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ADB Working Paper Series on Regional Economic Integration

Sequencing Regionalism: Theory, European Practice, and Lessons for Asia

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+Professor, International Economics, The Graduate Institute of International and Development Studies, Room 501, 5th Floor, Richard Wagner 1, 1202 Geneva. Tel: +41 22 908 59 33, richard.baldwin@graduateinstitute.ch

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Abstract

Feedback mechanisms are the key to sequencing when it comes to regional integration; can mean that today's policy or institution alters the political-economy landscape in a way that makes it politically optimal for future governments to take further steps toward integration—even when these steps are not politically optimal from today's perspective. After outlining the theory, the paper uses feedback mechanisms to organize Europe's postwar integration narrative, and then draws lessons for today's integration of East Asia. The paper suggests that the spontaneous cooperation that created "Factory Asia" has not been codified. One starting point for Asian regional institutions would be to institutionalize the spontaneous cooperation that already exists on trade, services, and investment. New, creative thinking is needed on the sort of soft-law commitments and new modes of cooperation that would make this work with limited sovereignty pooling.

Keywords: sequencing regionalism, lessons of European integration, East Asian integration, regionalism

JEL Classification: F02 , F13 , F15

1. Introduction

Asia is a wonderful anomaly. Economic integration—defined as the removal of barriers to international commerce—has progressed in the region at a ferocious rate since the mid-1980s. No other region in history has so quickly opened its borders to trade. Intra-regional trade has boomed, transforming the region from a rather poor part of the world into "Factory Asia"—a manufacturing powerhouse that turns out millions of products at world-beating prices. That's the wonder.

The anomaly is that formal economic cooperation in the region, especially cooperation embedded in regional institutions, is almost nonexistent (with the important exception of ASEAN and more the Chiang Mai Initiative). This contrast invites one to wonder whether the time has come to redress the anomaly—to set up some regional institutions.

This paper addresses the question by drawing lessons from Europe's twin sequencing exercises—the European Union's (EU) supranational sequence and European Free Trade Association's (EFTA) more traditional intergovernmental sequence. After the introduction, the paper starts with sequencing theory (Section 2) before turning to the historical narrative of Europe's and Asia's sequencing in Section 3. Section 4 draws lessons from the integration sequences. Section 5 considers the implications of the analysis for future efforts to bring regional institutions to Asia. And Section 6 offers concluding remarks.

1.1 Existing Literature

Many discussions of regional sequencing start from what has come to be known as Balassa's "stages of economic integration," with the classic reference being Balassa (1961 a, b) or his book published the same year. This, however, is like the classic line "Play it again, Sam" from the film Casablanca. As all cinephiles know, the line was never spoken in the movie.[1] Likewise, Balassa's 1961 article never uses the word "stages." He lists five "forms" of economic integration and goes on to discuss their economic effects without ever implying that they were in any sense stages of integration, that is, a clear ordering of steps.[2]

Observers seem to assume that because Balassa listed them in order of increasing depth, they were in some ill-defined sense steps on a stairs to higher levels of regional integration. There has been remarkably little thought about exactly how and why one form of integration would lead to another. Empirically, I can think of no regional integration arrangement that followed his "stages." Indeed, Balassa's five forms were drawn from European discussions in the 1950s of alternative forms of regional integration that might have been adopted—a discussion that is quite sui generis as the paper by Kevin O'Rourke argues and Section 3 echoes briefly.

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1 The closest line is Bogart's: "You can play it for her, you can play it for me, so play it Sam, play it."

2 Pelkmans (1980) goes further and argues that Balassa's forms were incomplete and inconsistent even for early postwar Europe.

The earliest and one of the most influential thinkers on sequencing is Ernest Haas (especially Haas 1958). His thinking, which launched the Neofunctionalist School of international relations, was influenced by his work in the US military intelligence from 1943–46 and his observation of Europe's elite in the post-war chaos as they worked their way intellectually from trying to re-establish "business as usual" to embracing a truly miraculous level of supranationality.

Haas' formative observations took place at a time when institutions seemed to be shaping political actors in ways that induced the actors to embrace deeper integration. Haas was not an economist and did not focus on political-economy channels of influence; he focused on politics, ideas, and meetings of political elite. As a result, the Neofunctionalist School focused mainly on political spillovers to create chains of events whereby regional integration, once started, became a self-powered mechanism. Neofunctionalists posited that national interest groups would transfer allegiance from national to supranational institutions (without explaining very clearly the political economy of this reorientation) and that technocratic processes would become ever more powerful and independent of nation states. It is entirely possible that Haas was confusing correlation with causality. The late 1940s and 1950s saw all European leaders working their way through a checklist of alternative postwar architectures—ranging from business-as-usual to communism. European integration and supranationality is the only item to survive the elimination of these parallel, but national reflections. As the thinking was reflected in committee discussions, Haas may have formed the opinion that it was the contact among the elite that was shaping their opinions rather than third factors that they all faced in common—for example, Soviet aggression in Central and Eastern Europe, Euro-communism at home, and US pressure.

The shortcomings of Haas' theory are twofold. First, he was not clear about the mechanisms through which spillovers would operate. Given this lack of clear reasoning on the channels of transmission, the second shortcoming—the fact that his empirical predictions failed miserably in the case of the EU—led to widespread abandonment of this line of thinking.

More recent work has started to flesh out the political-economy mechanisms through which integration can beget integration. Notable examples of such explicit reasoning include Maxfield (1990), Kahler (1995), Frieden (1996), and Pastor (2001). For regionalism spreading, as opposed to deepening, there are many contributions—including Kemp and Wan (1976), Baldwin (1993), Deardorff and Stern (1994), Bergsten (1996), Frankel and Wei (1995), Frankel et al. (1997), and Oye (1992). More recent work by Plummer and Wignaraja (2007) and Estevadeordal and Suominen (2008) also provide important contributions.

The literature on why nations cooperate in forging trade agreements is much broader, but it does not get to the heart of the sequencing issue. The key to sequencing is the notion that one type of cooperation will change economic policy in a way that makes other forms of future cooperation possible that were not before. In short, some sort of feedback mechanism is needed if we want to think about "stages of economic integration." The next section presents several explicit political-economy mechanisms that could explain how and why the sequencing of regional integration matters.

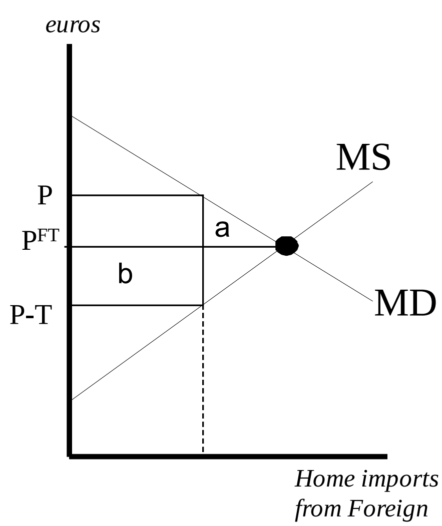
2. Theory: Sequencing and Feedback Mechanisms

The notion of optimal sequencing of regional integration presupposes two elements: (i) a set of time-linked constraints on the feasibility of various integration sequences, and (ii) a well-ordered ranking indicating which of the feasible sequences is preferred. We shall model the ranking with an objective function, the constraints with a concrete specification of nations' decision making rules, and the time linkages with laws of motion (feedback mechanisms) for the relevant state variables (measures of integration).

While we want to be far more expansive in terms of policy areas and range of nations considered, it is useful to illustrate basic issues in a setting marked by a tightly circumscribed set of policies and interactions. To start with, we consider a setting where inter-temporal issues do not affect the feasible sequence—there is no feedback mechanism so we can fix ideas as to our basic approach and highlight the importance of initial conditions. Specifically, consider a world with just two nations (Home and Foreign) where goods are traded but productive factors are not, and tariffs are the only barrier to goods trade. To simplify the political choice issues, we suppose that nations either set their tariffs to zero, or keep them at the initial level, T_0.

Consider three sequences for getting to global free trade in this setting. The first, which we label S1 for notational convenience, involves Home setting its tariff to zero in stage one, while Foreign maintains its initial tariff, then in stage two, Foreign also cuts its tariff to zero while Home maintains its tariff as zero; tariffs remain at zero from then on. The second sequence, S2, is where the Home and Foreign roles are reversed, and S3 is where they both set their tariffs to zero in stage one and maintain them at zero subsequently.

Figure 1: Tariff Cooperation



With the sequences laid out we now turn to feasibility issues. The feasibility of the three sequences depends upon the governments' motives. In the simple case where both governments only care about the sum of their citizen's welfare, then S1 is feasible only if T is large enough to make area "a" in Figure 1 larger than area "b" (in this case, the shift to unilateral free trade is politically optimal). In this case, S2 is obviously also feasible, as the two nations are symmetric. Of course if S1 and S2 are feasible, so is S3. However, if the tariff is lower to begin with, area "a" will be smaller than area "b," so unilateral liberalization is not feasible; only S3 is feasible as the simultaneous tariff cut allows nations to redress the terms-of-trade externality.

When only S3 is feasible, the issue of ranking is not difficult. However, if initial conditions are such that we have three feasible sequences, the issue of optimality arises. As there is no unitary actor whose preferences naturally generate the objective function, we consider a number of different objective functions. The first, which we call W1, values speed of liberalization per se. The second, W2, is the preferences of the Home government (say, Home is the hegemon or agenda setter for some reason outside the model). The third and fourth are the Foreign government's preferences, and the sum of welfare, W3 and W4 respectively.

What is the optimal sequence? The answer depends upon the objective function. Under objective functions W1 and W4, the simultaneous tariff cut sequence is optimal, but under W2 and W3, the answer will be S2 and S1 respectively. Note that we could think of many other objective functions, for example, maybe we would like to get to free trade with as little inter-sectoral reallocation of labor as possible, that is, to minimize adjustment costs. Or maybe the objective function would favor sequences that attain free trade with as little change as possible in the distribution of world income. Even in our highly stylized world, the different objective functions would indicate a different solution to the "optimal" sequence question.

Lessons

The point of this simple thought experiment is that optimality cannot be a general proposition, and this is for three distinct reasons. First, the ranking that we use to judge among feasible sequences will affect the solution. Second, the range of sequences that are feasible will depend upon the initial conditions. Third, the range of feasible sequences will depend on the political-economy processes inside each nation. Plainly, allowing for more nations, more policies, or more interactions will only strengthen the conclusion that there is no such thing as an optimal sequence in the abstract sense.

Having established this rather discouraging result, we proceed to investigate the key issues that arise when examining sequencing theory. Henceforth we shall abandon notions of optimality and concern ourselves only with feasibility.

2.1 Feedback Mechanism Analytics

Feedback mechanisms are the heart and soul of sequencing issues. The adoption of one set of policies feedbacks into the economic situation in which governments' future policy choices are made. If the feedback works in the "right" direction, the adoption of a particular policy in Period 1 can alter the political economy landscape in a way that makes it politically optimal for governments to adopt, in Period 2, a policy they found politically optimal to reject in Period 1.

The simple example above was without feedback mechanisms in the sense that the first stage in each sequence had no impact on political constraints affecting the attractiveness of subsequent stages. Our first thought experiment was, as they say, like Hamlet without the Prince. We turn now to putting the Prince back into the play. As before, we do this in an uncluttered setting in order to draw key lessons.

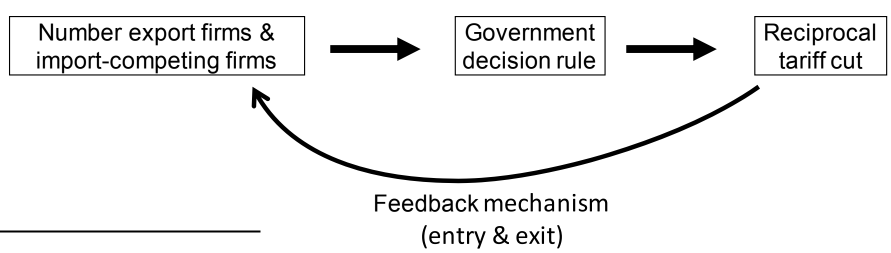
2.1.1 The Juggernaut Feedback Mechanism

To illustrate the basic issues that arise when considering feedback mechanisms, we frame the juggernaut theory of trade liberalization as a sequencing problem in our two nation example. We start with a simple statement of the juggernaut theory and then cast it as a sequencing problem.[3]

The juggernaut theory asserts that trade liberalization begets trade liberalization—once the liberalization ball starts rolling it is difficult or impossible to stop. The basic logic is simple to illustrate with historical examples. In 1947, when the GATT entered into force, tariffs were very high, almost as high as they were in the "terrible '30s". When tariffs were set in the 1930s they balanced the supply and demand for protection in the political market inside each nation with little or no concern for spillovers. The demanders of protection we focus on are import-competing firms and the workers they employ; the government is also concerned with general welfare, so it is reluctant to grant too high tariff protection.

Starting from this situation, the announcement of multilateral trade negotiation (MTN) based on the principle of reciprocity alters the array of political forces inside each participating nation. Reciprocity is the key. Rather than being bystanders in the tariff debate (as they were prior to the MTN), exporters realize that lobbying against domestic tariffs is now a way of lowering foreign tariffs. To put it differently, the MTN has changed the government's objective function and this holds for all nations in the MTN.

Figure 2: The Juggernaut Theory's Feedback Mechanism



[3] The word "juggernaut"—defined as "any massive inexorable force that advances crushing whatever is in the path"—stems from a British mispronunciation of the Hindu deity of the Puri shrine, Jagannath. A festival is held in Puri involving the "chariot of Jagannath," an enormous and unwieldy construction that requires thousands of people to get it rolling. Once started, however, it rolls over anything in its path. The juggernaut theory was first presented in Baldwin (1994); see Baldwin and Robert-Nicoud (2008) for a formalization.

This re-shaping of the political-economy landscape inside each nation makes each government want to cut tariffs below the initial level, but not necessarily to zero. The point is that if the tariff initially balanced supply and demand for protection when the exporters were politically inactive, then adding the pro-liberalization exporter to the political equation will surely mean that all governments find it politically optimal to lower tariffs from pre-MTN levels.

This is not the end of the story. The tariff cuts will feed back into the policy decision via changes in the economy (see Figure 2) but this will take time. As the tariff cuts are phased in over 5 to 10 years, the economic landscape is changed in all nations. Entry into export sectors expands output and employment as foreign tariffs come down, and exit in the import-competing sectors reduces production and employment as home tariffs are lowered (the long-run supply responses exceed the short-run responses).

In any endogenous-tariff model where a sector's political influence is positively linked to its size, the liberalization-induced entry and exit will feed back into policymaking. A few years down the road, when another MTN is launched, reciprocity again realigns the tariff-setting balance by turning exporters into anti-protectionists. But this time, the pro-tariff camp is systematically weaker in every nation and the pro-liberalization camp is systematically stronger. All participating governments will find it politically optimal to cut tariffs, but again not necessarily to zero. As these fresh tariff cuts are phased in, the juggernaut rolls forward.

2.1.2 Juggernaut Theory as a Sequencing Problem

Casting this as a sequencing problem, consider just two stages. In the first stage, an MTN is announced with a take-it-or-leave-it reciprocal tariff-cutting proposition, say tariffs should be cut on average by a third. Nations either accept or reject this offer. Only if both accept is the reciprocal tariff cut implemented. As to the feedback, note that the tariff level affects the number of firms in both nations. Specifically, the law of motion is:

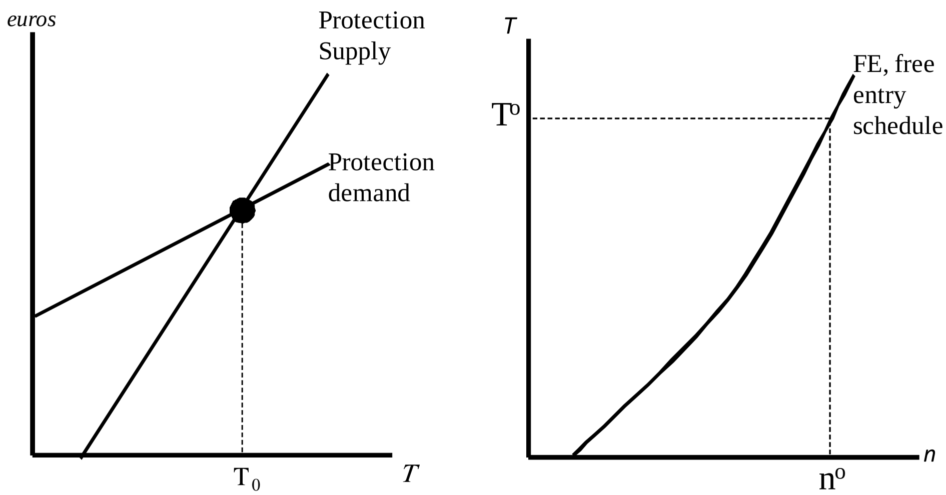
$$n_{i,t} = f[T_{t-1} - T_t]\, n_{i,t-1} \tag{1}$$

where the n vectors describe the number of firms in the import-competing and exporting sectors in nation-i in period *t*, and *f*[.] is an implicit function that describes the impact of tariff cutting on entry and exit (the reciprocal tariff cut will typically lower the number of import-competing firms and raise the number exporting firms). In the second stage, another MTN is held and another take-it-or-leave-it tariff-cutting offer is made to the two nations. (Because deviation is instantly observable with tariffs, we ignore enforceability issues).

