REGIONAL TRADE BLOCS: A CASE STUDY OF THE WELFARE IMPACT OF THE EUROPEAN UNION ON INDIA AND KENYA

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ABSTRACT

Some countries, including the big player in the world economy, the USA , believe that free trade liberalization based on principles of non discriminatory and multilateral bases as well as an open market will improve the welfare of many countries. However, other countries do not follow the idea of trade liberalization and hence respond by forming regional trading blocs. Therefore, the existence of such trading blocs will be examined, whether they are a '*building blocks*' or a '*stumbling blocks*', for sustaining the free trade liberalization. And hence, this paper focuses on three main parts: rationalization of the establishment of trading blocs; identification of the critical factors for the success of these blocs; and presentation of empirical evidence for the welfare implications of the trade diverting effects of the European Union through the analysis of two less developed countries, India and Kenya.

INTISARI

Beberapa negara, termasuk USA, meyakini bahwa liberalisasi perdagangan yang didasarkan prinsip non-diskriminasi dan pasar terbuka akan memperbaiki kesejahteraan banyak negara. Meskipun demikian beberapa negara lainnya tidak sependapat dengan gagasan tersebut dan membentuk blok perdagangan regional. Paper ini mengkaji keberadaan blok perdagangan regional (*European Union*) dengan memfokuskan pada tiga bagian pokok, yaitu rasionalisasi keberadaan blok perdagangan, identifikasi faktor kritis bagi keberhasilan blok perdagangan regional, dan kajian empiris dampak keberadaan blok perdagangan regional terhadap negara anggota (Inggris, UK) dan negara bukan anggota blok, India dan Kenya. Hasil kajian menujukkan bergabungnya UK kedalam blok perdagangan regional akan memberikan manfaat positif, dan sebaliknya memberikan dampak negatif bagi India dan Kenya.

REASONS FOR THE FORMATION OF REGIONAL TRADING BLOCS

The appearance of regional trading blocs in the 1990s, for instance the European Economic Area (EEA), the Asia Pacific Economic Cooperation(APEC), North Atlantic Free Trade Agreement (NAFTA), South Asian Association (SAARC), Gulf Cooperation Council (GCC) and the Economic and Customs Union of Central African States (UDEAC) is a reliable proof that the existence of free trade liberalization based on multilateral and non-discrimination principles is at the crossroad. Many economists, for instance Bhagwati (1991:16), regard one of the basic reasons to maintain free trade as being also, to some extent, due to the '*diminished giant syndrome*' or the psychological need' *to be number one*' of the USA as its contribution to the world economy tends to contract significantly. Another reason which triggers a group of countries to build regional trading blocs, particularly in the early 1990s, is the frustration of several countries with respect to the slow pace of the Uruguay Round negotiations. However, it may be that some other countries did it just to follow what we call 'regional trends'.

Therefore, it is important to note that at least two central factors should be identified why a group of countries intends to form a trading blocs: the expectation that incentives will be received by its members (Roy and Tisdell, 1997:2-3), and also the motivation of some countries to shape such trading blocs (Shiells, 1995).

Economic theory, as pointed out by Roy and Tisdell (1997) does not state explicitly whether or not the establishing of a regional trading blocs will improve the welfare for its members or the world as a whole. Trade creation and trade diversion unions as a main part of this theory emphasize more on production cost. The benefit received by the customer from lower prices should be taken into account in evaluating the impact of trading blocs to the region. Shiells (1995) argues that the difference between trade creation and diversions is on the welfare impact to the society. He, moreover, explains that trade creation tends to improve the welfare of its member countries, while trade diversion reduces the welfare of non-member countries.

The implementation of a custom union will raise competition and subsequently motivate the producer in its members to become more efficient. Besides, the formation of regional a trading blocs, to a certain extent, bring advantages to the members in the form of economies of scale, increasing foreign direct investment as an engine of economic growth. Salvatore (1995) expounds that another benefit of shaping trading blocs comes from the declining of long run average production costs due to many factors, for instance improved product quality and the enlargement of product variety.

Shiells (1995:30-31) elucidates that there are various motivations of each country to found and or join in a trading blocs. He, moreover, diagnoses such motivations which play a central role in driving a country towards building a regional trading blocs as follows:

1. To gain economic benefit from accomplishing a more efficient production through exploring economies of scale, intensifying economic growth from foreign direct investment as well as research and development.
2. To maintain non-economic goals, for instance enhancing political relations and managing migration flows.
3. To assure increased security of market access, particularly for smaller countries.
4. To get better bargaining power in multilateral trade negotiations and manifest against the slow pace of these negotiations, for example during the Uruguay Round.
5. To assist the development of regional infant industries through protecting its regional market.
6. To anticipate further damage to their trading advantages because of increasing trade diversion from non-member countries.

