

# **International Trade and Policy**

## **WEEK 8 – Trade Agreements and Regional Integration**

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# Agenda

- What is Regional Integration?
- Types of Economic Integration (FTA to Political Union)
- Key Concepts: Trade Creation vs. Trade Diversion
- Rules of Origin
- Deep vs. Shallow Agreements
- Case Study 1: European Union (EU)
- Case Study 2: Eurasian Economic Union (EAEU)
- Conclusions & Q&A

# Why Do Countries Integrate?

## *Section 1: Introduction*

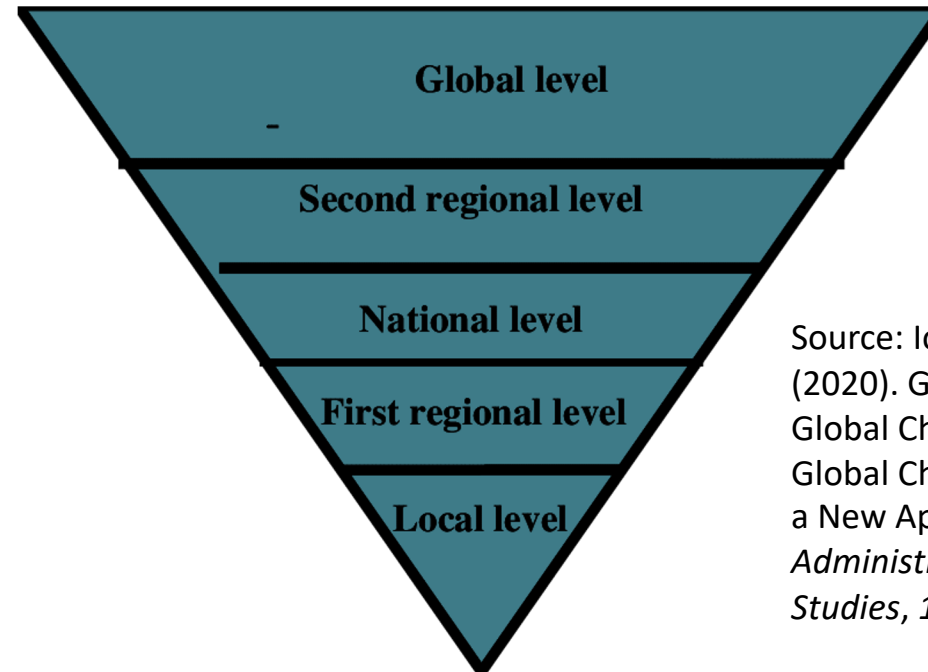
- **Economic Benefits:** Larger markets, economies of scale, increased FDI
  - **Political Benefits:** Peace, stability, collective bargaining power
  - **Strategic Benefits:** Reduce dependency on non-member states
  - **Challenge:** Loss of some policy sovereignty
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# The Spectrum of Integration

**Low integration: Preferential Access**

- Free Trade Area
- Customs Union
- Common Market
- Economic Union

**High integration: Political Union**



Source: Ionescu, V. R. (2020). Globalisation, Global Challenges and Global Chaos. The Need of a New Approach. *Public Administration & Regional Studies*, 13(1), 4-17.

# Key Terminology

- **Trade Agreement:** A pact between countries on trade terms
  - **Regional Integration:** Process where neighboring states cooperate via common institutions/rules
  - **WTO+:** Provisions going beyond WTO commitments
  - **WTO-X:** Issues not covered by WTO (e.g., investment, competition policy)
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# Type 1 – Preferential Trade Agreement (PTA)

## Section 2: Types of Economic Integration

- **Definition:** Lower tariffs on certain products from certain countries
  - **Not full free trade** – selective reductions
  - **Example:** Global System of Trade Preferences (GSTP) among developing countries
  - **Limitation:** Complex and often limited impact
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## Type 2 – Free Trade Area (FTA)