In this set up, the sequence is a pair of tariff cuts, $\chi_1$and χ_2. To keep things simple, we assume a simple objective function to rank feasible sequences: the goal is to cut tariffs as quickly as possible. The initial tariffs, which are assumed to be unilaterally politically optimal in the Nash sense, are T_0. To avoid ancillary complications, we take the nations as perfectly symmetric.

To crystallize the logic, we need to fill in some details. Government choices are determined by the maximization of a "politically realistic objective function." As Baldwin and Robert-Nicoud (2006) show, this means that tariffs are chosen to balance the supply and demand for protection in the political market much as a price balances supply and demand in a competitive market (left panel in Figure 3).

Figure 3: Supply and Demand for Protection, Unilateral Case



The supply of protection is the marginal cost to the government of imposing a tariff, where the cost is in terms of damage to the economy as measured by simple utilitarian indicators. The demand for protection comes from producer surplus generated by the tariff (or the lobbying expenditures associated with it). The supply of protection intersects the horizontal axis in the positive tariff range as the "optimal tariff" in this sort of model is not zero. It rises since the welfare damage done by a marginal increase in the tariff rises with the level of T. The demand for protection intersects the vertical axis because a marginal tariff increase will generate higher producer surplus even at a zero tariff; it is rising since the marginal benefit to import-competing firms of a marginal increase in the tariff rises with the level of protection (the margin benefit of protection to producers rises when there is more to protect). The politically optimal tariff is defined at the intersection of the supply and demand curves.

The number of firms is endogenous and related to the tariff as shown for import-competing firms in the right panel of Figure 3; a similar curve determines the number of firms in the export sector, but the relevant tariff would be the partner's tariff and the relationship would be negatively sloped as a lower foreign tariff would encourage domestic entry into the export sector.

We now turn to defining more precisely the meaning of a feasible sequence. The sequencing that we have in mind takes place over decades. In recognition of this, and the inherent myopia of governments, we assume the government makes its policy choices considering only "current" effects where "current" could mean a 5 or 10 year period. Formally, the initial tariff in both nations is T_0, and the question is whether the nations will accept a tariff cut to T_1, that is, whether

$$G[T_1, n_0; T_1] \geq G[T_0, n_0; T_0] \tag{2}$$

where n_0 is the vector of the initial number of firms; we show the partner's tariff behind the semicolon in the government's function, G, to denote the fact that the partner's tariff is beyond the direct control of each government, but can affect the government's view of the proposed tariff cut. A necessary condition for a sequence to be feasible is that T_1 is such that this inequality holds.

The second condition for a sequence to be feasible is that the second take-it-or-leave-it offer will also be acceptable. The condition formally is

$$G[T_2, n_1; T_2] \geq G[T_1, n_1; T_1]; \qquad n_1 = f[T_0 - T_1]\, n_0 \tag{3}$$

In words this says that both governments have to be willing to cut to T_2 given that the number of firms has been altered by the stage 1 tariff cut. The feedback of the Period 1 tariff cut on the Period 2 decision of the governments is formally captured by the law of motion.

In this setting, a very large number sequences will be feasible. The optimal sequence would be the largest politically acceptable tariff cut in stage one, followed by the largest politically acceptable tariff cut in stage 2 (conditional on the altered economic landscape brought about by the stage 1 tariff cut).

Lessons

This simple example shows a way of thinking about the sequencing of regional integration. The central element is that government decisions depend upon a state variable that moves slowly in response to previous policy decisions; as always with laws of motion, initial conditions matter. The feedback mechanism is thus the combination of the state variable's law of motion (especially how prior policy choices enter) and the state variable's role in the government's objective function.

Before moving on, we should note that in many cases, the liberalization of barriers needs no international coordination (as in the first example). Mutual liberalization would look like "spontaneous cooperation" even though there was no cooperation per se.

2.2 Several Notable Feedback Mechanisms

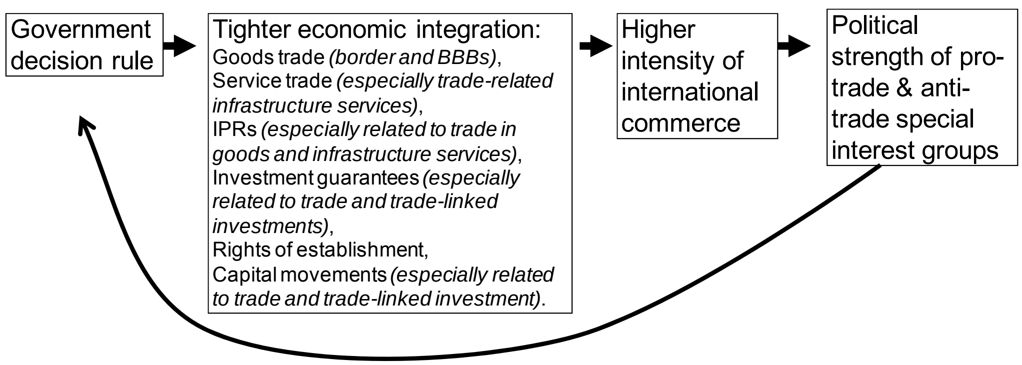
We now turn to a discussion of several feedback mechanisms that played important role in the European sequences and in Asia.

2.2.1 Juggernaut Mechanism

The basics of the juggernaut mechanism, as introduced by Baldwin (1994), are described above. Here we note it has implications that reach beyond tariff liberalization, highlighting the more general nature of international commerce. As Figure 4 shows, the logic can affect all manner of barriers to international commerce. It is worth highlighting such mechanism in three "corollary" feedback mechanisms, all of which were important in the European case.

As noted, in some cases, the liberalization of barriers needs no international coordination. For example, as trade flows rise and their directions diversify, domestic exporters may push their government to open the market to foreign providers of trade credit financing as a means of maintain competitiveness against other nations which have access to superior trade-credit services. Thus the juggernaut will have liberalized trade in such "infrastructure" services—services that facilitate exporting and importing—without any international cooperation; as the same juggernaut will be operating in many nations, we may see "spontaneous cooperation" without any formal or informal agreement among governments.

Figure 4: The Generalized Juggernaut Feedback Mechanism



BBB = behind-the-border barriers, IPR = intellectual property rights.

Trade/Behind-the-Border Feedback

Reciprocal tariff and quota liberalizations are almost always the first forms of regional cooperation because they are easy—easy in the sense of being easy to negotiate and easy to sell domestically. More precisely, nations find it easy to formulate a "balanced" package, that is, one that can attract a winning coalition of special interest groups in both nations. Exporters and import-competitors have a good idea of what is on the table. After all tariffs and quotas are specifically designed to hinder foreigners' market access, so the implication of their removal is easy for all parties to calculate.

Once tariffs are gone, however, exporters will still face other trade barriers, so called behind-the-border barriers (BBBs), such as idiosyncratic product standards, government-controlled or cartelized distribution networks, among others. Removing these is harder as it can be much more difficult to negotiate a balanced, politically feasible package. The key problem is that these BBBs are not, for the most part, explicitly designed to protect domestic firms against foreign competition.

Governments typically introduce micro-regulations—health, safety, and environmental product standards—with good-governance motives. They want to protect citizens and the environment, etc. However, these good intentions are typically subverted by ubiquitous political-economic pressures to favor domestic over foreign actors. Indeed, these rules are often so technical that only domestic firms have the know-how to write them. The regulated write their own regulations, or at least have an important input into their final shape. Such firms will naturally push for regulation that tilt the competitive edge their way against foreign rivals. In short, the protectionist content of BBBs is typically incidental to their announced purpose, but far from accidental.

Exactly because the BBBs are not explicitly designed to protect, and because they can be so technical, it can be extremely difficult for all parties to agree on the economic impact of removing specific BBBs. This in turn makes it difficult to craft a politically feasible package of reciprocal BBB liberalization.

All this goes to explain why governments worldwide turned first to tariff liberalization and only later to BBB liberalization. The GATT, for example, spend its first 20 years on tariffs, turning to BBB issues (or a specific variety called "technical barriers to trade" [TBTs]) only in the Tokyo Round.

As far as sequencing is concerned, the point is that tariff liberalization does not make BBB liberalization any easier from a practical perspective. The juggernaut effect, however, increases the size/power of the special interest groups that want their governments to find a way to liberalize BBBs while simultaneously reducing the size/power of the groups resisting BBB liberalization.

Trade/Finance Feedback Mechanism

This is a minor feedback mechanism, but one that was critical in Europe during the 1950s. Intra-European trade was in a logjam created by hundreds of bilateral deals that essentially reduced bilateral trade to barter (due to the inconvertibility of European currencies). No one could expand their exports without the foreign exchange necessary to buy the raw materials and capital goods necessary to ramp up production. But the foreign exchange could not be earned with exports hindered by bilateral barriers. The scarce inflow of convertible currencies (US dollars and Swiss francs) and gold were marshaled to pay for essentials, like food and fuel (Eichengreen 2007, p. 60).

The stage 1 policy was a clearing mechanism that multilateralized the bilateral deals. This allowed all sorts of Pareto improving trades, which in turned allowed production to rise along with export earnings. The new hard currency export earnings in turn relaxed the balance of payments constraints that lead to the foreign exchange restrictions and quantitative restrictions on imports. In essence the Period 1 policy (a clearinghouse) changed economic realities in a way that allowed governments to remove quantitative restrictions in stage 2.

Trade/Capital-Control Feedback

Barriers to trade and barriers to capital flows are separate. They are not, however, unrelated. As cross-border trade and investment flows draw economies closer, the distinction between payments for trade and payments for investment became blurred. Just to simplify business practices, corporations set up bank accounts in their foreign markets. As depositing money in a foreign bank account is a capital account transaction, it is easy to see how the two forms of convertibility can blend together against the background of international business.[4] Moreover tight trade integration often takes the form of intra-firm trade. That is, the home-based firm sells its products to a foreign-based affiliate, which in turn makes the foreign sale. These foreign affiliates naturally have access to foreign banking, financial services, and markets. This access can be manipulated by the parent company, so the firewall between capital and trade transaction can melt away.[5]

What this tells us is that deeper trade and investment ties reduce the effectiveness of capital controls. But there is also a pull factor. As the pace of trade and investment integration picks up, and the range and sophistication of financial products expands, the administrative burden imposed by capital controls becomes more tiresome and costly. At the same time, cost-competition becomes more intense. In this situation, exporters and importers begin to press their governments to liberalize some capital controls—basically as pro-business deregulation.

The feedback mechanism here is absolutely clear. Heighten trade and investment flows—themselves triggered by trade liberalization—change the political realities governments face when choosing capital market restrictions. The direction of change is systematically pro-liberalization. One could suppose that the causality was two-way (that is, loosening capital restrictions fosters cross-border trade and investment flows), but a one-way causality is all that the feedback mechanism requires; and it is the one clearly shaping the world. Even authoritarian regimes like the People's Republic of China (PRC) have trouble enforcing capital controls.

2.2.2 Domino Feedback

The feedback mechanisms discussed thus far concern the impact of policies chosen by the cooperating partners. There can, however, be policy spillovers. The domino mechanism describes the political-economy logic of one such spillover, namely trade

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4 To take a current example of how trade and financial transactions are blurred, consider what happens when one buys a book from Amazon.co.uk with a Swiss credit card. The book purchase and shipping are clearly trade, but the credit card usage means a short-term loan is extended in Swiss francs and then converted into pounds sterling. So in effect the buyer is borrowing pounds sterling short term to buy the book. Indeed, if the order is cancelled and the money refunded, the buyer will have ended up speculating on the franc-pound sterling exchange rate. All this goes to say that it can be quite difficult to clearly distinguish between capital account and current account motives for buying foreign exchange; and the problem gets more severe as the flow and sophistication of transactions increase.

5 A classic example is when trading companies speculate on a devaluation by leading and lagging payments for imports and exports; or it can get money out of the country by having the foreign subsidiary bill the parent company for intangible headquarter services.

diversion.[6] In this feedback mechanism, it is the choices of other countries in Period 1 that alter third-nation situations in Period 2 so that the third nations find it politically optimal to adopt integration policies that they had eschewed previously (in Period 1).

The domino theory starts with a positive model of participation in regional integration, with the easiest example being membership in a customs union. It proceeds in two stages—the immediate impact of an idiosyncratic deepening of integration among two or more nations, and the knock-on impact implied by this deepening. To start with the positive model, a nation's decision to join the customs union is determined by its domestic political equilibrium that balances pro-membership and anti-membership forces. The theory associates the pro-joiners with the nation's exporters, who gain from preferential access if the nation joins and suffer from discrimination if the nation stays out. The anti-membership political economy forces are associated with the import-competing industries that would lose from liberalization as well as non-economic objections to membership that are invisible to the econometrician. Consumers and taxpayers are taken as interest groups of second-order importance for the usual "Olsen's asymmetry" reasons.[7]

Given an initial political equilibrium, an idiosyncratic shock that deepens or enlarges the customs union generates new political-economy forces in nonmembers. Nonmember exporters now have a greater stake in membership—they face more discrimination if their nation stays out and greater market access if it joins. Anti-membership forces are also strengthened in nonmember nations as the liberalization implied by membership is heightened. If the industrial output of exporters is systematically larger than the output of import-competing sectors (which is normal as exporters usually produce for both domestic and foreign consumers) and both sides' political power is linked to size, the shock raises the pro-membership forces more than the anti-membership side. For outsiders previously indifferent to membership (politically), these changes shift the domestic political-economy equilibrium to the pro-membership camp.

The second stage starts if one nonmember actually does join the customs union. The enlargement implies that discrimination facing the remaining nonmembers expands—again heightening the pro-membership political-economy forces in outsiders—potentially producing a membership application from an outsider that previously found it politically optimal to stay out. The cycle repeats itself until a new political equilibrium in the customs union membership develops.

If the world had perfect information and synchronized periodicity in political decision-making, membership bids would be perfectly coordinated and bloc enlargement would occur in a step-like fashion. Uncertainty, imperfect information and mismatches of decision timing suggest that the new political-economy equilibrium is reached only

[6] See Baldwin (1993, 1995) on the original formulation of the domino theory, Baldwin (2006) for an early application to Asian regionalism, and Egger and Larch (2008) for empirical evidence.

[7] Olsen's asymmetry notes that the winners from protection (import competing firms) are asymmetrically easy to organized politically compared to the losers of protection (consumers); this is way governments typically listen more to the winners of protection.

gradually, that is, during the transition it may look like regionalism is spreading like wildfire.

Asymmetric Lobbying

The political-economy forces driving the domino effect are strengthened by the peculiar tendency of special interest groups to fight harder to avoid losses than to secure gains. Joining allows excluded firms to avoid damages as well as win new commercial opportunities, so trade diversion may play a particularly important role in generating new, pro-membership political-economy activity. Many explanations for this "loser's paradox" are possible, but one simple economic interpretation that is relevant to the domino theory is based on unrecoverable investments (sunk costs). Entry into most industries and markets involves large unrecoverable investments in product development, training, brand name advertisement, and production capacity. When this occurs, established firms can profit without attracting new firms, but only in so far as these profits constitute a fair return on the entry investments, that is, sunk costs create quasi-rents. Given that firms in an industry will have already incurred sunk costs, the deepening of an existing bloc, or formation of a new one, will generate de novo forces pushing the government to redress the new discrimination. The most direct path would be to join the bloc, but other modalities are possible. Governments of excluded nations may seek to restore profits by calling for a multilateral trade round, or forming their new trade bloc.[8] See Baldwin and Jaimovich (2010) for a formal model that relies on this effect to extend the domino logic to free trade agreements (FTAs); Baldwin (1994) focused on the customs union case.

2.2.3 Trade/Exchange Rate-Stabilization Feedback

The trade/exchange rate mechanism shows how deeper trade relations alter a government's stance on exchange rate stability. This logic has been discussed by Freiden et al. (2005) and in earlier work dating back to the early 1990s. It has also been documented empirically by Devereux and Lane (2003), and Broda and Romalis (2009). While Freiden (1996) is quite explicit about posing the mechanism as influencing the sequencing of regional integration, he is not very specific about the exact channels through which the mechanism works, so it is worth spending a few words fleshing this out.

Which economic actors both care about the exchange rate and are politically organized to make their views heard by the monetary authorities? Exporters are the most obvious special interest group. They are in the business of transforming domestic labor, capital and technology—all of which are priced in domestic currency—into goods that they sell abroad for foreign currency. Depreciation lowers the price of their inputs relative to the price of their outputs and thus raises profitability of foreign sales. In short, exporters like depreciations, and this preference intensifies as the exported share of production rises.[9]

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8 See Baldwin and Robert-Nicoud (2002, 2005) for a formal treatment of the ideas and Baldwin (1993) for an early formal model.

9 This assumes that, as is typical, nominal depreciation is not immediately offset by a rise in the domestic currency price of inputs. Offsetting price changes have happened when workers figure out that depreciation is a roundabout way of lowering wages relative to those of foreigners, and thus demanded higher wages. Wage indexing does this automatically, but often with a lag.

The second group consists of firms that sell domestically and produce with the help of imported inputs (ranging from fuel and other raw materials to parts and components). Appreciation lowers the cost of their inputs relative to the price of output, so a stronger currency boosts their bottom line. In short, domestic firms like currency appreciation—increasing as their imported-input shares rise. A third group are the import competitors, where depreciation "subsidizes" foreign competitors.

Consider the dilemma facing monetary authorities. If they let the currency drop in value, exporters will cheer them, but the domestic firms will scream. A rise in the currency's value elicits the opposition reactions. Stable exchange rates avoid this dilemma.

The key to the feedback mechanism is that the magnitude of both anti-depreciation and anti-appreciation political voices gets stronger as a nation opens its doors to trade. In short, trade liberalization alters the environment in which a government chooses exchange rate policy, systematically increasing its interest in maintaining stability. The more open the economy, the greater the political-economic pressure to stabilize exchange rates.

