CAN economic blocs. The growth of within-bloc trade implies that exports from your country to these blocs may be declining over time. Discuss strategies for counteracting such a shift. What recommendations would you make to a company for pursuing opportunities within these blocs? What is the role of international business research, market entry strategy, foreign direct investment, marketing strategy, and collaboration for maintaining or augmenting commerce with these blocs?

globalEDGE Internet Exercises

(http://globalEDGE.msu.edu)

AACSB: Reflective Thinking, Analytical Skills, Ethical Reasoning

Refer to Chapter 1, page 27, for instructions on how to access and use globalEDGE™.

1. There has been much opposition to the Free Trade Area of the Americas (FTAA). For a sampling of arguments against this proposed pact, visit www.globalexchange.org; www.citizenstrade.org/stopftaa.php; and www.corpwatch.org. Also visit the official site of the FTAA at www.ftaa-alca.org, or get information on the proposed pact from globalEDGE™. Based on your reading of the chapter, evaluate the anti-FTAA arguments. What is your position? Do you agree or disagree with arguments made by the critics? Why or why not? Do you think the proposed FTAA would harm small Latin American countries? Would it be a boon only to large countries such as Brazil, Canada, and the United States?

2. Visit the Web sites of three major economic blocs. One way to do this is to enter the acronyms for each bloc into a globalEDGE™ search. Using the "Success Factors for Regional Integration" framework highlighted in this chapter, discuss the likely long-term prospects for success in each of these blocs. For each bloc, which of the success factors are strongest and which are weakest? Which bloc seems to have the best chances for long-term success? Why?

3. NAFTA is a free trade area, and the EU is a common market. Visit the Web sites of these two economic blocs, www.nafta-sec-alena.org and europa.eu.int, and explain the business strategy implications of each type of economic bloc. Small and medium-sized enterprises (SMEs) tend to be disadvantaged when it comes to competing against large corporations in regional economic blocs. What steps can SMEs in particular take to maximize prospects for success when doing business in a free trade area? What steps can SMEs take when doing business in a common market?

CKR Cavusgil Knight Riesenberger

Management Skill Builder©

Entering the Retailing Sector in the New EU Member States

Retailers expand internationally primarily through foreign direct investment. Major retailers such as Wal-Mart and Tesco have been expanding abroad since the 1970s. Recently, retailers have been targeting Eastern European countries that have joined the European Union (EU) since 2004. With a population of almost a half-billion people, the EU is an impressive potential market. However, recent enlargement of the EU from 15 to 27 members has proven difficult. Challenges have arisen due to differences in the economic conditions and the developmental stage of the new members, which are mainly Eastern European countries and former satellites of the Soviet Union.

AACSB: Reflective Thinking, Analytical Skills

Managerial Challenge

Numerous retailers are making plans to take advantage of the entry of new country markets into the EU. However, choosing the best markets to locate stores is complex because there are so many locations to consider. Managers conduct research to ensure they establish stores in locations most likely to enhance company performance.

Background

As a single unit, the EU has the largest economy in the world. The countries that joined the EU since 2004 differ in many ways from the original EU members. Most are former Soviet satellites that were under a communist command economy for several decades. New entrants such as Poland, Hungary, and the Czech Republic had to adjust their economies to qualify for EU membership. There are substantial business opportunities in these countries for large-scale retailers. Income levels in the new members are growing and the countries are excellent sites from which retailers can source manufactured goods at lower cost.

Managerial Skills You Will Gain

By completing this C/K/R Management Skill Builder©, as a prospective manager, you will:

1. Learn about the EU and its expansion to include countries in Eastern Europe.
2. Examine conditions in Eastern Europe faced by potential entrants.
3. Understand the factors to consider when locating retail stores abroad.
4. Determine how country factors relate to maximizing competitive advantage in the location of retail stores.

Your Task

Assume that you work for a large retailer, such as Wal-Mart, Tesco, or Zara. Management wants to expand into new member states of the European Union. Your task is to conduct research to determine the most attractive location for establishing a large retail store and central distribution center.

Go to the C/K/R Knowledge Portal©

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Proceed to the C/K/R Knowledge Portal© to obtain the expanded background information, your task and methodology, suggested resources for this exercise, and the presentation template.