- **Definition:** Eliminate internal tariffs/quota; each country keeps its own external tariff
  - **Key feature:** Rules of Origin (RoO) to prevent trade deflection
  - **Examples:** USMCA (NAFTA successor), AFTA (ASEAN)
  - **Challenge:** “Trade deflection” – goods enter via lowest external tariff country
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# Type 3 – Customs Union

- **Definition:** FTA + Common External Tariff (CET) on non-members
  - **Eliminates need for Rules of Origin internally**
  - **Examples:** Mercosur (partial), EU's original form (1968-1992)
  - **Benefit:** Simpler customs administration
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## Type 4 – Common Market

- **Definition:** Customs Union + Free movement of factors of production (labor, capital)
  - **Additional elements:** Mutual recognition of qualifications, capital market integration
  - **Examples:** European Economic Area (EEA), early EU (1993 – Maastricht)
  - **Challenge:** Requires harmonized labor and business laws
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## Type 5 – Economic Union

- **Definition:** Common Market + Harmonized economic policies (fiscal, monetary)
  - **Shared currency possible (monetary union)**
  - **Examples:** EU (Eurozone countries)
  - **Requires:** Central bank, budget coordination, transfer payments
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# Type 6 – Political Union

- **Definition:** Complete integration – common government, parliament, military, foreign policy
  - **Not yet fully achieved anywhere** (EU is closest but still intergovernmental on key issues)
  - **Example in progress:** EU federalist aspirations
  - **Historical example:** United States after 1789
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# Visual Summary – Depth of Integration

Type	Internal Tariffs	Common External Tariff	Factor Mobility	Unified Policies
PTA	Partial	No	No	No
FTA	Yes	No	No	No
Customs Union	Yes	Yes	No	No
Common Market	Yes	Yes	Yes	No
Economic Union	Yes	Yes	Yes	Partial
Political Union	Yes	Yes	Yes	Full

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# Why Not Just Jump to Political Union?

- Loss of national sovereignty is politically difficult
  - Requires similar income levels and business cycles
  - Need for fiscal transfers (rich to poor regions)
  - Cultural and language barriers
  - Democratic accountability concerns
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# Regional Integration in the World

- European Union (EU),
  - EurAsian Economic Union (EAEU),
  - United States-Mexico-Canada Agreement (**USMCA**)
  - Association of Southeast Asian Nations (**ASEAN**),
  - Southern Common Market (**MERCOSUR**),
  - African Continental Free Trade Area (**AfCFTA**),
  - Gulf Cooperation Council (**GCC**),
  - South Asian Association for Regional Cooperation (**SAARC**)
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# Checkpoint – Activity

- **Question:** Which type of integration is the Eurasian Economic Union (EAEU) officially?
- **Answer:** Customs Union + some common market elements – officially an Economic Union, **but incomplete**)



Source: India Briefing from Dezan Shira Associates

<https://www.india-briefing.com/news/india-expands-industrial-cooperation-with-the-eurasian-economic-union-29472.html/>

## Section 3: Trade Creation vs. Trade Diversion

### *The Core Welfare Question*

- **Integration is not automatically good** – depends on whether it creates or diverts trade
  - Introduced by Jacob Viner (1950)
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# Trade Creation (Good)