Two corollaries of this logic are both important and obvious. First, nations tend to stabilize bilateral exchange rates with major trade partners because they tend to elicit the largest special-interest group reactions. Plainly then, preferential liberalization that shifts a nation's trade toward its regional partners tends to make governments more interested in the stability of bilateral exchange rates between regional partners. Second, as smaller nations tend to be more open, their monetary authorities are more likely to face pressures to keep their exchange rates stable. As small countries, at least in Europe, often have very lopsided trade dependence on a few (often one) nearby, large partners, these nations frequently fix their exchange rates to those of their large neighbors. In extreme cases, like Ireland, Lichtenstein, Luxembourg, Morocco, Andorra, among others, exchange rate stability was in the polar form of a currency union even before the World War II.

In a nutshell, the trade/exchange rate-stabilization feedback mechanism describes the way an increase in bilateral trade changes the political-economy parameters affecting policymakers' choices on further integration—in this case, exchange rate stabilization policies ranging for unilateral pegging to a currency union.

Importantly, this feedback mechanism works both ways—trade makes policymakers want stable exchange rates; and stable exchange rates stimulate trade—but the two ways are very asymmetric in terms of magnitude. The trade-to-exchange rate stability direction is strong (Devereux and Lane 2003). The exchange rate stability-to-trade link is weak, as recent research has shown, revising the early, flawed research by Rose (2000) that showed large effects; see Baldwin et al. (2008) for a review of the evidence. Thus, liberalising bilateral trade can foster the adoption of policies that stabilize bilateral exchange rates (up to and including a currency union), but stabilizing bilateral exchange rates does not, per se, foster bilateral trade liberalization.

2.2.4 Institution/Institution Feedback

Institutions, once set up, rarely die; they adapt. In particular, if the institutions prove useful to participating nations, operational problems that arise can result in solutions involving more institutionalization. Section 3 provides several examples.

National governments often agree on things subsequent governments come to regret. When it comes to intergovernmental cooperation, these situations almost always end in one party reneging on its commitments. Knowing this might happen, the European Economic Community (EEC)—but not the EFTA—established supranational institutions that could induce them to stick to the original deal. This is a feedback mechanism as the Period 1 establishment of supranational institution can alter the political realities facing governments in Period 2 in a way that the governments find it politically optimal to adopt integration policies that they otherwise would have rejected.

The classic example concerns BBBs. Even as tariff barriers were being phased out, Europeans began to erect new trade barriers, detailed technical regulations and standards that fragmented European markets. While the extensiveness of such barriers was new, the idea was not. Their trade-inhibiting effects were recognized in the 1957 Treaty of Rome; Article 100 requires "approximation" (Euro-speak for harmonization) of national regulations for the "proper functioning of the common market."

In the late 1960s, the European Commission tried to cajole the EEC6[10] into liberalizing BBBs, but to no avail. Its members did not find BBB liberalization to be politically optimal. The deep problem was that the common-standard approach required unanimity in the Council of Ministers under the Treaty of Rome rules; in essence BBB liberalization was subject to an intergovernmental process of cooperation, not a federalist process, and the EEC proponents simply did not want to cooperate. (Neither did the EFTA, supporters by the way).

The supranational institutions set up in 1957 could not accept this failure as the Court and the Commission were duty-bound to enforce the Treaty. EU law and EU Court decisions are supreme and its decisions have direct effect. Because the Treaty of Rome was made part of each member's legal system, each member's respect of its own national legal system implied acceptance of the Court's power. In the key cases (Dassonville 1974 and Cassis de Dijon 1979), the Court ruled that BBBs were equivalent to quantitative restrictions and thus prohibited by the Treaty. More specifically, the EU Court created the presumption that Member States' national standards were equivalent in terms of their ability to satisfy the legitimate goals of regulation. Thus, a member state could not prohibit the sale of a good that was lawfully made and marketed in another member state—even if the good was produced according to technical or quality requirements that differ from those imposed on domestic products.

This supranational decision radically altered the political-economy reality of standards-related behind-the-border protection. If any member's standards were automatically acceptable in all member markets, domestic firms had no reason to lobby for costly,

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[10] Belgium, France, Italy, Luxembourg, the Netherlands, and (the then) West Germany.

idiosyncratic standards. Indeed, as lax standards implied a cost advantage, domestic firms had an incentive to lobby for the cheapest standards. Or to put it more directly, the Court's imposition of the mutual recognition principle created the specter of a race-to-the bottom that undermined members' de facto sovereignty over product standards. Thus switching to majority voting on such standards (in the Single European Act) allowed EC members to regain control over the production regulation process.

This is a feedback mechanism. The supranational Court, which was created in Period 1, made a ruling that changed the political-economy forces affecting nations' choices in Period 2, and in this case it made members accept policies in Period 2 that they had rejected in Period 1.

2.2.5 Trilemma/Exchange Rate-Stabilization Feedback Mechanism

The final feedback mechanism is more involved, explaining how the removal of capital controls can affect nations' choice of exchange rate regimes. The mechanism is founded on the famous trilemma. This states that a nation cannot attain the following trinity of policy freedoms: freedom to set exchange rates, freedom to set monetary policy, and freedom to set capital controls.

Now suppose the trade/capital-controls feedback has induced governments to liberalize capital flows, thus making the "holy trinity" holier (more unattainable for mortals). The trilemma then forces governments to choose between, on one hand, fixing exchange rates by slaving monetary policy to defense of parity, and, on the other, choosing monetary policy for domestic stabilization, but then allowing the exchange rate to fluctuate with market whims. Now suppose also that the trade/exchange rate-stabilization mechanism has induced governments to stabilize bilateral exchange rates with their major trade partners. This combination of effects thus induces governments to choose the most unexpected to the three angles in the impossible triangle; they sacrifice de facto sovereignty over monetary policy.

This is a feedback mechanism as the Period 1 choice of capital market liberalization alters the economic realities that affect government choices on exchange rate regimes in Period 2. Backing this up one step, it is easy to see an aesthetically pleasing sequence whereby trade liberalization triggers capital market liberalization, which in turn triggers exchange rate cooperation of some form—possible all the way to currency union. An extreme example of this mechanism can be seen in Ecuador's unilateral dollarization and Argentina's strict currency board, although of course both of these were unilateral moves, not cooperative ones.

2.2.6 The Race-to-the-Bottom Unilateralism Feedback Mechanism

The main vehicle for tariff liberalization among the world's rich nations was reciprocal trade agreements—both multilateral and regional—in the 1950s, '60s, '70s, and '80s. Developing nations did not participate in the GATT tariff-cutting exercise as the GATT's principle of "special and differential" treatment allowed their exporters to free-ride, gaining better access to rich nations' markets without having to face down their own import-competing industries. This is why the juggernaut never worked in Asia, outside of

Japan. Tariff cutting came much later and in a very different way to most emerging markets and developing nations—including most of those in Asia. The vehicle was unilateralism, not regionalism or multilateralism.

Any feedback mechanism driving unilateralism must be quite different, as the juggernaut mechanism relies on reciprocity. The key is to explain why governments find it politically optimal to remove tariffs they previously found politically optimal to impose. One mechanism is race-to-the-bottom (RTB) unilateralism (Baldwin 2006). The trigger for this mechanism is the spatial unbundling of manufacturing production. But understanding this requires a bit of background on why nations put high tariffs on in the first place.

Developing nations traditionally maintained high industrial tariffs hoping that these would stimulate domestic industrial production via the "infant industry" logic (as it had in North America, Europe, and Japan in the 19th century). With few exceptions, the high tariffs failed to create substantial industry and where it did few progressed beyond the protected-infant stage. However, following the success of the "four-tigers" (the Republic of Korea; Taipei,China; Singapore, and Hong Kong, China) many developing nations—especially in Asia—pursued "dual track" development strategies. On one hand they blocked the imports of manufactured goods to promote domestic production of manufactures, especially electrical and mechanical machinery. On the other hand, they promoted manufactured exports by setting up export processing zones and duty-free zones to attract foreign direct investment (Greenaway, Morgan, and Wright 2002, Ando and Kimura 2009).

The exogenous shock that disturbed this high-tariff political-economy equilibrium was the "information and communication technologies" (ICT) revolution. Beginning in the mid-1980s, advances in ICT dramatically reduced the cost of organizing complex activities over distances. Deregulation and technology teamed to decimate the price of telecommunications and computing power. New forms of communication appeared and rapidly transformed the workplace. Faxes became standard equipment. Cellular phones caught on and telecommunications networks became denser and more reliable even as they became cheaper. Above all, the internet—first email and then web-based technology—revolutionized information sharing, no matter how far the distance. It was not just cheaper communications costs, but it coincided with the spectacular fall in the price of computing power. Things that required a Cray super computer in 1984 could be performed on a high-powered PC by the mid-1980s. This encouraged the development and widespread use of information-management software (ranging from excel spreadsheets to sophisticated database programs).

The upshot of the ICT revolution was the rapid development of international supply chains. Cheap and reliable telecommunications, combined with information management software and hardware, transformed the difficulty of organizing group-work across large distances, making it feasible to separate various production stages geographically. Manufacturing stages that had previously been performed inside a single factory could now be dispersed internationally without an enormous drop in efficiency or timeliness. Firms in advanced nations began to unbundle the manufacturing process spatially and place segments of the value-added chain in nations with more appropriate production costs. Firms found it profitable to unbundle and move off-shore some stages (especially labor-intensive stages) to nations where low productivity was more than offset by low wages.

There were many low-wage nations that wanted these off-shored jobs and investment, so competition was intense. One element of the competition took place on parts and component tariffs—in particular on the imported intermediate goods that these offshore factories imported.

Note that the political-economy forces engaged in this sort of liberalization are quite different to those described in the juggernaut feedback mechanism. There are three key differences:

- First, much of the unilateral tariff cutting involved goods that had little domestic production. Importing an advanced Japanese gearbox to be assembled at a Toyota factory and then exported generates little domestic opposition.
- Second, many these imports were re-exported after having been assembled with other parts, so the importing and exporting is organized by the same firm. That way, the traditional indifference of exporters to domestic import barriers vanishes and with it the need for reciprocal trade agreements to assemble a pro-liberalization coalition.
- Third, competition among developing nations for off-shored jobs accelerated the process. Off-shored manufacture jobs from technologically advanced nations provide large gains for developing nations. Since removing tariffs makes export-processing activities (trade and investment) easier and more profitable for the off-shoring company, companies asked for such tariff cuts. As there were many nations competing for these investments, so it was difficult for any individual nation to resist calls for unilateral tariff liberalization.

Feedback Effect

The feedback part of this mechanism comes from the manner in which the production unbundling and off-shoring shifts the nature of competition in manufactures. If some firms, say Japanese firms, are getting their parts and components from an efficient international supply chain, nations that that try to source everything domestically will be at a disadvantage. Thus competition among final goods producers pushes all to unbundle their value-added chains and source parts from the lowest nation suppliers. In short, once nations start the unbundling process, other nations must follow or lose jobs. The effect in East Asia was to destroy the viability of one the dual-track development strategy—production unbundling turned import substitution into a one-way street with only one destination—uncompetitive industry.

2.3 Spontaneous Cooperation

The feedback-mechanism approach to regional integration sequencing covers most of the formal aspects of regional economic integration. In Europe and elsewhere, however, some pro-integration economic cooperation occurs spontaneously. That is to say, the nations each find it politically optimal to unilaterally adopt policies that foster regional integration.

In the European context, the primary example is exchange rate stabilization. The effect departs from the same basic political-economy mechanism that drives the “Trade/ER-stabilization feedback” mechanism. Namely, central banks typically face pressure to stabilize bilateral exchange rates with their main trade partners. In the case of a subset of EU members, this mechanism fostered participation in formal, exchange-rate cooperation such as the Exchange Rate Mechanism (ERM) and Eurozone. For many other EU members, and some non-EU Western European nations, the pressure resulted in spontaneous cooperation.

Switzerland and Austria (before EU membership) are good examples. Their economies are engaged in the EU almost as thoroughly as Germany’s. As a result, their central banks face approximately the same pressures to stabilize rates to EU currencies—especially the deutschemark. This is spontaneous cooperation. They adopt policies that are pro-integration (reducing bilateral exchange rate volatility promotes bilateral trade), but there is no formal agreement, no quid pro quo.

In Asia, the primary examples of spontaneous cooperation are unilateral tariff reduction on parts and components, and stabilization of bilateral exchange rates independently against the US dollar.

3. Historical Sequences: Europe and East Asia

It has often been said that the difference between theory and practice is greater in practice than it is in theory. It has also been said that the difference between fiction and reality is that fiction has to make sense. Both adages apply well to the actual sequence of regional integration sequences in Europe and East Asia. History doesn’t really make sense, but this section uses the feedback mechanism approach to organize the historical narrative in the two regions in a way that allows lessons to be drawn.

3.1 Europe’s Twin Integration Sequences

There was nothing planned about the early years of European integration. European integration was driven by a sequence of opportunistic advances, when governments seized particular moments to lock in key institutional commitments. Not all initiatives bore fruit; the path to today’s EU is littered with a long series of failed initiatives; the story of these failures tells us a great deal about the sequencing of regional integration.

This section presents a highly abbreviated historical narrative of European sequences of integration. It is necessary to stress the plural “sequences” as most scholars focus exclusively on the supranational integration path pursued by “The Six”. While this path is surely the most fascinating to historians—exactly because it is so unusual—this same reason makes it less useful as a precedent for Asia today. For the sake of this working paper, this section has been greatly abbreviated. Interested readers can find the full discussion in Baldwin (2009), Baldwin and Wyplosz (2009), or, on some aspects related to EFTA, O'Rourke (2009).

3.1.1 The Two Sequences

Europe provides a controlled experiment when it comes to studying the role of institutions in regional integration sequences. The late 1950s saw the launch of two integration exercises that had extremely different institutions, but memberships that were not wildly dissimilar.

- One sequence started with institutions that were (and are) supranational to an extent that is almost unthinkable today.

EU members are routinely required to adopt laws that they oppose, that is, those where they are outvoted explicitly or implicitly in the Council of Ministers.[11] Member State courts do not have the final word on cases pertaining to their own laws dealing with Single Market or currency union issues; here the European Court of Justice's opinion is supreme and its decision has direct effect on Member States legal systems.

- The other sequence started with purely intergovernmental institutions that resembled institutions adopted in subsequent decades in regional initiatives around the world.

Until the EU forced EFTA to set up the EFTA Court as part of the European Economic Area (EEA) in the mid-1990s, EFTA was basically an occasion for members' ministers to talk about common issues. EFTA was strictly about trade, in that it did not require members to be democracies (Portugal was ruled by the dictator Antonio Salazar from 1932 to 1968).

3.1.2 Initial Conditions

Initial conditions matter, as the previous theoretical section argued (and any scholar of human events will confirm). The key initial conditions in Europe were all related to WWII and its causes. The fear that the "solution" to WWII might merely set the stage for WWIII—as the solution to WWI set up the conflicts that lead to WWII—was the prime force in shaping Europe's integration at least up to the late 1960s.

The First Plan, its Abandonment, and Replacement

Plan A for Europe's post-war architecture was to neuter Germany—a thought based on the premise that Germany caused WWII. This was agreed or accepted by all major post-war powers. Plan A was not to be. Two early post-war facts derailed Plan A.

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[11] Many Council decisions are decided by "consensus"—no formal vote taken, but "shadow voting" still occurs. Nations decide whether the measure will pass despite their "no" vote; and they decide to be "good losers" by agreeing to let the measure be adopted without a vote. In such cases they avoid a direct loss of face, or unnecessarily causing ill will.

1. The uncoordinated pursuit of recovery produced a tangle of new trade barriers, which in turn stymied the recovery, especially bilateral balance-of-payments-linked quotas that limited much of European trade to barter arrangements.

2. The Union of Soviet Socialist Republic's (USSR) action in Central and Eastern Europe showed that it was bent on pushing Communist regimes to power in all nations it occupied in 1945 and perhaps into West Europe as well.

Plan A was out of the question. By the late 1940s, it was clear to all that a strong Germany would be part of Europe's postwar architecture.

Plan B was to embed Germany economically and perhaps politically into a community of European nations. The belief was that this would ensure Germany became a strong ally and economic partner, rather than a potential foe and economic rival. But Plan B had two versions:

- Plan B1 involved supranational integration, or the "pooling of sovereignty" as it is euphemistically called in Europe—when nations may be bound by a policy it opposed (much like proveniences within nations have to obey federal law, even those they oppose).

This was accepted by those that could be called "federalists". The citizens of nations most affected by WWII in human and economic costs felt their governance systems were deeply flawed—prone to warfare and frequent economic disruption. They were open to radically new forms of governance; the two choices at the time were communism and supranational European integration—where substantial sovereignty was pooled in newly constructed supranational institutions. This group included Germany, France, the Benelux nations as well as Spain, Portugal, Austria, Finland, and much of Central Europe.

- Plan B2 involved economic cooperation of the traditional intergovernmental variety—when nations were only bound by policies they accepted.

This was embraced by a distinct set of nations, the "intergovernmentalists". Citizens of these nations—those whose governments were viewed as having performed well in WWII—were only willing to contemplate economic cooperation on a traditional, strictly intergovernmental basis. People who lived where governments had somehow managed to avoid foreign occupation, fascism, and catastrophic loss of life tended to maintain traditional faith in national government. For them, pooling sovereignty with nations who caused or were deeply involved in these gruesome events would be the greatest of follies. This included the United Kingdom (UK), Denmark, Norway, and Iceland as well as the neutral countries: Ireland, Sweden, and Switzerland.