In short, Roy and Tisdell (1997: 2) and Shiells (1995: 31) conclude that the form of trading blocs will give benefit to its member countries only if the trade creation is greater than trade diversion.

One important point which should be noted is that the founding of such a regional trading blocs does not break the GATT principle. Bhagwati (1991: 58-79), Roy and Tisdell (1997) confirm this issue by referring to Article XXIV of the GATT. Therefore, some principles should be taken into account regarding establishing regional trading blocs to promote global free trade, such as WTO compatibility, low MFN tariffs, liberal accession clauses, liberal rules of origin, deep integration as well as the limiting antidumping action principles (Shiells, 1995:30).

THE SUCCESSFUL FACTORS FOR THE REGIONAL TRADING BLOCS

Several valuable factors, as suggested by Salvatore (1995: 305-306) should be satisfied in order to achieve the success of the trading blocs:

a. High pre-union trade barriers among members to create trade among union members rather than divert trade from non-members to members.

b. Low trade barriers with non-members will lead to smaller cost of trade diversions.
c. Greater specialization and trade creation among the members will improve the competitiveness of their economy.
d. Geographical proximity and less transportation cost among members will encourage trade creation.
e. The greater the trade volume during pre-union trade, the greater welfare gain after the union is established.

On the other hand, by considering the European Union (EU)'s experiences, Shiells (1995:32) points out the key success factors for the EU. First, the actual net trade creation received by members through deep economic integration. Second, a strong political motive which emphasizes regional political stability. Third, low cost adjustment in order to minimize the number of plants having to be closed. Fourth, strong willingness to enlarge the scope of the blocs. For example willingness of the EU to expand from initially creation of the internal market in goods and services to become an economic and monetary union, including a single currency. Fifth, long-time availability commitment to facilitate economic integration.

CASE STUDY

The European Union

Sapir (1992:1491) expounds that the foundation of the European economic integration is internal trade liberalization. He elucidates three major phases in the process of trade liberalization within the EU. First, the elimination of customs duties and quantitative restrictions, started in 1958 and completed in 1968 signed by the introduction of a common external tariff. Second, the elimination of internal trade barriers and expansion of its membership from six to twelve member countries, 1973-1986. Third, the completion of the internal market for goods, services, and capital as well as labor. The last phase ended in 1992.

The existence of the EU as one of the regional trading blocs has a meaningful implication for both its member and non-member countries. In this regard, Roy and Tisdell (1997:4) argues that "*if trading blocs perform well, the welfare of member countries increases, but at the same time, the welfare of non-member countries may diminish*". Therefore, the next section will examine the welfare impact of the EU on non-member countries, that is India and Kenya.

Common Agricultural Policy (CAP)

The Common Agricultural Policy is directed at protecting most of the EU farmers. By referring to Article 39 EEC Treaty, Borchardt (1996:25) states that the objective of CAP is to guarantee the security of food supplies at a stable and reasonable price, to improve productivity through technical progress and more rational agricultural production, as well as to ensure a fair standard of living for farmers. Moreover, Carbaugh (1995:235) expounds that an essential element of the CAP lies in the support of prices received by farmers for their produce. Besides, it is also an implemented program involving deficiency payment, output controls and direct income payment. Although CAP succeeded in achieving farm surpluses, Borchardt (1996:25) points out that these surpluses became a heavy burden on the Community budget due to the foundation for undertaking the CAP is price support system.

Operationally, two central instruments to implement the CAP in an attempt to support the EU farm prices are the variable import levy and export subsidies. Initially, the EU determines and sets the common farm price at a relatively high level. And subsequently, the EU imposes tariff on agricultural product imports so as to equalize the common farm price. On the other hand, the EU subsidizes export of agricultural products to the market in rest of the world. The amount of subsidy is the differences in price between world price and the common farm price.

As a consequence, the implementation of CAP creates negative impacts to mainly LDC's export industries and economic growth. Furthermore, the application of the EU's dumping strategies by selling its surplus product in LDC's markets at lower prices will damage the opportunity of agricultural and economic growth in these countries. Finally, not only for the LDCs, but the world economy overall will suffer from the implementation of the CAP.