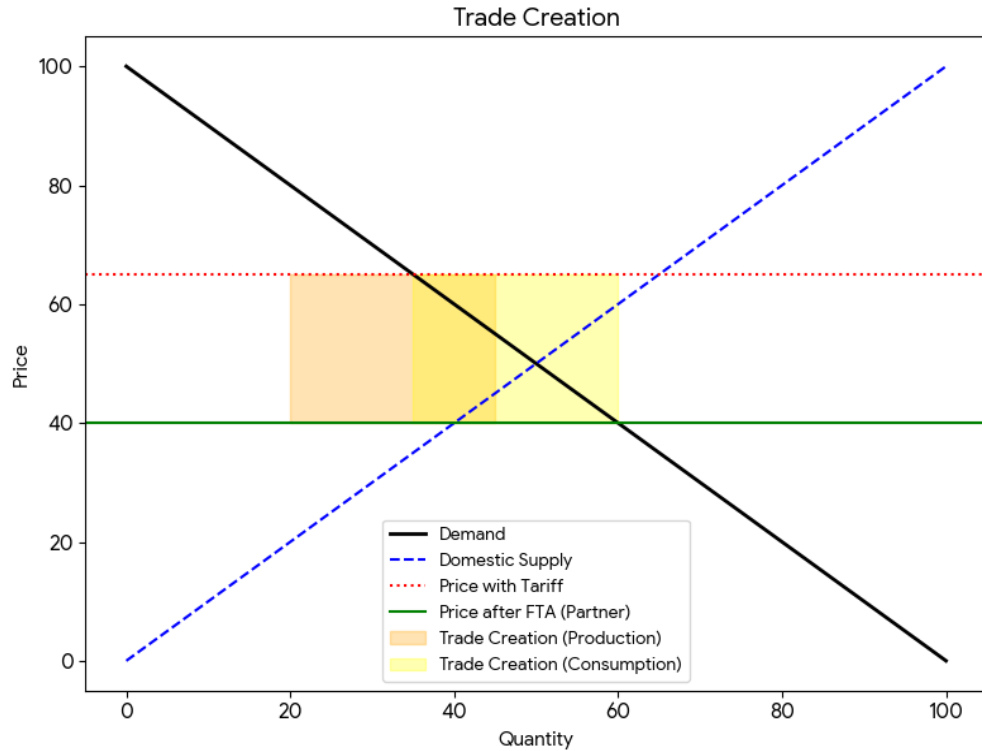
- **Definition:** High-cost domestic production replaced by lower-cost partner production
  - **Result:** More efficient resource allocation → world welfare ↑
  - **Example:** Germany buys wine from France (low cost) instead of making poor wine in greenhouses
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## Trade Diversion (Potentially Bad)

- **Definition:** Low-cost world producer replaced by higher-cost partner producer due to tariff preferences
  - **Result:** Less efficient allocation → world welfare ↓ (though member gains)
  - **Example:** UK joins EU – stops buying cheap bananas from Central America, buys more expensive Greek bananas (tariff-free inside EU)
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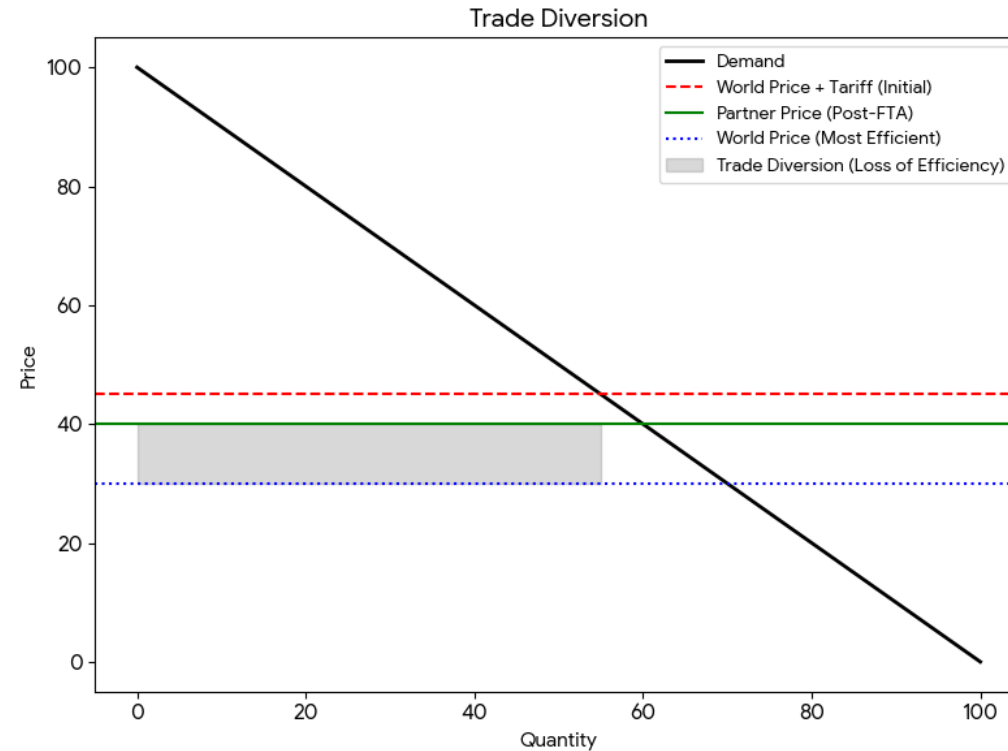
# Visual Comparison