As we shall see, the two groups repeatedly reacted in very different ways to common shocks and feedback mechanisms. The first step in the half-century story of European integration came with intergovernmental cooperation subsidized by US taxpayers.

3.1.3 The First Phase: European Payments Union and Experimentation

European economic integration was launched by the US, specifically by the US-funded Marshall Plan. The starting point was the European Payments Union (EPU), which removed most balance-of-payments-related trade barriers (bilateral quantitative restrictions). This sparked rapid trade and industrial growth in the 1950s. The Marshall Plan, which provided much needed hard currency, came with strings attached. In order to get dollars, Europe was required to seek self-sustaining integration schemes among themselves—the US believed that recovery in a peaceful Europe required economic integration).

The result was a number of experiments and many proposals that were never adopted. The list is long, but two initiatives are worth noting: the federalist French-Italian customs union treaty signed in March 1949, and the Intergovernmental European Customs Union Study Group that began work in 1947.

Franco-Italian Customs Union Treaty, the European Customs Union Study Group and the European Coal and Steel Community

Italy and France signed a treaty in March 1949 that envisaged a tariff union within one year and an economic union within six years. It was never ratified. As it turned out, the loss of sovereignty was too great compared with the economic gains from integration. The discussions, however, showed that real economic integration in Europe would be difficult because governments at the time intervened in their economies so thoroughly that simply removing tariffs might do little more than unbalance a stable situation, with the liberalizing impact of each tariff cut being offset by a string of murky behind-the-border measures. To prevent such offsets, parties put very deep disciplines into the treaty that would have required them to pool a great deal of sovereignty over economic policy.

The second initiative was a West Europe-wide customs union. This was discussed by all Organization for European Economic Co-operation (OEEC) members via a committee that was almost immediately formed upon implementation of the Marshall Plan (the European Customs Union Study Group, or ECUSG). The ECUSG produced two reports in 1948 but did little beyond highlighting the deep schism between federalist and intergovernmentalists. The customs union was too deep for intergovernmentalists (a customs union requires supranational decision-making on the common external tariff). For the federalists, it was too shallow.

One experiment that came into force was the European Coal and Steel Community (ECSC). While it was a time-limited arrangements (it molted from irrelevance to inexistence in 2002), it became a useful experiment in European-led integration. Unlike the EPU, the ECSC was a deeply federalist institution, and an important one at that. Coal and steel were, at the time, considered the “commanding heights” of modern industry and crucial to national military strength. French foreign minister Robert Schuman explicitly justified his Plan as a means of making future Franco-German wars materially impossible. The specific proposal concerned Germany’s and France’s coal and steel sectors, but Schuman welcomed all Europeans who could live with supranationality.

In the first of a long series of repetitions, European reactions diverged. All federalist nations who were both democracies and free from Soviet influence joined this sectoral integration effort (France, Germany, Italy, and the Benelux nations—"The Six"). Intergovernmentalists shared the Beneluxers support for Franco-Germany rapprochement, but the idea that they themselves would pool sovereignty with the Six was beyond serious consideration.

Failed Moves to Military and Political Integration: European Defense Community and European Political Community

While not very successful in economic terms, the ECSC was a turning point. For diverse nationalistic motives, the Six came to view European integration as best solution to the "German problem."[12] By the time the ECSC was up and running in 1952, Europe was a very different place than it was in 1945. The highly favorable experience with European integration (mostly with the EPU which had been operating since 1950, but also the Six's experience of negotiating and establishing the ECSC), combined with the Cold-War linked necessity of German rearmament, led the Six to embrace the European Defense Community (EDC).

Although ultimately rejected by the French Parliament in 1954, the EDC was the high-water mark of proposed European supranationalism. Supported by the US (which was hoping to shift more of the defense burden to Europeans), the Six signed the Treaty establishing the EDC in May 1952. It called for 40 divisions sharing the same uniform and operating under a supranational command. Political guidance was to come from a Commissariat of nine members, a Council of Ministers, and a parliament-like EDC Assembly.

Establishing a European Army without clear political control was a non-starter, so parallel talks on a European Political Community (EPC) were launched. The Constitution for the EPC (drafted by the unelected and highly idealist ECSC Assembly) strikes today's reader as idealistic to the extreme (and indeed it was never signed by governments, much less ratified). Many of its more moderate elements, however, were carried over into the EEC's 1957 Treaty of Rome.

Due to Dutch efforts, the EPC also delved deep into economic integration. The so-called Beyen Plan (December 1952) called for a Common Market involving the free movement of goods, services, capital, and labor across all sectors of the economy. The ECSC Assembly adopted the EPC by a near-unanimous vote in March 1953.[13] The French Parliament rejected the EDC Treaty in 1954. This left the "German question"—how to embed a rearmed Germany—unanswered. An alternative solution was rapidly adopted when France lifted its veto on German membership in the Western European Union

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[12] The French viewed it as a counterbalance to US-UK influence, and a way of assuring Germany's recovery did not threaten modernization of France's archaic manufacturing sector. The US supported it as an anti-communist bulwark. Germany saw it as the surest way to regaining sovereignty. Italy embraced it as a counterbalance to Communism at home, and a way to seal off its fascist past. Beneluxers were overjoyed with anything that lessened the prospects of a new Franco-German war.

[13] The governments of the Six, which had yet to sign or ratify the Assembly's draft of the EPC Treaty, found much to complain about in the draft. This was the first but not last time that a European parliamentary body proved to be radically more federalist than its Member State governments. The EPC sank along with EDC.

(WEU) (October 1954), and finally agreed to West German sovereignty in 1955; in the same year, Germany joined the North Atlantic Treaty Organization (NATO), established a new army, and rearmed in earnest with US assistance.

3.1.4 European Integration Takes Off

Compare Europe 1955 to Europe 1945. In 1945 the plan was to return Europe to its prewar structure of independent nation-states. The hobbling of Germany was the keystone of this new architecture—essential to avoiding WWIII.

In 1955, the first part of the new architecture was in place, but without a keystone. Germany was on track to dominate European industry (this time eclipsing even Great Britain) and it was assembling the most powerful West European army ever. With the cataclysm of WWII still fresh, many Europeans, including many Germans, wondered whether Germany's NATO membership, the ECSC, and the presence of the common Soviet enemy would be sufficient to prevent history from repeating itself. By 1955, coal and steel were no longer the "commanding heights" in economic or military terms.

Having failed in their "frontal assault" of directly setting up a European Army, European Defence Community, and European Political Community, attention turned to backdoor economic integration—the Bayen Plan elements in the EPC. The push factor (solving the German question) was operating at the same time as a pull factor.

Europe's trade, industry, and incomes were booming in the mid-1950s, growing at rates that would be the envy of many East Asian economies today. As explained in the theory section, trade begets trade liberalization and vice versa, so this economic miracle fostered a political environment that favored further trade liberalization. Specifically, this juggernaut feedback mechanism was triggered by intergovernmental integration—primarily the EPU and to a lesser extent the GATT tariff cutting Round in 1947, 1949, and 1951.

Messina and the Treaties of Rome

The month Germany joined NATO, Benelux countries sent a memo to France and Germany suggesting that the economic elements of the rejected EPC be reconsidered as the core of a European Economic Community. The memo also mentioned two projects favored by France, ECSC-like sectoral integration in the transport and atomic energy sectors. With the push and pull factors in mind, foreign ministers of the Six met in Messina in June 1955 to start a process that soon led to two treaties, signed 25 March 1957. The first created the European Atomic Energy Community (Euratom)—something like a modern version of the ECSC but one that never function as expected.[14] The second created the European Economic Community (EEC). The Treaties of Rome were

[14] France, which pushed hardest for Euratom (making it a condition for its acceptance of the EEC), expected atomic energy to play as important a role in postwar industry as coal did in the prewar period. As France was developing atomic power, and Germany was banned from doing so, Euratom was to be a means of channeling and maintaining French influence in this new "commanding heights" sector. This never happened; its institutions, along with those of the ECSC, were absorbed into those of the EEC in 1965. Today Euratom's major project is to coordinate the EU's participation in the international fusion reactor.

quickly ratified by the six national parliaments and the EEC came into existence in January 1958.

European Economic Community Institutions

The Treaty of Rome committed the Six to extraordinarily deep economic integration. It set up supranational institutions such as the European Commission, the European Parliamentary Assembly (which became the European Parliament), and the European Court of Justice.[15] In addition to forming a customs union (removing all tariffs and quotas on intra-EEC trade, adopting a common external tariff, and delegating to the European Commission responsibility for external tariff policy for the EEC), it committed the members to free trade in services, free mobility of workers, capital market integration, and a range of common policies (for example, a common competition policy and a common production subsidies policy) some of which were to be implemented by executive decisions of the supranational European Commission.

There were, however, deeper elements sprinkled across the Treaty whose import only became apparent with time. To start with, the preamble announced that the first goal of the EEC was “to establish the foundations of an ever closer union among the European peoples …”. This mattered when the Court of Justice interpreted the Treaty. It also mattered when the European Commission—the guardians of the Treaty—decided what sort of legislation to introduce. Another example is the Treaty Article that requires members to approximate their laws to the extent necessary for the smooth functioning of the Common Market. After a series of landmark Court decisions in the 1970s, this eventually triggered the radical deepening of EEC integration As embodied in the 1986 Single European Act (more on this below).

The depth of the Treaty of Rome was not really a surprise at the time. Given the logic that emerged from the failed Fanco-Italian Customs Union Treaty, and the logic that led to the inclusion of the Beyen plan in the failed EPC, and the logic that produced supranational institutions in the ECSC, the EEC was clearly expected to go deep. This was driven by a combination of practical mercantilism and European idealism—the relative importance of which is impossible to decide definitively. As far as mercantilist motives are concerned, the basic point was that the governments of the Six believed that removing tariffs alone could lead to cheating. They required assurances that each others’ tricky behind-the-border-barriers (taxes, subsidies, exclusive producer or distribution cartels, dual pricing of rail transport, etc.) could not be used to nullify the market access created by the removal of tariffs and quotas. The fact that this embedded a rearmed Germany into a supranational European framework rendered even more attractive the depth explicitly agreed to and the open-ended nature of the commitment to an ever closer union.

The actions of the Six forced the hand of the other OEEC nations; once again, the same political-economy factors were to produce very different choices among the federalist and the intergovernmentalists.

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[15] See Baldwin and Wyplosz (2009) Chapter 2 and 3 for details on EU institutions.

3.1.5 Domino Feedback: The Intergovernmentalist React

Britain was invited to participate in Messina and the European economic integration process, but sent no representative to Messina and formally withdrew from the process leading to a Common Market in November 1955. Yet the reality of the EEC destroyed the OEEC status quo and triggered a domino effect. Britain first renewed efforts to get a shallow but OEEC-wide trade agreement, but this was steadfastly refused by the Six.

The EEC introduced a powerful new political-economy force into the European integration dynamic—discrimination. Before the EEC, trade liberalization (orchestrated by the OEEC) did not discriminate against OEEC members.[16] The EEC promised to remove all trade barriers on a discriminatory basis and impose a common tariff against nonmembers. This pending discrimination from a huge and fast growing market left the other OEEC members—most of them small—on the sidelines. Fearing the discrimination and marginalization that might occur if they faced the EEC bilaterally, seven of these "outsiders" reacted by forming their own bloc in 1960, the European Free Trade Association (EFTA). This coordinated response was greatly facilitated by UK leadership.

Domino Effects: 1961–1973

The 1960s saw the trade liberalization promised by the Treaty of Rome and the Stockholm Convention (EFTA's founding document) come to fruition. This had an immediate and dramatic impact on trade patterns. During the customs union (CU) formation, the EEC's share in its own trade rose from about 30% to almost 50%. At the same time, the share of EEC imports coming from six other major European nations remained almost unchanged, falling from 8% to 7%.

The domino-mechanism's "gravitational force" can be estimated statistically by looking at the negative impact that non-membership had on sales between EFTA and the EEC. In Figure 5, the relevant numbers (EU01) show that discrimination peaked in the early 1960s, and again in the mid-1970s, in synch with EFTA moves to draw closer to the EEC market. The discrimination factor facing EU firms into the EFTA market is also shown, but is generally not statistically significant. The early surge comes from the rapid implementation of the EEC customs union; it comes down as the multilateral tariff-cutting of the GATT's Kennedy Round begins to dampen the margins of preference by lowering the EEC's common external tariff.

This trade diversion generated de novo political-economy forces for lowering between-group barriers via the domino feedback mechanism. Of course, the same happened to EEC firms in EFTA, but given that the EEC's market was about twice the size of the EFTA market, pressures on EFTA members to adjust were much greater than those on EEC nations. Britain was the first to react. In 1961, Great Britain overcame its long standard opposition to federalist integration and applied for EC membership. (See O'Rouke [2009] for more detail on the British thinking between 1957 and 1961.)

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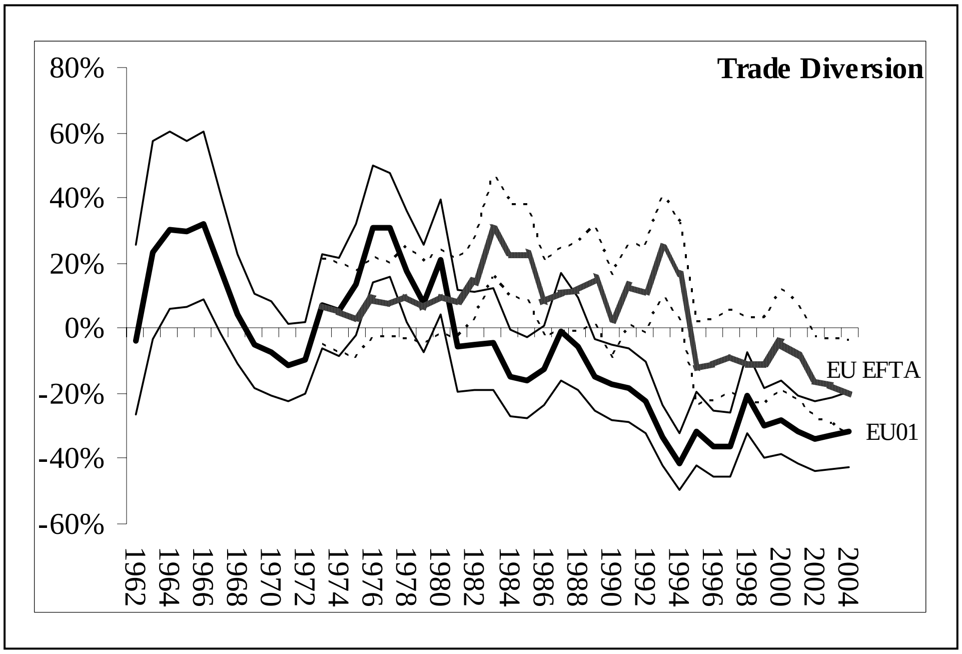
[16] The ECSC was a members-only club, but it was essentially joint management of declining sectors that other Europeans offset with national policies.

Figure 5: Trade Diversion in the European Union and the European Free Trade Association, 1962–2004



EFTA = European Free Trade Association, EU = European Union.

Notes: Heavy lines show the point estimates for the year-by-year estimates; the lighter lines for the standard errors. EU01 is the trade diversion effect facing EFTA members. EU EFTA is the effect facing EU nations.

Source: Baldwin and Rieder (2007).

This move requires some explaining, as Britain had decided to withdraw from Common Market discussions just five years earlier. Note that while Britain's move was unilateral, it triggered a second domino effect that induced Ireland, Denmark, and Norway to follow Britain's lead, likewise overcoming opposition to supranationalism. (The other EFTA members still found the EEC's depth of integration too high a price to pay for redressing the economic discrimination.)

French President Charles De Gaulle unilaterally vetoed the UK's application in 1963 and again in 1967 after the same four EFTA members reapplied. After De Gaulle resigned as French President, EEC membership for the four was agreed in 1973. Norway's population (which is even more intergovernmental than its government) refused EEC membership in a referendum.

This triggered a third domino effect. The impending departure of four EFTA members to the EEC was anticipated well in advance and would have resulted in new barriers being constructed between the new EEC members and the remaining EFTAs as the EEC is a customs union. Moreover, it would have heighted the discrimination by widening the range of EFTA competitors that enjoyed EEC preference. EFTA industries pushed their governments to redress this situation. The result was a set of bilateral free trade agreements (FTAs) between each remaining EFTA member and the EEC, designed to take effect when the UK and company acceded to the EEC.

By the mid-1970s trade arrangements in West Europe had evolved from two non-overlapping circles to two concentric circles. The outer circle, which encompassed both EFTA and EEC nations, was a virtual free trade area for industrial products—the concatenation of three types of agreements. The inner circle was the EEC's Common Market.

3.1.6 Deeper Economic and Monetary Integration

The first decade after European integration took-off was a characterized by remarkable growth in income and trade, especially intra-Europe trade. In addition to triggering the domino effect just discussed, booming trade and investment triggered two sequencing feedback mechanisms: the juggernaut effect and a trade/exchange rate mechanism.

Behind-the-Border Barriers
EEC leaders had committed themselves to liberalizing behind-the-border-barriers (BBBs) in the 1957 Treaty of Rome and, critically, charged the independent European Commission and European Court of Justice with making sure that actions followed words.