Empirical Results

In this study, India is chosen as a representative for South Asia, while Kenya represents Africa. Both India and Kenya were former British Colonies. Moreover, they have undertaken trading with the British for a long time. Data used in this analysis are from 1964 to 1997, for the EU, the UK, India, and Kenya. To get a constant price, the consumer price index in each year is used and the year 1964 as the base year. In addition, to create a hypothetical increase or decrease in a country's earnings (for instance India) it is assumed that the 1964 value share of a country (India, Kenya, or the UK) in another country's (for instance the UK or the EU) imports had been maintained in subsequent years. A summary results of this analysis are presented in the Table 1.

Table 1. The Result Summary of Various Trading Patterns

Trading Pattern	Total Export or Import		Hypothetical Earning		Hypothetical gain or loss		Conclusion
	Current price (million $)	Constant Price (million $)	Current Price (million$)	Constant Price (million $)	Current Price (million $)	Constant price (million $)	
India export to EU	56700.48	114484.28	59898.54	187189.00	-3198.06	-72704.72	India loses
India export to UK	24636.43	67398.85	95591.43	206812.27	-70955.0	-139413.42	India loses
UK import to EU	1440921.1	1975307	1117244.05	1664782.72	323677.05	310524.77	UK gains
Kenya export to EU	7261.43	51123.73	20942.12	172756.24	-13680.69	-121632.50	Kenya loses
Kenya export to UK	4828.56	35846.80	13171.85	76073.85	-8343.29	-40227.05	Kenya loses

Data Source: IMF, 1998.

India and the EU

The total import value of the EU from the world and India to the EU increases significantly during the period 1964-1997 both in current and constant prices. For example, the total import value in constant price of the EU increases from US$265338.28 million in 1964 to become US$1199341.13 million in 1997, whereas total exports from India to the EU grow from US$1919.51 to become US$4561.64 millions. By assuming that India maintains the 1964 value share in the EU imports, it can be seen that India suffers from this trade. This situation is supported by the fact that India's hypothetical earning is greater than its total exports to the EU. This means that India lost in this trade. The total hypothetical loss of India is US$ 3198.06 and US$72704.72 millions in both current and constant prices, respectively (see Table 1).

Figure 1 affirms completely that India suffers from this trade. It can be seen from Figure 1 that the line of India's exports to the EU is always below the hypothetical earning. Also, the line of hypothetical gain or loss lies under the horizontal line.

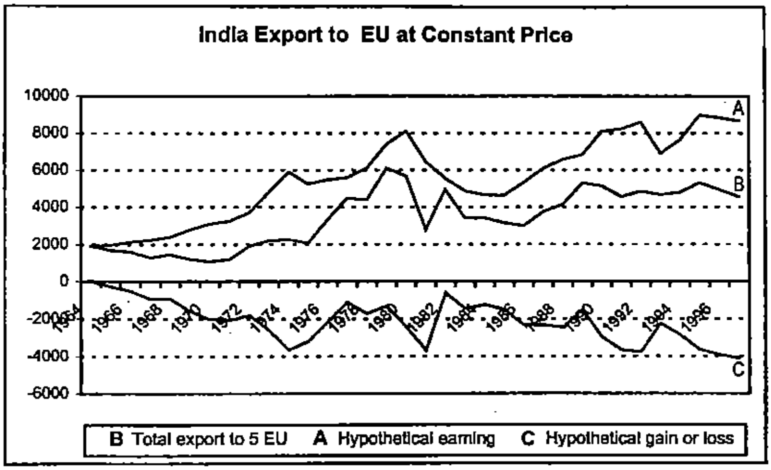

Figure 1. India Export to EU at Constant Price, 1964-1997

India and the UK

The share of India's exports to the UK's total imports from the world in the base year is 2.48% and 2.87% in current and constant prices, respectively. By maintaining this share for the consecutive years, hypothetical earning for India of US $95591.43 (current price) and US$ 206812.27 millions (constant price, Table 1) are generated. Meanwhile, India's exports to the UK in this periods were US$ 24636.43 and US$ 67398.85 millions, respectively. Because the fact that hypothetical earnings of India are greater than its total imports to the UK, India faces a hypothetical loss in undertaking trading with the UK. The value is around US$- 70955.00 and US$ -139413.42 million, both in current and constant prices.