## Figure 1: Trade Creation



Source: Created by the author

## Figure 2: Trade Diversion



Source: Created by the author

# Net Effect on a Country

- **Determinants of net gain:**
    - High pre-integration external tariffs (more to gain)
    - Similar cost structures among partners (less diversion risk)
    - Geographic proximity (lower transport costs)
  - **Empirical finding:** Most FTAs are net trade-creating, but some sectors lose
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# Section 4: Rules of Origin (RoO)

## What Are Rules of Origin?

- **Definition:** Criteria to determine the “nationality” of a product in an FTA
  - **Why needed?** Without RoO, non-members could ship goods via the lowest-tariff member country (trade deflection)
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# Types of Rules of Origin

- **Wholly obtained:** Agricultural products, minerals (100% from within FTA)
  - **Substantial transformation:** Change in tariff classification (CTH – Change in Tariff Heading)
  - **Value-added rule:** Minimum % of regional value content (e.g., 40% from FTA)
  - **Specific processes:** “Yarn forward” rule in textiles
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# The “Spaghetti Bowl” Effect

- **Problem:** Multiple overlapping FTAs with different RoO → high compliance cost
  - **Example:** A car part may need different RoO for USMCA vs. EU-Japan FTA
  - **Solution:** Cumulation (diagonal or full cumulation across agreements)
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# Costs and Benefits of RoO

Benefits	Costs
Prevents trade deflection	Administrative burden
Protects sensitive domestic industries	Discourages use of FTA preferences
Encourages local supply chains	Creates compliance costs for SMEs

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# Real-World Example – USMCA Auto RoO

- **USMCA** (2020) increased Regional Value Content (RVC) for autos:
    - 75% (up from 62.5% in NAFTA)
    - 70% steel/aluminum must be North American
    - 40-45% of auto content from high-wage (\$16/hr) labor
  - **Purpose:** Force auto production back to North America
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# Deep vs. Shallow Agreements

## *Definition*

- **Shallow agreements:** Only tariffs and quotas
  - **Deep agreements:** Tariffs + behind-the-border policies
    - ✓ Investment, competition policy, labor standards, environmental rules, IPR, digital trade, regulatory coherence
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# The Deepening Trend

- 1950s-80s: Shallow FTAs (goods only)
  - 1990s-2000s: Added services, investment, IP (WTO+)
  - 2010s+: Deep integration (regulatory alignment, e-commerce, state-owned enterprises)
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# Examples of Deep Provisions

- **Regulatory coherence:** Mutual recognition of standards
  - **Labor & environment:** Enforceable chapters (e.g., USMCA)
  - **E-commerce & data flows:** No data localization
  - **Competition policy:** Anti-trust cooperation
  - **State-owned enterprises (SOEs):** Disciplines on subsidies
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# Why Deep Integration Matters

- **Modern trade is in tasks, not just goods** (global value chains)
  - Non-tariff measures (NTMs) are now bigger barriers than tariffs
  - Deep agreements raise FDI by 20-40% (World Bank study)
  - **Downside:** Greater sovereignty loss → political backlash
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# Shallow vs. Deep – Comparison