Just after completing the customs union, the European Commission—which is institutionally obliged to ensure that Treaty commitments are honored—embarked on BBB liberalization. It adopted a plan in May 1969, called the General Programme.[17]

The focus on BBBs reflected more than legalistic impulses. When the Treaty of Rome was signed, tariffs and quotas were very important barriers to trade and product regulation was primitive by today's standards. As European incomes rose in the take-off stage, the range of BBBs—especially product standards and regulation—widened. European governments started to introduce more micro regulations—health, safety, and environmental product standards designed to protect citizens. Given the ubiquitous political economic pressure to favor domestic actors, many of these new rules and standards favored domestic firms. The protectionist content of the new BBBs was incidental to their purpose, but far from accidental.[18] The impact of these on trade flows can be seen in Figure 5 as EFTA-to-EU trade diversion rises again in the 1970s.

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[17] The General Programme comprised four Council resolutions and a framework decision adopted on 28 May 1969. The resolutions concerned a detailed timetable for a large number of directives on industrial products, the same for foodstuffs, the expression of the Council's intention to institute mutual recognition of conformity assessments, and a procedure for adapting directives to technological advances. The framework decision prescribed a standstill of Member State measures concerning products covered by the General Programme, and a requirement that Member States inform the Commission of new provisions for products not covered. This launched what came to be called the "traditional" or "old" approach to TBT liberalization. The adopted approach relied on detailed technical regulations for single products or groups of products implemented by unanimously agreed directives. See Lauwaars (1992) or Pelkmans (1980) for details.

[18] For more on this logic see Baldwin (2000) and Baldwin, Evenett, and Low (2009).

The same changes affected EFTA governments quite differently. Addressing technical barriers to trade—such as health standards for food—requires discussion of policies traditionally considered the exclusive purview of nation-states. Although EFTA governments were facing the same juggernaut pressures as the EEC governments, they were unwilling to engage in the sort of federalist process that would be required to effectively address BBBs. They did, however, react in a multilateral setting, trying to promote the internationalization of product standards, thereby reducing their protectionist content.

The International Standards Organisation, which had been set up in 1947, had languished up to the late 1960s, but one of EFTA's big industrialized exporters, Sweden, pushed for its reinvigoration with the appointment of Olle Sturen with support from the Swedish Standards Institute in September 1968. As the ISO's first Annual Review in 1972 wrote, "it was in the sixties that international standardization really began to break through. Whereas about 100 Recommendations were published in the fifties, about 1400 documents were approved in the sixties." The ISO was not by any means a good solution to the BBB problem, but it was about the best that could be done by staunch intergovernmentalists in the 1960s.

Exchange Rate Stabilization: Economic and Monetary Union I

The trade/ER feedback mechanism steadily ratcheted up pressure for exchange rate stability since the start of European trade liberalization in 1950 with the EPU. For much of this period, however, exchange rate stabilization was overseen by the IMF's Bretton Woods system.

From a European perspective, Bretton Woods was lacking. It stabilized rates against the US dollar within a fluctuation band. Even when EEC nations maintained their central rate against the dollar, the band meant that the bilateral rate could deviate against each other by twice the band width. Changes in the Bretton Woods central rates were also decided by a body dominated by the US, not by the EEC Six. Both of these features made Bretton Woods an imperfect policy response to the rising pressures for exchange rate stabilization within the EEC. EEC leaders responded in 1969 by proposing a sweeping deepening of European integration on this score.

Leaders of the Six, meeting in December 1969—for the first time without the anti-federalist Charles De Gaulle (he was replaced by the new, pro-European French President Georges Pompidou)—called for a plan on the staged introduction of a monetary union by 1980. The result was the 1970 Warner Plan. This was a huge leap in ambition as monetary cooperation was only meekly mentioned in the Treaty of Rome. In the late 1950s, Bretton Woods was working well and most considered as unrealistic the notion that the Six could establish a monetary system independent of dominant currencies—the dollar and the pound sterling. However, the Hague declaration did not come out of thin air.

As part of a review of progress in the second stage of the custom union's implementation, a Committee of the Six central bank governors was establish along with a call for prior consultation on exchange rate changes.[19] The spark for the EEC's big step, however, was the exchange rate turmoil of 1969—when the French franc was devalued 12.5% against the dollar (August) and German mark was revalued by 9.3% (October). All this took place in an atmosphere where chronic US trade deficits undermined the dollar's credibility as "paper gold." This chipped away at the solidity of Bretton Woods fixed exchange rate system because the dollar—and the US' ability and willingness to transform dollars into gold—was the heart of the system.

Shock and Reaction

Extremely poor macroeconomic performance in the early 1970s forced the EEC to shelve the Warner Plan, but discussion surrounding the plan revealed the difficulties of a monetary union in Europe. Most notably, the EEC leaders assumed that monetary union would be part of an important deepening of the Common Market—what they called "economic union." The Hague Council introduced the phrase "Economic and Monetary Union" or EMU (often misstated as European Monetary Union), which was brought back in the 1992 Maastricht Treaty (Issing 1973).

This was not a matter of beautiful words inspired by an idealistic desire to deepen European integration. It reflected hard economic and political-economic realities. Discussions quickly revealed that forming a monetary union would only be politically acceptable to EEC members if it was accompanied by important flanking policies, most notably liberalizing capital flows and tight coordination of national debt and deficit policies. As discussion of a customs union between France and Italy in the 1940s revealed the ineffectiveness of removing tariffs and quotes without disciplining BBBs, the 1969 discussion revealed an intrinsic lumpiness in the integration process—slipping gradually into monetary union would not be possible.

While EMU was off the agenda, the trade/ER feedback mechanism was still functioning, forcing EEC leaders to react to the shock of global monetary instability triggered by irresponsible US policy and greatly amplified by the breakdown of Bretton Woods and the first oil shock. In March 1972, the EEC set up a plurilateral exchange rate stabilization system called the "snake," its purpose being to reduce fluctuation of EEC currencies against each other. However the Six's macroeconomic responses to the 1973–75 recession were uncoordinated and quite different; inflation reached double digits in most European nations—apart from Germany and the group of nations that unilaterally pegged to the deutschmark (the so-called DM bloc). As the crises settled down and the recession passed, EEC leaders decided to strengthen exchange rate stabilization by setting up a European Monetary System (EMS) in 1979. This was akin to the Bretton Woods system with a European Currency Unit (a weighted basket of all EEC

[19] The institutional aspect of this reveals much about how EEC leaders' views of supranationalism had changed since the 1950s. The Committee of Governors of the Central Banks of the Member States of the European Economic Community was not an official EEC body subject to supranational control by the Commission and the Court. It was intergovernmental cooperation; indeed, its meetings were held at the Bank of International Settlements (BIS) in Basel right up till the creation of the European Monetary Institute in 1994. Indeed the BIS handled operations for the European Monetary Cooperation Fund until 1994, just as it had handled transactions for the Marshall Fund's EPU.

currencies) as the anchor instead of the dollar. By stabilizing against the ECU, the whole grid of EEC bilateral exchange rates was stabilized.

In addition to sowing the seeds of the euro, the 1970s disparate monetary reactions to a common external shock illustrated how difficult full monetary cooperation would be when national central banks were beholden to national politicians. The emergence of stagflation also illustrated the limits of discretionary macro policy. European nations that tried to stimulate demand via expansionary monetary policies ended up with recessions and double-digit inflation, while those that were more restrained experienced recession with much more modest inflation. These two facts acted in a scissor-like manner to cut support for keeping central banks under the direct political control of national governments—an outcome that reappears in the story in the 1990s.

Intergovernmentalist Reactions to the Bretton Woods Shock

The break of Bretton Woods was a global shock that destroyed the status quo; all European nations had to react. As monetary policy is one of the most sensitive national policies, the thought of formally pooling sovereignty on monetary and exchange rate affairs was abhorrent to the staunch intergovernmentalists left in EFTA.

The trade/ER feedback mechanism, however, forced these governments to do something about the instability. The reaction was “spontaneous cooperation,” or what might be labeled “fortuitously coordinated unilateralism.” Because the EFTAs had roughly similar trade patterns—they all traded a great deal with the EEC9—their individual stabilization efforts mimicked the effects of the more institutionalized and federalist EEC schemes. Indeed some of the EFTAs (Austria and Switzerland) were core members of the deutschmark bloc and thus were unilaterally shadowing Germany monetary policy and thus stabilizing their bilateral exchange rates—at least as effectively as some formal EEC monetary arrangements (such as France and Italy).

The schism took a new turn when it came to monetary cooperation in the 1970s. EEC membership for the UK, Ireland, and Denmark meant that some intergovernmentalists were among their EEC ranks. Britain decided not to join the new monetary integration schemes, so the federalist-intergovernmentalist schism started operating within the EEC as well as between the EEC and EFTA.

Institution/Institution Feedback

The first years of the EEC revealed problems with the functioning of European institutions. The most obvious was duplication and overlap among the separate but parallel institutions of the EEC, the ECSC, and Euratom. In 1965, the Six adopted the Merger Treaty, merging the ECSC and Euratom institutions into EEC institutions. To reflect this, the name European Communities (EC) was adopted.

This is a clear example of institution/institution feedback. The integration accomplished by supranational institutions created a situation where the smooth functioning of these institutions became an important matter to the member nations. Problems that were swept under the rug in the interest of political expediency in 1957 could no longer be ignored.

A second example came with the creation of the "European Council." Member States in the Treaty of Rome were to be represented on a Council of Ministers. However, the power of initiative—the agenda was formally assigned to the European Commission. National leaders of the member states felt they needed to get back in charge of the European agenda. The Council of Ministers was not an appropriate institution as it met at the Ministerial level, not the Head of State level, and its agenda was largely shaped by the Commission, not its members.

In reaction, national leaders of the Six would sporadically meet to hash out high-level political compromises and set political directions to guide the work of the Commission and Council of Ministers. In 1974, French President Giscard d'Estaing called for the formalization of these meetings into a "European Council." This body—entirely outside the EU's formal structure until the 1990s—worked on a purely intergovernmental basis, although of course the fact that the fallback may involve initiatives from the Commission and majority voting in the Council of Ministers put a limit on veto power.

A third example came with the 1970s Budget Treaties. Before, budget obligations were being met by annual, ad hoc contributions from members—an exercise that always created tension, especially as the EEC's agricultural policy—the Common Agricultural Policy—became increasing expense.

A fourth example was the creation of the Committee of Governors of the Central Banks of the Member States of the European Economic Community—where institutional cooperation generated pressures to deepen further institutional cooperation.

3.1.7 Institutions Begin to Matter: Reigniting European Economic Integration

While the terrible economic environment of the 1970s fostered exchange rate cooperation (both explicit and spontaneous) among EU and EFTA nations alike, it ruined EU efforts to advance trade integration beyond tariffs; the General Programme was a complete failure. The deep problem was that harmonizing standards required unanimity in the Council of Ministers under Treaty of Rome rules—in essence BBB was subject to an intergovernmental process of cooperation, not a federalist process—and the EEC members just did not want to cooperate.

While EU members were happy to ignore their Treaty of Rome commitments, the supranational institutions set up in 1957 could not accept the General Programme's failure. The Court and the Commission were duty-bound to enforce the Treaty. Here judicial activism by the supranational European Court of Justice was the critical factor.

As a result of a series of landmark decisions—directly effecting all member's legal systems and which could not be appealed in nation courts—the EU Court created the presumption of "mutual recognition;" that Member States' national standards were equivalent in terms of their ability to satisfy the legitimate goals of regulation.[20] Thus, a Member State could not prohibit the sale of a good that was lawfully made and marketed in another Member State—even if the good was produced according to technical or quality requirements that differ from those imposed on domestic products. In practice, the only import-discriminating measures that escaped this injunction were those justified on health grounds, and the Court critically scrutinizes these.

As an unintentional consequence of the judicial override—an override that was only possible due to the existence of the supranational institution—was to open the door to potentially massive competition among member state standards. If any member's standards were automatically acceptable in all member markets, domestic producers would press for a relaxation of standards in order to gain competitiveness, or at least match the advantage held by firms producing in members with lax standards.

The Court's decisions created the specter of a race-to-the-bottom that undermined members' de facto sovereignty over product standards. Needless to say, nothing even remotely like this occurred to EFTA members as they had no supranational institutions and in any case had not pledged themselves to BBB liberalization.

The Institution/Integration Feedback

The Court decisions and the Commission's interpretation of them triggered a reaction by EEC leaders. The result was the so-called "new approach" BBB liberalization. This was adopted with lightening speed by Euro-integration standards. The path-breaking Cockfield White Paper appeared in mid-1985 and by mid-1987 the Treaty implementing it (the Single European Act) was ratified by all Member State parliaments. The result was a flurry of Single Market directives and a massive deepening of Europe's product market integration. Indeed, the scope of the new approach was widened to sectors that were initially thought to be too sensitive, such as automobiles, air transport, and energy.

It is important to realize how the Court's decisions flipped the sovereignty/cooperation trade-off. Before the mutual recognition principle, maintaining an idiosyncratic standard was a way to protect domestic production for more competitive foreigners. Non-cooperation was the Nash outcome. After the mutual recognition principle, maintaining an expensive, idiosyncratic standard meant cripplingly exporters' competitiveness. In short, the EU Court pulled the rug out on the ability of national regulatory authorities to use standards and regulations as protection. This made cooperation a best strategy for all EU members—this explains why the Single European Act was adopted so quickly despite being a radical loss in de jure sovereignty—even Britain's federalist Prime Minister Margret Thatcher embraced the loss of sovereignty implied by the switch to majority voting on Single Market issues. The mutual recognition principle also rearranged firms' incentives to lobby for strange standards. EU industry had little to gain from opposing the Single European Act.

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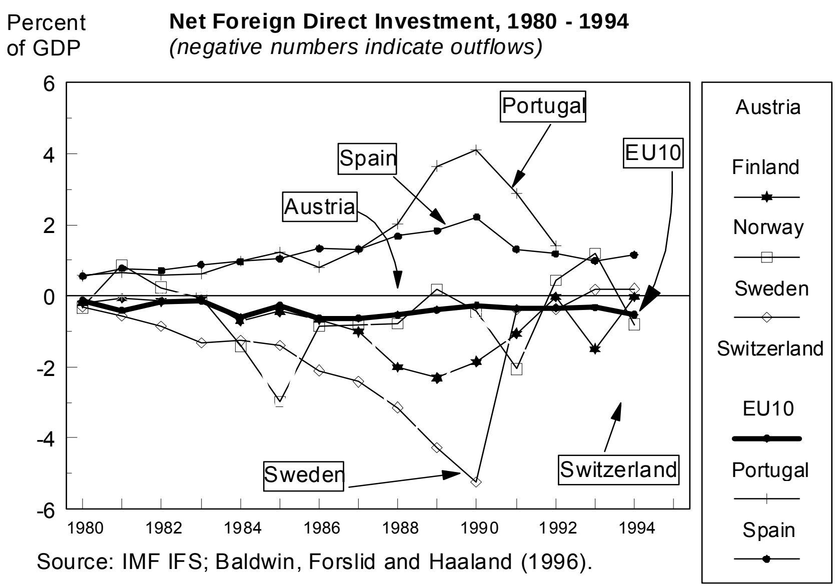
[20] The general legal basis for removing BBBs is Article 100 (original numbering) of the Treaty of Rome. The Court, however, felt Article 100 was too general to be of use in challenging specific barriers. Instead, the EU Court referred to the EEC Treaty's Article 30 (this is similar to the US Constitution's Commerce Clause), which states that "quantitative restrictions on imports and all measures having equivalent effect shall, without prejudice, be prohibited between the Member States."

The point bears repeating. Before mutual recognition, cooperation on standards meant decreasing national control over its standards. Mutual recognition destroyed this status quo, making cooperation the best way of increasing national control over product standards. Once again the distinction between de facto and de jure control was forced to the fore by shocks that were external to the policy process.

3.1.8 Domino Feedback Effects: EFTAns 'Forced' into Supranationality

The Single European Act would greatly deepen EU economic integration. Non-EU Europeans again found themselves threatened by discrimination. EFTA firms reacted by "voting with their feet,"—moving production to the EU. As Figure 6 shows, foreign direct investment boomed in the nations joining the Single Market (Spain and Portugal—banned from the EU until they restored democracy in the mid-1970s—joined in 1986 after prolonged accession talks) and faltered in nations that seem to be left out—especially the industrial EFTAns, Switzerland, Sweden, and Finland.

Figure 6: Investment Diversion and the Single Market



Source: IMF IFS; Baldwin, Forslid and Haaland (1996).

EU = European Union.

As in the 1960s and early 1970s, EFTA firms again prompted their governments to offset the discrimination by seeking closer ties with the EC. As we shall see, however, a new element emerged during this exercise.

Given the domino-theory political-economy forces, it is easy to understand why the EFTAns would want to participate in the Single Market. The vehicle was to be the European Economic Area (EEA) agreement. There are, however, two aspects of the EEA that are truly extraordinary.

- The EEA is unbalanced in terms of the rights and obligations of EFTAns in future EU legislation.

In essence, it forces the EFTAns to accept all future EU Single Market legislation without granting them any formal input when forming these new laws. This took the falsity of de jure regulatory sovereignty to new heights.

- The EEA created a good deal of supranationality among the EFTAns, and forced the EFTAns to speak with one voice on many issues during the negotiations.

This supranationality was extraordinary for two reasons. First, the EU imposed this supranationality on the EFTAns to simplify the task of keeping the Single Market homogeneous. Second, the EFTAns had resisted supranational authority since the end of WWII, so it is astounding that they said they would accept it.