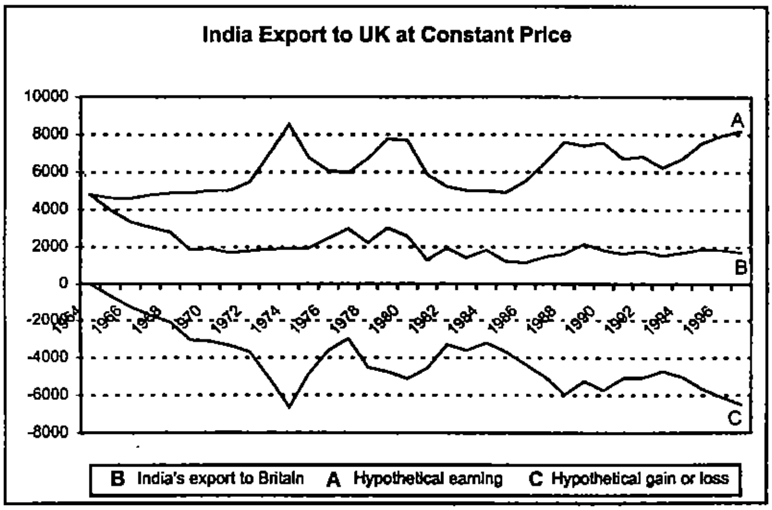

Figure 2. India Export to UK at Constant Price, 1964-1997

Figure 2 depicts clearly that India's exports to UK declined from around US$4798.18 million in 1964 to become a mere US$1709.76 million. In contrast, India's hypothetical earnings rose impressively. As a result, the line of hypothetical gain or loss tends to go down smoothly under the horizontal axis. Figure 2 shows that India suffered a complete financial loss compared to the UK in their trading.

The UK and the EU

From 19964 to 1977, in terms of hypothetical gain or loss, the UK lost out in their trading with the EU members. This result, to a certain extent, indicates that by joining the EU, the UK has benefited to expand imports to the EU members with lower prices compared to the EU non-members. Overall, hypothetical gain of the UK from 1964-1997 is around US$ 310524.77 (Table 1) millions in constant price.

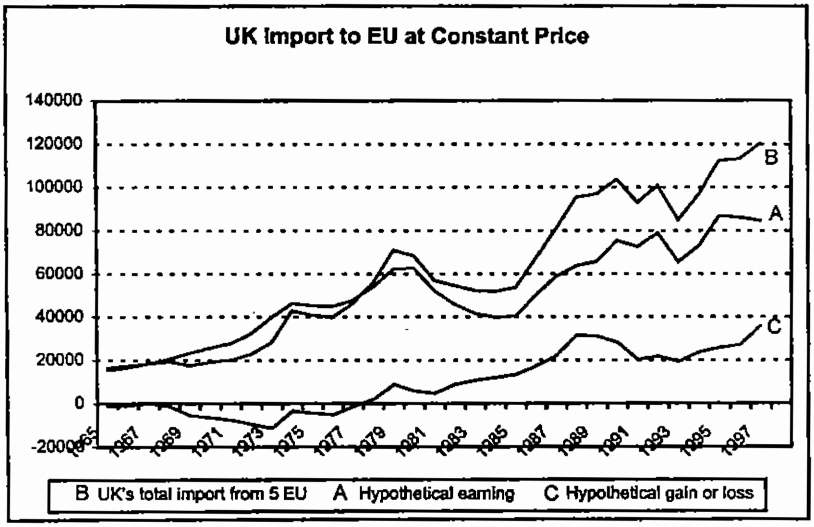

Figure 3. UK Import to EU at Constant Price, 1964-1997

Figure 3 reveals that since 1978, total imports of the UK from the EU-members enlarged steadily over its hypothetical earnings. Therefore, the line of hypothetical gain or loss moved up the horizontal line of symmetry.

Kenya and the EU

Similar to India, Kenya faces the same problem in line with its trading to the EU. Analytical result shows that total imports to the EU from the world during the analysis period extend firmly both for current and constant prices. For instance their total imports increase from only US$ 265338.28 million in 1964 to become US$1199341.13 million in 1997 or increase around 352% in constant price.

On the other hand, Kenya's total export to the EU members decreased from US$ 1753.53 to become only US$ 363.41 millions. As a result, Kenya faced a hypothetical loss in its trading with the EU totaling around US$-121632.50 at that time.

Figure 4 confirms that the hypothetical gain or loss line moves below the horizontal line of rotation. This figure indicates that Kenya lost a lot of its trading share in trading with the EU, especially compared to its share in 1964. This situation became worse and is supported by the fact that the shift of the hypothetical line tends to go down continuously.