<b>Aspect</b>	<b>Shallow</b>	<b>Deep</b>
<b>Focus</b>	Border measures	Behind-the-border
<b>Sovereignty loss</b>	Low	High
<b>Enforcement</b>	Tariff reduction only	Strong dispute settlement
<b>Impact on trade</b>	Moderate	Large (especially services)
<b>Example</b>	GATT-era, early FTAs	CPTPP, EU Single Market

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## Section 6: Case Study 1 – European Union

### EU – The Most Integrated Bloc

- Started 1951: ECSC (coal & steel)
  - 1957: Treaty of Rome (Common Market)
  - 1993: Single Market (4 freedoms)
  - 1999: Euro (monetary union)
  - **Current:** Economic union + political integration elements
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# EU's Deep Integration Features

- Customs Union + Common Market + Monetary Union (Eurozone)
  - Supranational institutions: Commission, Parliament, Court of Justice
  - Harmonized regulations (CE marking, food safety)
  - Schengen area (no internal border controls)
  - Common agricultural and trade policy
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# Trade Creation vs. Diversion in EU

- **Trade creation:** Massive intra-EU trade ↑ from 40% to 60%+ of total
  - **Trade diversion:** Common External Tariff hurt some non-members (e.g., Turkey, Morocco)
  - **Net effect:** Strongly positive for members, mixed for outsiders
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# Rules of Origin in EU

- **Preferential RoO** for FTAs with non-EU countries
  - **Pan-Euro-Med cumulation zone** – diagonal cumulation with Morocco, Tunisia, etc.
  - **New 2021 RoO:** More flexible, allows value-added from cumulation
  - **Internal EU:** No RoO within Single Market
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# Challenges to EU Model

- Brexit (2016-2020) – sovereignty concerns
  - Asymmetric shocks (Eurozone debt crisis)
  - Migration disputes (common market vs. national control)
  - Regional disparities (North vs. South)
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# Section 7: Case Study 2 – Eurasian Economic Union

## EAEU – Overview

- **Founded:** 2015 (Belarus, Kazakhstan, Russia, Armenia, Kyrgyzstan)
  - **Predecessor:** Customs Union (2010)
  - **Population:** ~183 million
  - **GDP:** ~\$2.5 trillion (PPP)
  - **Goal:** Deep integration but less supranational than EU
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# Level of Integration

- **Officially:** Economic Union (beyond Customs Union but short of Common Market)
  - **Achieved:** FTA + CET + common competition rules + labor mobility (common market for workers)
  - **Not fully achieved:** Single energy market (target 2025), common financial market
  - **Institutions:** Eurasian Economic Commission (supranational, but weak)
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# Trade Creation and RoO in EAEU

- **Trade creation:** Intra-EAEU trade grew post-2015, but heavily oil-dependent
  - **Trade diversion:** Western sanctions on Russia → diverted trade to China, but EAEU preferences limited effect
  - **RoO:** Common rules (non-preferential for third countries); preferential RoO for FTAs (Vietnam, Iran, etc.)
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# EAEU vs. EU – Key Differences

<b>Feature</b>	<b>EU</b>	<b>EAEU</b>
<b>Supranational power</b>	High	Low
<b>Common currency</b>	Yes (Eurozone)	No
<b>Labor mobility</b>	Full	Yes (workers)
<b>Political integration</b>	Aspirational	Minimal
<b>External influence</b>	Democratic institutions	Russia-led

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# Conclusion and Key Takeaways

- **Spectrum matters:** FTA to Political Union – each has trade-offs
  - **Not all integration is welfare-improving:** Watch for trade diversion
  - **RoO are necessary but costly** – they shape supply chains
  - **Deep agreements** drive modern trade but require regulatory sacrifice
  - **EU** remains the gold standard for deep integration
  - **EAEU** is a newer, less integrated model with political constraints
  - **Future trend:** More mega-regionals (AfCFTA, RCEP), digital trade, climate provisions
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**Thank you!**