As it turned out, virtually none of the EFTAns were willing to live with the EEA as it was negotiated. By the end of negotiations, Austria, Finland, Sweden, Norway, and Switzerland had put in EU membership applications. For these countries, the EEA was viewed as a transitional arrangement. Swiss voters rejected that EEA in December 1992, effectively freezing their EU application. Accession talks with the four EFTAns were successful, so the EEA consisted of the EU-15 on one hand (Norway's voters rejected membership in a referendum) with Norway, Liechtenstein, and Iceland on the other. Switzerland negotiated the Bilateral Accords with the EU-15; these mimic the EEA without requiring Swiss participation in EFTA's new supranational institutions (e.g. the EFTA Surveillance Authority).

Of course, the membership bids of Sweden, Switzerland, Finland, and Austria would have been unthinkable in the old Cold War environment. From 1989, the East-West political division of Europe crumbled and then vanished; without these profound political changes, it is not clear that Sweden, Finland, and Austria could have joined the EU.

Monetary Integration: The Role of Feedback Effects

When it comes to European integration, the headline shock in the monetary sphere was the breakdown of the Bretton Woods system that led federalists to join the EMS and intergovernmentalists to adopt unilateral pegs of various kinds. There was, however, a powerful force for change operating in the background—the trade/capital-market feedback mechanism.

The Trade/Capital-Controls Feedback

As the pace of trade and investment integration picked up, and the range and sophistication of financial products expanded, the administrative burden imposed by capital controls became more tiresome. At the same time cost-competition became more intense. Exporters and importers began to press for liberalizing some capital controls as a pro-business deregulation.[21] As a result, nations around the world, including in Europe, began to relax capital controls (Wyplosz 2001).

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[21] To take an example for today's world of how trade transaction and financial transaction are blurred, consider what happens when you buy a book from Amazon.co.uk with a Swiss credit card. The book purchase and shipping are clearly trade, but the credit card usage means a short-term loan is extended in Swiss francs and then converted to pounds sterling, so in effect the buyer is borrowing pounds short

While this feedback effect progressively changed the realities across Europe, and many EC members were well on their way to phasing out capital controls unilaterally (for example, the UK eliminated them in 1979), the federalists reacted with new rules and supranational procedures, the 1986 Single European Act. This Treaty committed EC members to removing all controls by 1993—a Council decision in 1989 moved the deadline up to July 1990, labeling this as the first stage towards Economic and Monetary Union (EMU).

The intergovernmentalists mimicked this unilaterally, often prompted by their banks and trading firms to match the EU's liberalization pace. See Wyplosz (2001) for the timing of this liberalization for EC and EFTA nations.

Trilemma/Exchange Rate-Stabilization Feedback Mechanism

The removal of capital controls in particular, and the growth international financial markets in general, changed exchange rate and monetary policy options facing nations. The trade/capital-market feedback mechanism induced European governments to choose a policy of free capital movement. This forced governments to choose between, on the one hand, fixing exchange rates by slaving monetary policy to defense of the parity; and, on the other hand, choosing monetary policy for domestic stabilization purposes, but then allowing the exchange rate to fluctuate with market whims.

Of course the trade/ER-stabilization mechanism was still in force, so governments found it political optimal to stabilize bilateral exchange rates with major trade partners. Thus governments sacrificed de facto sovereignty over their monetary policy by shadowing Bundesbank monetary policy. In essence, the EMS—which had been set up to function symmetrically—ended up operating as a DM zone, much like Bretton Woods was a dollar zone. Germany set its monetary policy to stabilize its domestic economy and the rest of Europe followed suit to defend their DM exchange rate.

The story of behind this turn of events is quite short. By the time 1980 came around, and the world economy was starting to recover from the second oil shock, central bankers around the world decided to defeat inflation with a recession-inducing money crunch. This sort of exercise always involves a confidence game. If workers believe the central bank is serious about defeating inflation, then they will stop asking for higher wages, and the wage-price spiral is broken. While the world rarely works this way, if everyone believes everyone, inflation can be defeated without a recession. If confidence is lacking, workers continue to press for higher wages and a recession is necessary to force firms to restrain price rises. Yet with prices rising less quickly than wages, real wages rise and firms must fire workers to bring labor productivity and real wages back in line.

All this meant that central bankers in Europe were looking for sources of credibility. In the early 1980s, the central bank with the most credibility was the Bundesbank—as it had stuck to its anti-inflation policy through the stagflation period. The federalist

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term in the process of buying the book. Indeed, if the order is cancelled and the pounds refunded, the buyer will have wound up speculating on the franc-pound exchange rate. All this goes to say that it can be quite difficult to clearly distinguish between capital and current account motives for buying foreign exchange. And the problem gets more severe as the flow and sophistication of transactions increase.

participants in the EMS and the intergovernmental shadowers came to view the defense of their bilateral exchange rate with the DM as an extremely effective way of showing workers, firms, and markets that they had indeed changed their spots; that they too would be just as tough on future inflation as the Bundesbank had been since 1949.

In the EU, this was called the “hardening” of the EMS. The practice of frequent central rate adjustments was abandoned. In France it was called the “franc fort” policy (orchestrated by the current ECB President, Jean-Claude Trichet). In the EFTA it was called common sense.

German Unification Shock: De Facto versus de Jure Sovereignty Once Again

By the late 1980s, most European nations had de facto delegated their monetary policy to the Bundesbank. This caused few problems; the external anchor had results in quite favorable macroeconomic performance in the 1980s. Inflation was falling and growth was rising—stagflation in reverse.

All this changed when the Berlin Wall came down and West Germany essentially annexed newly independent East Germany. To smooth the unification, the German government cranked up spending. To keep unification politically popular, it did not raise taxes as much. The result was an unintended fiscal stimulus to the West German economy that was already at full employment. The Bundesbank raised interest rates to counter the government’s pro-cyclic fiscal policy (it was politically independent of the government since inception and was not at all happy about the deficit spending). One can argue over how appropriate this policy mix was for Germany. But for the rest of the Europe, it was an unmitigated disaster. The EMS members and the EFTA shadowers got the restrictive German monetary policy without the offsetting fiscal expansion. Recession soon followed.

This shock ended Europeans’ complacency with their position in the impossible triangle. The easiest and most natural policy would have been to force a revaluation of the DM in the EMS, but this ran into the trade/ER-stabilization forces combined with France’s new-found love of le franc fort. As the recessions deepened, markets came to believe that various nations would sooner or later find it politically optimal to devalue against the DM. With all capital controls freshly removed, speculators were free to borrow billions to place one-way bets against increasingly unrealistic bilateral exchange rate pegs.

The result was a series of exchange rate crises that produced two very divergent reactions. The federalists decided that the solution to the trilemma was to eliminate fixed exchange rates by eliminating national currencies. Note that for all the EMS members apart from Germany, a move to monetary union would involve an increase in their de facto control over monetary policy. They had already slaved monetary policy to Bundesbank decisions. So for them, a single, joint central bank would be like putting a Frenchman, an Italian, or whoever, on the Bundesbank decision-making committee. Once again de jure and de facto sovereignty flipped around. From the perspective of the late 1980s and early 1990s, monetary union involved a gain in sovereignty for everyone except Germany.

The intergovernmentalist, who saw the logic but could not face the prospect of losing de jure monetary sovereignty, chose to switch their choice of angles in the impossible triangle. They abandoned their formal exchange rate peg and went back to using monetary policy for domestic stabilization (although with a firm eye on the exchange rate).

It was thus that Europe entered its most recent stage of integration.

3.1.9 Single Currency and Bretton Woods II

The largest shock ever experienced by postwar Europe was the collapse of the division of Europe that came in the last few months of 1989. From the perspective of European integration, the most significant was the 9 November 1989 fall of the Berlin Wall. This "political earthquake" destroyed the status quo in the EU.

It was plain that West Germany wanted unification of the East and West Lander and this created the possibility of a grand bargain. On one hand, Germany wanted to get East Germany into the EC via the back door—without the usual accession negotiations. This was not a small thing to ask as a unified Germany would be a behemoth. With 80 million citizens and 30% of Europe's output, a united Germany would be a third larger than France, the UK, or Italy. This raised many fears ranging from a disturbed political balance in the EU, to the unlikely but still scary specter of German militarism. On the other hand, France and the rest of the EC members who had de facto delegated their monetary policy to Germany wanted this policymaking transferred to a joint central bank—the deutschmark for unification was the grand bargain.

On 3 October 1990, Germany is unified and the Eastern Lander enter the EC by fiat; three weeks later the European Council completes preparations for two sets of Treaty-writing talks known in the EC as intergovernmental Conferences (IGCs). One IGC was to develop plans for the Economic and Monetary Union (EMU); the other to develop plans for Political Union.

Both IGCs were misleadingly labeled. The IGC on Economic and Monetary Union was basically about monetary union, the necessary institutions required, the entry criteria, and the necessary flanking policies such as restraints on "members" fiscal debts and deficits. The IGC on political union was, with one major exception and some quickly dismissed proposals for real political integration, basically a tidying up exercise.

The big change discussed concerned

- Decision-making procedures (extending the range of topics where new laws could be made by supranational decision in the Council of Ministers);[22] and

[22] These issues were not settled and were addressed by a long series of IGCs and Treaties up to and including the Lisbon Treaty which came into force in 2010.

- Creation of the two new intergovernmental pillars for cooperation on home and justice matters and foreign and defense matters was less significant than most believe.

In essence, the pillars gathered under the EC's wings a series of co-operations that had been going on outside the Community's formal remit—such as the environment, health, energy, research and technology, and consumer protection.

The big European nations had cooperated on defense and security matters since the creation of the WEU. The Maastricht Treaty's pillars, however, allow this intergovernmental cooperation to be more easily coordinated with other EU policies and some hoped that it would trigger an institution/institution feedback effect that would induce member states to transfer real sovereignty to the EU. So far, though, it is hard to see outcomes on the CFSP side that would not have come about as the result of ad hoc cooperation among the big EU members. On the home and justice side, the juggernaut mechanism continues to blur the distinction between domestic and international policy, leading members' special interest groups to push for ever greater integration, much of which is now taking place inside the EU. One should note, however, that the most successful of these, the Schengen Accord, was set up outside the EU initially. Several non-EU members have joined while some EU members have not, so this is not clearly an example of EU integration spawning forces that produced more EU integration.

In January 1999, a subset of EU members adopted the electronic euro, taking the step to cash euros in January 2001. While Eurozone membership has grown, some EU members seem firmly resistant to join. Apart from small nations, there does not seem to be a domino-like feedback mechanism whereby a currency union draws in an every widening circle of members. There is, however, a feedback mechanism linking the common currency to deeper financial market integration, especially on technical issues like payment clearing mechanisms.

Intergovernmentalist Reaction: Bretton Woods II

Intergovernmentalists have found that a managed float against the euro is almost as good a solution economically as euro membership—without the formal loss of monetary sovereignty. Indeed the available econometric evidence shows that being outside the Eurozone does not harm exports to the Eurozone—there was not trade diversion of the type observed with discriminatory tariffs or BBB liberalization (Baldwin 2006c).

All West European nations have found it optimal to establish central bank independence as a buffer against opportunistic monetary policy by politicians only interested in short-term political goals. The removal of capital controls all but made necessary in Europe, but the globalization and sophistication of capital markets is also an important driving force. Indeed a very large number of governments around the world have decided they cannot trust themselves and have handed monetary policy sovereignty to independent, unelected officials. In many of these nations, especially in Europe, these central banks have adopted inflation-targeting strategies. Outside of Europe, especially in East Asia, many have chosen a peg to the US dollars (or a basket with a large dollar weight) as their external anchor. Regardless of which it is, the effect has been something like Bretton Woods II because the US Fed has pursued something like an inflation-targeting strategy (as least until it scrambled to pump-prime—and quantitative easing—to avoid a more serious recession in 2009 and 2010).

This uncoordinated set of policies—spontaneous cooperation—has gone a long way to allowing individual nations to replicate the currency and exchange rate stability effects of more formal monetary cooperation (for example, the EMS or Eurozone).

3.2 Feedback Mechanisms and Sequencing in Asia

As noted in the introduction, Asia experienced remarkably little formal integration among the major economies until the beginning of this century. Nevertheless, economic integration has proceeded in the region at a rapid pace since the mid-1980s. As Dee (2007) puts it: "From the 1980s, East Asia developed high levels of intraregional trade in response to market forces, not preferential trade agreements (PTAs). … The ASEAN Free Trade Agreement (AFTA) came into force in 1992, but this did not create much preferential trade. …. With successive rounds of unilateral liberalization, the margins of preference on the remaining lines were small. … less than 5% of intra-regional trade takes place at the preferential rate."

This section considers the sequencing of regional integration initiatives in Asia and considers the feedback mechanisms driving its. The focus is on East Asia as that is where the largest and most successful initiatives are found.

As we shall see, the feedback mechanism that produced 20 years of East Asian tariff cutting is quite different to those that induced tariff cutting in Europe. In Europe reciprocity was the key (generalized juggernaut effect); in Asian reciprocity played almost no role. Before turning to the political-economy feedback mechanism, it is therefore necessary to describe the key difference between East Asian regionalism and European regionalism.

3.2.1 The Development of "Factory Asia"

Regional trade in East Asian before 1985 was held down by three factors:

- The very unequal size distribution (Japan was the only large economy);
- The great development-level disparities (Japan was the only advanced economy); and
- The "dual track" development strategies that actively discouraged imports of most manufactured goods, but especially those produced by East Asian economies—all East Asians wanted to produce and export the same thing, namely mechanical and electrical machinery (especially electronics).

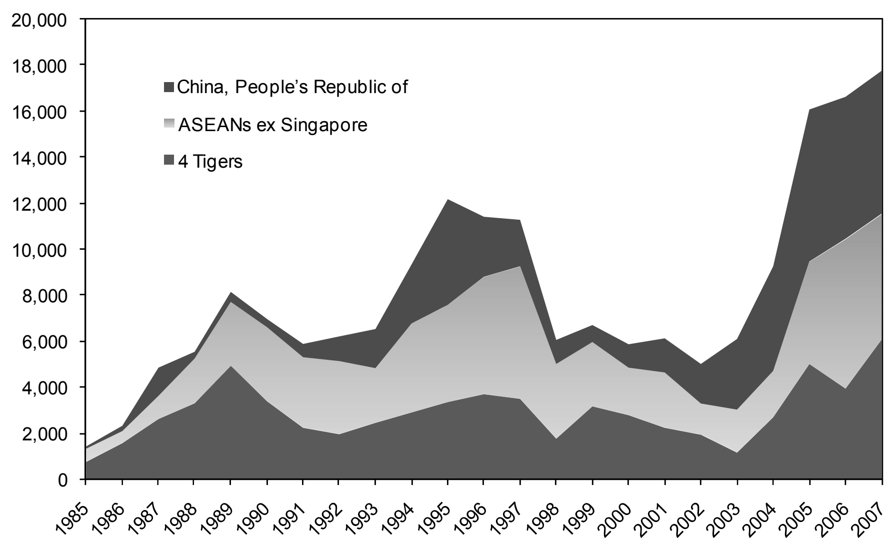
These three elements resulted in a pattern of protection against "neighbors" exports and correspondingly exaggerated reliance on extra-regional export markets, especially the US and EU.

Information and Communication Technologies Revolution and the Second Unbundling

East Asia was set on a new course by the ICT revolutions that began in the mid-1980s (Baldwin 2008).[23] Then, the US and Japan began to geographically unbundle their manufacturing processes, moving offshore some stages to developing nations. For the US, Mexico was the main destination for these new factories. For Japan, developing East Asia was the natural destination. Technology opened the door for offshore development and competition pushed firms over the threshold—especially large Japanese firms. In essence, the production bays that used to be contained in a single factory in, say, Nagoya, became their own factories and were dispersed to locations that had factor prices and other characteristics better suited to the particular needs of the production stage. Factory Asia was born.

Japanese firms' off-shoring strategies fit in nicely with the export-track of the dual-track development strategies and the RTB unilateralism feedback mechanism began to operate. To attract such investment, ASEAN members unilaterally reduced their tariffs on triangle trade in what may be viewed as a "race-to-the-bottom." Often this came in the form of "duty drawbacks" and duty-free treatment for plants located in export processing zones. An illustration of this can be found in the placement of auto and electronics plants by Japanese firms in East Asia from 1975 to 2004 (Figure 7). Toward the end of the 1990s, when the PRC decided to join the world economy, unbundling accelerated—attracted by the very low, productivity-adjusted cost of labor in the PRC.

Figure 7: Placement of Japanese Plants in East Asia, 1985–2007



ASEAN = Association of Southeast Asian Nations.
Source: Organisation for Economic Co-operation and Development online data.

[23] Some authors ascribe the change to the 1985 Plaza Accord that fostered yen appreciation; others focus on the 1997 crisis. Neither of these accounts explain why production unbundling and unilateral liberalization started in North American and Latin America at the same time it started in East Asia.

Rapid industrialization

The development of Factory Asia was accompanied by a spectacular re-orientation of developing Asians' export composition. The region where only Japan and the "four tigers" were able to export manufactured goods became a region where manufactured exports became pervasive. As Table 1 shows, the larger ASEAN members relied primarily on commodity exports in the mid-1970s. There was a marked change toward manufactures in the subsequent decade, but by the mid-1980s, more than half these nations' exports consisted of primary products. The radical reorientation came between the mid-1980s and today. As the last column shows, manufactured goods account for the lion's share of all five nations' exports.

The image of Factory Asia is intended to invoke the way in which trade in this remarkable region differs from that in Europe or North America. To a large extent, the manufactures trade within East Asia is trade in parts and components. More specifically, one can think of East Asia as falling into two groups: headquarter economies (Japan; the Republic of Korea; Taipei,China; Hong Kong, China; and Singapore) and factory economies (the PRC and the rest of ASEAN). Although the pattern is evolving, firms in the headquarter economies tend to develop and market final goods in advanced nations, especially Japan, the EU, and the US. Factory economies tend to specialize in producing various segments of value-added chains.