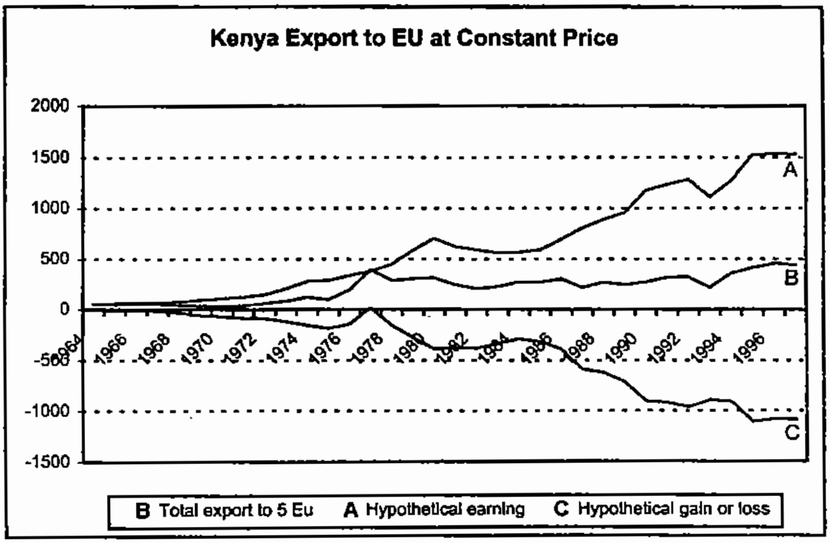

Figure 4. Kenya Export to EU at Constant Price, 1964-1997

Kenya and the UK

As well the EU, the UK's total import from the world increased whether in current or constant prices. Total growth of its imports during the period analyzed is 1794% and 71%, respectively. Unfortunately, this growth was not followed proportionally by Kenya as one of its trading partners. Kenya's growth exports to the UK were around 441% in current price and –86% in constant price. Table 1A points out that Kenya hypothetically lost in its trading to the UK. The hypothetical loss of Kenya's exports to the UK was US$-8343.29 and US$-40227.05 millions, respectively for current and constant prices.

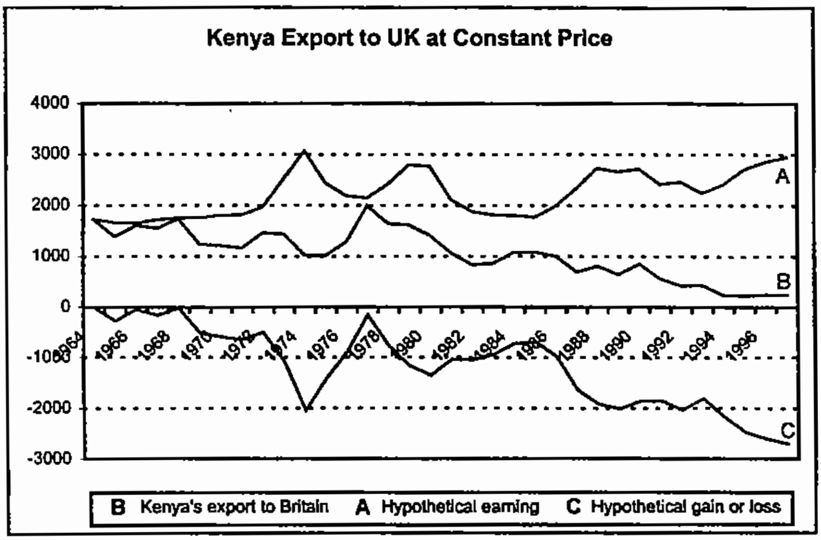

Figure 5. Kenya Export to UK at Constant Price, 1964-1997

The declining of Kenya's exports to the UK is depicted in Figure 5. From Figure 5, it can be seen that Kenya's exports decrease sharply, especially since Kenya's peak exports were reached in 1977. For instance, Kenya's exports to the UK were around US$1724. 9 million in 1964, enlarged to become US$1992.21 million in 1977, and subsequently dropped continuously to a mere US$ 241.18 million in 1997 in constant price.

The gathering together of the UK to the EU affects not only itself but also others countries, particularly trading partner countries, such as India and Kenya. The total increase in the UK's imports from the EU during the period 1964-1997 were US$310524.77 million, whereas the total decrease in the UK's imports from India were aroundUS$-139413.42 million and from Kenya US$–40227.05 million. Evidence in the data suggests that as a whole the UK has diverted its trade from India and Kenya to the EU member countries. Moreover, the UK trade diversion expands the trade volume of the EU member countries.

CONCLUDING REMARKS

Several economic effects of the UK incorporation to the EU can be identified. First of all, it increases the hypothetical gain received by the UK itself. Second, this may enlarge the trade of the EU member countries due to the trade creation effect. However, the EU non-member countries, India and Kenya, suffer financial loss because of the trade diversion effect created by joining the UK to the EU. One reasonable alternative offered to solve this problem is that India and Kenya which do not belong to such a powerful economic trading union, negotiate with the EU as a powerful trading blocs to gain some trade concessions. Moreover, they have to improve their economy so their goods and services can remain competitive in the world market.

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