Table 1: Non-Oil Export Composition
(% of Total Non-Oil Exports)

	1976–77	1983–84	2003–04
Indonesia			
Primary Products	98	75	33
Manufactures	2	25	67
Malaysia			
Primary Products	91	63	12
Manufactures	9	37	88
Philippines			
Primary Products	90	51	10
Manufactures	10	49	90
Thailand			
Primary Products	85	66	20
Manufactures	15	34	80
Viet Nam			
Primary Products	75	87	25
Manufactures	25	13	75

Source: Athukorala, Prema-chandra (2006).

One way to see this is to look at the sector composition of the parts and components that major ASEAN members import and export. In the image of Asia Factory, these nations import parts in, say, electrical equipment add some value and then re-export the parts (Table 2).

This is especially true for the Philippines, where 73% of its imports of parts and components are in electrical machines (includes electronics) and 83% of its export of parts and components is in the same product categories.

The People's Republic of China Contrasts with Major Association of South East Asian Nation Economies

Once the PRC joined the world economy—with, for example, WTO application and eventual accession—the nature of Factory Asia became more differentiated. The "headquarter" economies—Hong Kong, China; Japan; the Republic of Korea; Taipei,China; and Singapore—engaged in parts and components processing in the larger ASEAN economies (Indonesia, Malaysia, the Philippines, Thailand, and more recently Viet Nam) for assembly in the PRC (Table 3).

Table 2: Association of South East Asian Nations Parts and Components Imports and Exports by Sector, 2003–04

(% of Total Parts and Component Trade)

	Malaysia		Philippines		Thailand		Viet Nam		Indonesia	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
Power generating machines	0	3	0	1	3	6	3	16	5	17
Special industrial machinery	1	2	0	2	1	2	4	10	3	11
Metalworking machinery	0	0	0	0	0	1	1	3	0	1
General industrial machines	1	3	1	1	6	7	9	12	5	21
Office machines	21	13	11	17	21	14	3	8	10	1
Telecomm and sound equipments	8	5	4	4	15	4	6	9	21	3
Electrical machines	68	73	83	73	49	54	69	28	47	16
Road vehicles	1	2	2	2	6	12	5	13	10	28
Other transport Equipment	0	1	0	1	0	2	0	2	0	2
Part and components trade	100	100	100	100	100	100	100	100	100	100

Source: Athukorala, Prema-chandra (2006)

Table 3: Development of Factory Asia: Role of Parts and Components
(%)

	Japan		NIE3		ASEAN4		PRC	
	1990	2005	1990	2005	1990	2005	1990	2005
P&C machinery to East Asia	7	16	9	25	7	17	5	5
P&C machinery to rest of world	19	18	8	12	7	11	2	16
Final machinery to East Asia	8	8	7	8	3	7	9	16
Final machinery to rest of world	41	29	17	17	5	12	3	14
Sum machinery in total exports	76	70	42	62	22	47	19	50

ASEAN = Association of South East Asian Nations; ASEAN4 = Indonesia, Malaysia, the Philippines, and Thailand; EA = East Asia; NIES = Newly Industrialized Economies; NIES3 = the Republic of Korea; Singapore; and Hong Kong, China; P&C = parts and components, PRC = the People's Republic of China; ROW = rest of the world.

Notes: "Intra-East Asia" here includes the PRC, ASEAN4, and NIES3. Due to lack of data available from UN COMTRADE, Taipei,China is not included in East Asia. Machinery includes both mechanical machinery such as transport equipment and electrical machinery, which includes electronics.

Source: Calculations based on Ando and Kimura (2009) appendix tables.

The first salient point is that East Asian markets for final machinery have not become more important for East Asian exporters. For Japan, the Newly Industrialized Economies of Hong Kong, China; the Republic of Korea; and Singapore), and ASEAN4 (Indonesia, Malaysia, the Philippines, and Thailand), the share has remained steady at under 10% of total exports. The exception is the PRC, which has almost doubled the share of its total exports from the sale of final machinery to East Asia.

The second salient point is the rapid increase in the importance of parts and components trade within East Asia. In all cases—again with the exception of the PRC—the role of P&C exports to East Asia almost tripled from 1990 to 2005. The PRC has seen its share of P&C exports to the region stagnate at 5%. The region's preponderant and growing reliance on machinery exports is clear from the last line in the table. While the figure fell from 76% to 70% for Japan over the 15 years, it increased sharply for the other regional players.

In a nutshell, Factory Asia involves mostly trade in parts and components among East Asian nations with the exception of the PRC, which has become an important exporter of final machinery to the region.

3.2.2 The Muted Role of Institutionalized Cooperation

Formal regional trade agreements have only recently begun to matter in East Asia. Here we present a highly stylized historical sequence based on Baldwin (2008). It is useful to distinguish three phases of East Asian regionalism:

Phase I—Rampant Unilateralism. From the mid-1980s to 1990, tariffs on intra-regional trade were reduced. But this was due to unilateral tariff cuts in the region driven by competition for investments and jobs related to Factory Asia. This phase is marked by an almost total lack of formal regionalism.

Phase II—Regionalism Delayed, Unilateralism Accelerated. From roughly 1990 to 2000, East Asia witnessed an acceleration of unilateral tariff cuts as the PRC's emergence heightened competition among East Asians for jobs and investment linked to an ever-expanding Factory Asia. Formal regionalism was kick-started by former Malaysian Prime Minister Mahathir Mohamad with his East Asian Economic Community (EAEC), which led to the ASEAN Free Trade Agreement (AFTA) in 1992. Mahathir's vision, however, was much broader yet geographically exclusive.

The US feared that an Asian-only economic bloc might bring in or even be dominated by the communist PRC, a nation whose economic resurgence was already causing concern (the US was still quite uncertain about PRC motives in the early 1990s). In 1993, the US countered Mahathir's vision by backing the 1989 Australian proposal of creating the Asia-Pacific Economic Cooperation (APEC)—a new twist on the old strategy of undermining one preferential trade arrangement by proposing a larger one (as the UK did in the 1940s and 1950s). This diversionary tactic worked and the "exclusively Asian" aspects of Mahathir's vision were sidestepped and replaced by the oxymoron "Open Regionalism."

Phase III—Rampant Regionalism. In November 2000, PRC Premier Zhu Rongji triggered a domino effect by suggesting that his country might be interested in an FTA with ASEAN. This idiosyncratic initiative strengthened pro-FTA political forces in excluded nations—especially Japan and the Republic of Korea. The result was a domino effect still being felt today.

Domino Effects in Asia

The November 2000 PRC initiative was something of a surprise to ASEAN. But it remained in line with 1990s PRC attitudes. One key element of the PRC economic development strategy during the 1980s and 1990s was the desire to avoid antagonizing others in the process. Because the PRC's success in attracting industrial jobs and investment was increasing viewed as a threat by some ASEAN members, Zhu Rongji chose a big-hearted gesture to assuage ASEAN concern over competition from the PRC.

Although the idea came as something of a surprise, it was generally welcomed surprise by ASEAN. It was immediately clear to most ASEAN leaders that preferential access to the large and fast growing PRC market would enormously boost their own attractiveness for creating new Factory Asia employment—although they naturally had reservations about liberalizing so-called "sensitive sectors." A study group on a possible PRC-ASEAN FTA was the concrete result of the surprise.

The formal proposal for a "[People's Republic of] China-ASEAN Free Trade Area" (CAFTA) came from Rongji in November 2001. ASEAN leaders accepted it in principle, agreeing to set up groups to study detailed issues. This led to a Framework Agreement on Comprehensive Economic Cooperation in 2002, which foresaw an “ASEAN-[People's Republic of] China Free Trade Area” (ACFTA) by the year 2010 along with some “Early Harvest” liberalization of agricultural goods. A whole series of agreements have been subsequently signed, most notably a trade in goods agreement concluded in late 2004.[24]

The surprise PRC proposal to ASEAN set off alarm bells all across Asia, but especially in the advanced economies of Japan and the Republic of Korea. Export dependence figures make the reason absolutely clear (Table 4). For Japan and the Republic of Korea, the AFTA discrimination in the ASEAN markets is relatively unimportant since Japan send only 17% of its exports to the region (and most of those face low MFN tariffs as we saw); the figure for the Republic of Korea is 13%. The ACFTA, however, changes the picture dramatically. ACFTA would imply that Japan-based and Republic of Korea-based firms would face tariff discrimination in markets covering 36% and 43% of these nations' exporters in 2003. Moreover, just as in Europe in the 1950s, the ‘insiders’ are growing much faster than the outsiders, so the importance of getting in at an early stage is even more important than current export dependency ratios would suggest.

It is also important to note that both the PRC and the ASEANs have relatively high MFN tariffs on many industrial goods, especially the sort finished products at which Japan and the Republic of Korea excel—consumer electronics, autos and the like. The importance of this is that it opens the door to the possibility that ACFTA would be highly discriminatory, i.e. have very high margins of preference. Worse still, the MFN tariffs of the PRC and most ASEANs are either not bound or bound at rates that substantially exceed the applied rate. In other words, the ASEANs and the PRC could—without formal repercussions in the WTO—raise their applied rates against exports from Japan and the Republic of Korea.

Table 4 shows it should be no surprise that the PRC demarche to ASEAN triggered flashing red lights throughout the region—especially in Japan and the Republic of Korea. If the PRC and ASEAN were really to trade freely with each other preferentially, Japan plainly needed a plan for redressing any discrimination that might arise.

Table 4: Actual and Projected “Exclusion Indexes,” 2003
(%)

	Japan	KOR	PRC	Malaysia	Thailand	Indonesia	Philippines	Singapore	Viet Nam
ASEAN	17	13	8	29	22	11	19	31	15
ASEAN+PRC	36	43	8	43	36	22	34	45	23
Japan		10	14	10	15	25	14	6	15
KOR	8		4	4	2	8	4	4	2

ASEAN = Association of South East Asian Nations, KOR = the Republic of Korea, PRC = the People's Republic of China.

Source: Trade data from Comtrade.

[24] CAFTA and ACFTA acronyms have been used interchangeably, but all refer to the same November 2004 Agreement.

Moreover, Japan worried about “missing the train.” In the 1960s, the UK was forced—commercially at least—to join an organization whose foundations were set without its participation. The lessons from Europe were: get involved early and stay involved no matter what, and propose an alternative that is more suitable to your interests.

Japan chose the first option by approaching each ASEAN member to create an FTA while simultaneously launching slower talks with ASEAN as a group. It also revived discussions of a possible Japan-[Republic of] Korea FTA. The Republic of Korea is a significant destination for Japanese exports (see Table 4). More to the point, the PRC would be only half as interested in ASEAN as it would be in the combined Japan-[Republic of] Korea market. The threat of tariff discrimination against ASEAN and ACFTA exports arising from a Japan-[Republic of] Korea FTA would substantially counterbalance the possibility of ACFTA discrimination—not from an economic point of view, but rather from a diplomatic and domestic political perspective. In fact, Japan and the Republic of Korea launched FTA talks in 2003, which stalled in 2005.

Japan also pursued the second option—forming an alternative arrangement. Japan also sought an FTA with ASEAN as a whole as well as with individual FTAs with the most economically important ASEANs (Singapore, Malaysia, Thailand, Indonesia, the Philippines and Viet Nam). In January 2002, Japan proposed an FTA with ASEAN and a Joint Declaration was signed in November. Commitment on both sides grew throughout 2003 with a complicated diplomatic dance of declarations, joint study groups, and framework agreements; the ASEAN-Japan (AJ) FTA talks actually began in 2005. In parallel with, but slightly preceding the AJ FTA moves, Japan initiated FTA talks with Malaysia, the Philippines, and Thailand (they started in 2004).

The Republic of Korea had problems very similar to those of Japan. However, the lower export dependence of the PRC and ASEAN on its market left the Republic of Korea a narrow range of options. Although more hesitant in its reaction to the possibility of discrimination from ACFTA at first, the Republic of Korea signed a Framework Agreement with ASEAN at the same meeting as Japan (October 2003) and opened talks with ASEAN in 2005.

The dominos continue to fall in East Asia as other trade partners—the US, the EU, India, Australia, and New Zealand, sought FTAs with ASEAN, and in most cases, the PRC.

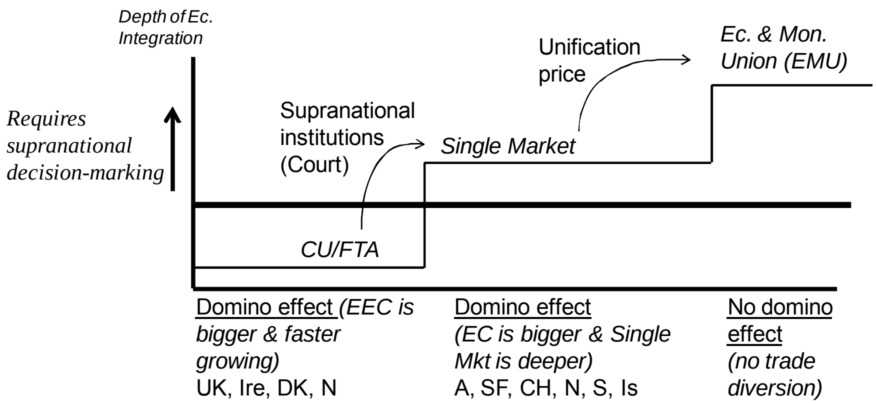
4. Lessons: Europe and East Asia

Using the feedback mechanism approach to regional sequencing, several clear lessons emerge from Europe and Asia sequences. We start with European sequences.

4.1 Lessons from Europe’s Twin Sequences

The historical narrative offers critical details that help explain the evolution of EU and EFTA integration sequences—and how they became intertwined via domino effects. To draw abstract lessons for Asia’s future integration, it is better to suppress detail and focus on the main points (Figure 8):

Figure 8: Highly Stylized European Integration and Institutions Sequences, 1944–1969



CU = customs union, EC = European Communities, EEC = European Economic Community, EMU = Economic and Monetary Union, FTA = Free Trade Agreement.

Source: Based on Baldwin (1994).

4.1.1 Europe's Sequences in a Nutshell

There was a highly stylized rendition of the 1957–2002 path toward Europe's twin integration sequences.

- European integration had highly unusual initial conditions; Europeans were reluctant to engage in serious regional integration until forced by a combination of outside pressures (intensification of the Cold War and direct pressure from the US).
- By the end of the 1960s, both blocs had removed tariffs and quotas on trade in goods. Further integration of the goods market (such as tackling behind the border barriers) stopped until the mid-1980s. This halt was de jure for EFTAns (they had not committed to deeper integration) and de facto for the EEC (decision making bogged down, so new national barriers were erected faster than the EEC could remove old ones). The pro-liberalization feedback mechanisms were not strong enough to overcome national special interest groups opposed to deeper goods market integration.
- A domino effect stemming from the EEC's customs union induced three EFTA members to change their minds on the gains-versus-sovereignty-loss trade off; they joined the EEC in 1973, triggering a secondary domino effect that eliminated all industrial tariffs between the EEC and EFTA.
- In the 1970s, the EEC's supranational institutions (its Court and Commission) used their powers to destroy the protectionist status quo by establishing the legal principle of mutual recognition. This eroded de jure sovereignty over product standards, as it tended to give commercial advantage to firms producing to the cheapest standard. For this reason, the switch to more

federalism (in the shape of majority voting on such matters instituted by the 1986 Single European Act) had the seemingly paradoxical effect of raising Member States de facto sovereignty on standard-setting.

- This switch did not happen in EFTA as it lacked supranational institutions at the time.
- The Single European Act triggered another domino effect: EFTA firms began to “vote with their feet,” shifting production from EFTA to the EU—this “investment diversion” induced all remaining EFTA supporters to switch sides on the gains-versus-sovereignty tradeoff. Most EFTA supporters went for full EC membership, while the rest opted to sacrifice de facto sovereignty but maintain de jure sovereignty by joining the EEA agreement (Bilateral Accords in Switzerland’s case).
- Importantly, this domino effect forced EFTA supporters to adopt supranational institutions (EEA Surveillance Authority and the EFTA Court). The EU insisted that they could not grant EFTA firms Single-Market access to the EU if they did not have supranational institutions to ensure the integrity of the single market.
- In the 1980s and 1990s, feedback mechanisms induced most EU and EFTA governments to give up de facto sovereignty over monetary policy by pegging their currencies to the deutschemark; they maintained de jure sovereignty by keeping their currencies, but to avoid problems they freed their Central Banks from government interference by making them politically independent. In short, most EU and EFTA governments lost control over national monetary policy by the end of the 1990s.
- When Germany wanted to bring East Germany into the EU without negotiating accession, a grand bargain emerged that allowed all Eurozone members to increase their de facto sovereignty over monetary policy by sacrificing their de jure sovereignty (shifting monetary policy from the Bundesbank to the European Central Bank); only Germany lost de facto sovereignty—compensated by the back-door entry of East Germany into the EU.

4.1.2 The Lessons

Lesson #1: Gain versus Pain Matters

All governments are reluctant to give up sovereign control of economic policies. Most European nations, however, proved themselves willing to give up sovereignty (or as they say in Brussels “pool their sovereignty”) when the political-economy benefit of doing so was sufficiently large compared with the perceived cost of sovereignty loss.

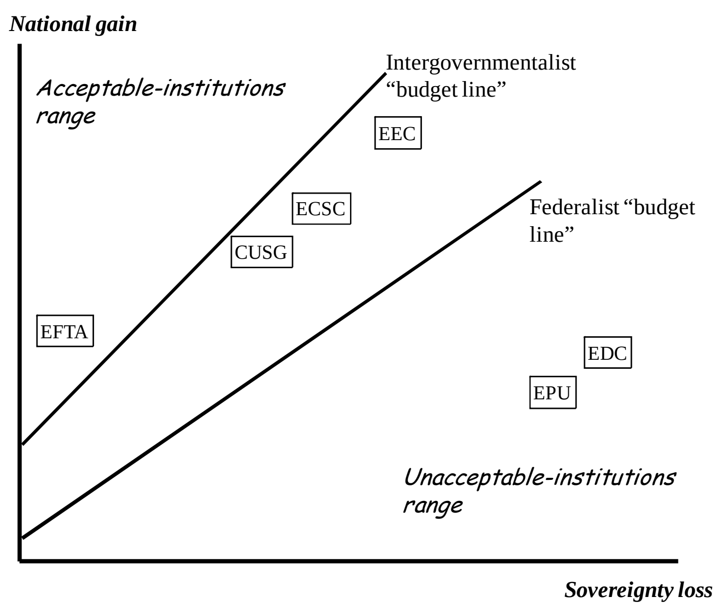
The obvious examples here are the varied fates of the EPU, the EPC, the EDC, the ECSC, and the EEC. Even inside the EEC, the tradeoff came down on different sides on different issues. In the Treaty of Rome, for example, the Six agreed to give up sovereignty on trade policy as far as tariffs and quotas were concerned, but not when it came to behind the border measures such as product standards; the Treaty specifies majority voting (federalist solution) on the former, but unanimity (intergovernmental solution) on the later.

Figure 9 illustrates the trade off involved in some of the many European initiatives. The vertical axis shows the initiative's gain (political and/or economic), while the horizontal axis shows the initiative's sovereignty loss. Note that since the federalist nations were systematically more open to pooling sovereignty, their "budget line" is below the intergovernmentalists everywhere. As a consequence, several proposals that were acceptable to the federalists were not acceptable to the intergovernmentalists.

For example, when comparing the OEEC status quo of the 1950s to the 1957 Common Market, Britain decided the Common Market gains were not worth the sovereignty loss and they quit the Messina process before it was completed. By contrast, Britain did find the gain of EFTA worth the implied loss in policy autonomy. In short, in the 1950s the UK went for the small-gains-small-pains option.

An important theme of this paper is that various feedback mechanisms—above all the domino effect—have the ability of shifting nations' perception of the benefits of a particular scheme and thus pushing a scheme "over the line." Again, Britain provides a clean example. By 1961, the UK reversed judgment on the EFTA versus EEC choice and applied for membership in the Common Market. One reason for this is that the success of the EEC—a success that was very much uncertain in the latter 1950s—boosted the gains from joining. Not only would joining provide the gains from the Common Market, it would also avoid the discrimination that British firms would otherwise face. The sum of the gains from joining plus the gains from avoiding the emerging trade discrimination meant that the gain outweighed the sovereignty loss from 1961 onwards.

Figure 9: The Gain-Sovereignty "Budget Line"



CUSG = Customs Union Study Group, ECSC = European Coal and Steel Community, EDC = European Defense Community, EEC = European Economic Community, EFTA = European Free Trade Association, EPU = European Payments Union.

Lesson #2: Deep economic integration requires supranational institutions
The experiments in the 1950s and the spreading of the Single Market via the EEA showed that the pooling of sovereignty was the sin qua non of deep integration—no easy, intergovernmental route was possible. To support this deep integration, ECSC-like institutions were necessary. The key elements were

- A Council represented by Member State governments;
- An agenda-setting executive Commission also charged with surveillance, implementation, and enforcement; and
- A supranational Court to adjudicate disputes among members, among institutions, and between institutions and Member States.

The need for some form of Parliament to represent Member States' constituents was clear, but the extent of its powers was not (these have evolved over the decades).

This lesson was strengthened during experience with the Single European Act. This fait accompli forced EFTA governments to redress the new discrimination by embracing supranational institutions—long negotiations revealed that no intergovernmental solution was possible. EFTA supporters either had to accept "hegemonic supra-nationalism,"—simply accept new EU Single Market Directives without having any formal decision-making influence—or they had to swallow long-held reservations and join the EU. All EFTA governments (except Iceland) opted for membership. Norwegian and Swiss voters overruled their governments in referendums—so these nations continued with the fiction of sovereignty over single-market matters, while in fact they were forced to adopt all new EU Single Market Directives without participating in relevant decision-making bodies.

Lesson #3: Institutions matter
That institutions do matter is very clear. Two examples of European integration sequences show this clearly.

The integration behavior of the two sequences (EEC and EFTA) was broadly similar until 1968, when both finished eliminating all tariffs and quotas on intra-bloc trade. In 1969, the EEC launched an ambitious deepening of goods-market integration (tackling BBBs) and hatched a plan for a monetary union by 1980. EFTA did nothing on either score.

The incipient divergence of the two integration sequences, however, did not happen. Due to strong resistance from Member States (or more precisely special interest groups in those benefitting from idiosyncratic product standards and other BBBs), the EU's attempt at deeper integration was a complete failure. Plans for monetary union were also shelved.

If the EEC had not set up supranational institutions in 1958, the state of European integration in the late 1970s would probably have perpetuated itself. Institutions came into play on both BBB liberalization side and on monetary issues. The Court instigated mutual-recognition principles destroying the deadlock on BBB liberalization, leading to the Single European Act. Rising supranational budgetary outlays associated with the CAP rendered intra-EEC exchange rate fluctuations intolerable and thus drove EEC leaders to overcome differences by setting up the EMS.

In the late 1980s and early 1990s, the EMS hardened into a deutschemark bloc, where most European (including some EFTA supporters) had de facto sacrificed monetary sovereignty for the sake of monetary stability—all except Germany, of course, as the they became the pilot of the deutschemark bloc. This situation (which affected EFTA members and EEC members alike) might never have changed had it not been for leverage created by EEC supranationality over Germany as it brought East Germany into the EU without accession negotiations. For example, if Germany had been a member of EFTA instead of the EEC, other EFTA supporters would have had very little leverage over Germany when it requested that products from the Eastern Lander be granted duty-free access to all EFTA markets—surely not enough leverage to get Germany to give up its cherished deutschmark and Bundesbank.

The size of regional initiatives and the direction of spillover effects matters. Today, EFTA consists of two small and two tiny nations, Switzerland, Norway, Liechtenstein, and Iceland—and it has supranational institutions (an EFTA Surveillance Authority and EFTA Court). The UK, Denmark, Sweden, Austria, Finland, and Portugal all left the EFTA for the EU. When 10 Central and Eastern European nations were freed in the late 1980s, they made EU membership a strategic goal. Joining EFTA was never seriously considered. Inside Europe, supranationalism won when the dominos fell in the direction of the bigger market, which was the EU, not the EFTA.

The “gravitational” forces driving the domino effect explain why ongoing integration would raise incentives for EEC members to join the EFTA, or EFTA members to join the EEC. The initial conditions, however, made this a very uneven “horse race.”

Lesson #4: Size matters

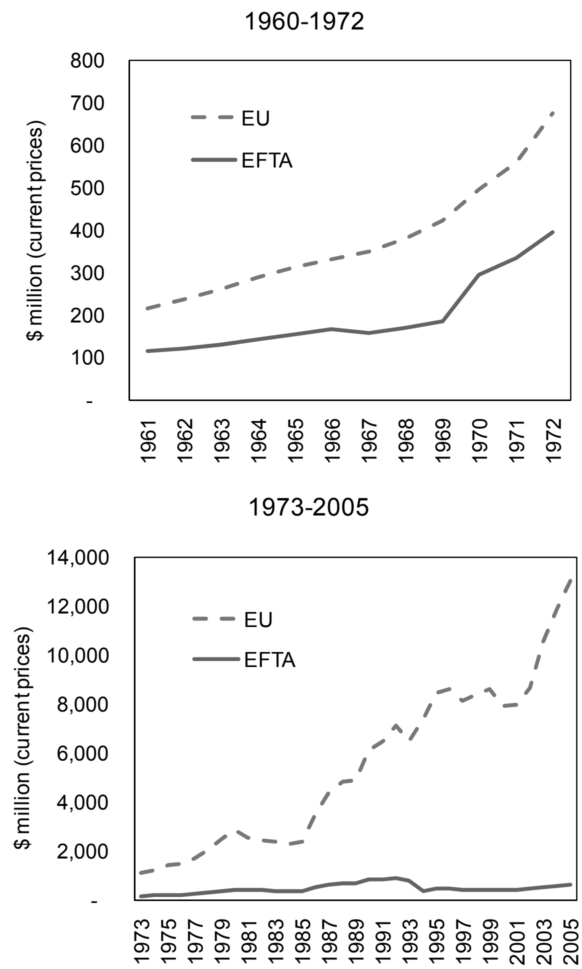
Figure 10 shows the EEC’s market started out almost twice as large as the EFTA market and grew faster. As the EEC enlarged, the domino effects got stronger. Nowadays, the EU market is more than 20 times the EFTA’s.

In my reading of history, the EU’s institutional model came to dominate Europe because it applied to a larger market. If EFTA supporters had started with EU like institutions and the Six with EFTA-like institutions, it seems unlikely that supranationalism would have won the competition.

Lesson #5: Formal monetary integration is extremely difficult

The European experience from the 1970s right up to the creation of the Eurozone shows that formal monetary integration is extremely difficult even in the presence of strong regional institutions. Even given the EU’s supranational institutions, monetary integration was asymmetric until an idiosyncratic shock permitted the “grand bargain,” which opened the door to the euro. Two points here: (i) the sovereignty “cost” of such an arrangement, and (ii) the economic benefits of having one.

Figure 10: Incomes in European Economic Community versus European Free Trade Association, 1960–1972 and 1973–2005
(1990 US dollars)



EFTA = European Free Trade Association, EU = European Union.

Source: IMF online database.

A formally symmetric exchange rate scheme, like the EMS—where nations on both strong and the weak sides of a currency fluctuations were expected to intervene—requires supranational institutions. In particular, it requires nations to promise to use reserves to help correct the consequences of other nations' imbalances. For a variety of reasons, EU leaders set up early exchange rate mechanisms outside the EU's supranational institutional framework. The result was that the de jure symmetric EMS slipped into a de facto deutschemark bloc—where Germany set monetary policy unilaterally and the rest of Europe followed.

On the benefit side, recent research has shown that the microeconomic gains from participating formally in a monetary arrangement are not much greater than the gains of doing so informally. The exchange rate crises of the 1990s suggested governments would have to choose to harden the links or suffer exchange rate volatility proved exaggerated. As it turned out, giving central banks independence of government while providing clear guidelines was enough to square the circle. As the experience of Eurozone shadowers such as Denmark and Sweden has shown, it is possible to enjoy many benefits of a formal monetary arrangement while maintaining de jure sovereignty over monetary policy.

4.2 Lessons from East Asia's Muddle through Approach

Given its later start, East Asia's sequence is much shorter to recount than Europe's.

4.2.1 East Asia's Sequences in a Nutshell

Before the early 1990s, there was no formal economic integration in East Asia worth noting. All economic integration was driven by unilateral liberalization that helped establish Factory Asia.

In 1992, inspired by Mahathir's East Asian Economic Community (EAEC), ASEAN set up the AFTA in 1992. But little preferential liberalization occurred and AFTA utilization rates were woefully low. The PRC's impending WTO membership and its bilateral FTA demarche toward ASEAN in 2000 changed everything, triggering several rounds of domino effects. The first was to induce ASEAN leaders to strengthen their own efforts to substantially eliminate all intra-ASEAN tariffs. The result is that AFTA preferences are now being used to a much greater extent.

The possibility of new discrimination also induced Japan and the Republic of Korea to react by embracing a sequence of regional FTAs. The US and the EU have followed suit.

East Asia has also made some government-led progress on financial integration via the Chiang Mai Initiative Multilateralization (CMIM) and the Asian Bond Markets Initiative. These, however, involve minimal loss of sovereignty—and in fact, the CMIM has never been used.

4.2.2 The Lessons

The lessons from East Asia's short experience with regionalism are much less clear than in Europe. The first one, however, seems very solid.

Lesson #1: Supranationalism is out of the question
In Asia, powerful, supranational institutions are out of the question. European nations agreed to historic shifts in power in a highly unusual setting—a time when large segments of European voters distrusted those governments that had so badly handled the tumultuous 1914–1945 era and its ensuing repercussions. Most governments in Asia find themselves in an almost diametrically opposed situation. They helped guide the "East Asian Miracle." Most East Asians today enjoy living standards many times higher

than their parents and prospects for their children look even brighter. The notion that most East Asian voters would support radical change in the way governments manage national sovereignty is farfetched.

Lesson #2: East Asia is unlikely to have a clear leader
Regional integration schemes in Europe, and indeed around the world, are almost always an initiative spawned by a regional hegemon, or cooperation between two regional hegemons. In East Asia, however, no leader has yet emerged. Decade-long debates over establishing a regional architecture makes it fairly clear that no one nation will take the lead.

The default in East Asia has been ASEAN. While economically small, it still matters in trade and it has the enormous advantage of operating and without threatening East Asia's dominant economies.

Lesson #3: Spontaneous cooperation on exchange rates
As in Europe, the trade/ER-stabilization feedback mechanism induced East Asia to unilaterally stabilize their exchange rates against baskets of currencies. Given the similarity of trade patterns, the composition of these baskets remains similar. In particular, given the dominance of the US market for the export of final goods, the US dollar tends to dominate. This "spontaneous cooperation" provides East Asia with de facto monetary integration—in the sense that integration effectively coordinates East Asian monetary policies much as the EMS coordinated monetary policies in Europe in the 1980s. In Europe, integration involved rules and institutional agreements de jure, but de facto operated as a deutschemark bloc. Although East Asia has no de jure scheme, it is de facto operating as a dollar bloc—helping stabilize the grid of bilateral exchange rates in the region.

4.2.3 Caveats

There are three important caveats. The first one concerns when to start.

Initial Conditions
Initial conditions matter. Conditions in Asia today and conditions in postwar Europe are about as diametrically opposed as one can imagine.

Europe began from a tangle of bilateral trade restrictions crippling intra-European trade. So any gains from cooperation were great. Economic integration was desperately needed, yet the initial conditions and forms of the barriers meant that it could not happen unilaterally. Western Europe also faced pervasive external pressures encouraging, indeed requiring, Europe to set up institutional arrangements and economic integration schemes. The US with its Marshal Fund was willing to spend a great deal in facilitating the process—mostly driven by concerns over spreading communism and Soviet aspirations in Eastern and Central Europe—concerns shared widely among Western Europeans at the time.

Both elements are missing in today's Asia. Asia, at least East Asia, is marked by very low trade barriers, at least on high trade-volume items. Outside economic powers may not be opposed to institutionalizing Asian regionalism, but they are most certainly unwilling to subsidize it.

Moreover, Europe started with a political atmosphere where citizens across many nations wanted radical change. As a reaction to the dismal wartime performance of status quo governance, one large fraction (and pressure groups) wanted to embrace communism, while another large fraction was willing to contemplate a pooling of sovereignty. The "Soviet menace," as it was known at the time, ensured the latter group's aims prevailed. Asian governments, by contrast, have supported the "economic miracle" for several decades. No large fraction of citizens or pressure groups wants radical changes in the allocation of sovereignty between the nation-state and regional institutions.

In short, Europe started its twin integration sequences when demand for regional institutions had never been higher and resistance to them never lower. Asia starts when demand for regional institutions remains modest and resistance is high.

Sequencing Institutions versus Sequencing Integration

In Europe, the sequencing of institutions and integration were thoroughly intertwined because they began in tandem. The OEEC launched the integration of the 1950s, and the EEC and EFTA launched the integration of the 1960s and 1970s. The massive deepening of European integration in the 1980s and 1990s where launched by massive institutional changes (the Single European Act and EEA in the first instance and the Maastricht Treaty in the second).

Asia, by contrast, has followed an integration sequence since the mid-1980s, achieving a high level of trade integration and a good level of exchange rate stability. All this economic integration has occurred with remarkably few regional institutions.

In trade, the trigger was technological advance that allowed the "second unbundling" and development of Factory Asia (Baldwin 2006a, 2008).[25] These changes created a political-economy environment where "race-to-the-bottom unilateralism" was politically optimal, at least for parts and components (Baldwin 2006b, 2008). Preferential trade liberalization in the region took off as the PRC-ASEAN FTA triggered a domino effect (Baldwin 2008). For both reasons, but especially the "spontaneous cooperation" built into race-to-the-bottom unilateralism, intra-Asian trade shares rose rapidly, bringing their export patterns even closer into line than originally.

Returning to the caveat, the problem facing Asia today is how to sequence regional institutions given that trade integration has proceeded such a long way on the basis of "spontaneous cooperation." One must be very careful in drawing simple analogies with EEC and EFTA integration.

[25] The second unbundling is also known as trade in tasks, fragmentation, vertical specialization, slicing up the value-added chain, international supply sourcing, offshoring, among others.

4.2.4 Lessons

The European experience very clearly shows that nations will only accept losses of policy autonomy in line with the political-economy gains of doing so. Turning around the old exercise dictum, the lessons of Europe tells us: “No gain, no Pain.” Applied to today’s Asia, we have to observe that economic integration is, de facto already quite advanced in East Asia, so gains from standard regional integration—the elimination of tariffs on intra-regional trade—would be modest. These modest political-economy gains tell us that any institutions must also expect at best modest sovereignty loss. Or, to rephrase the reversed adage, when it comes to institutionalizing Asian regionalism: “modest gains, modest pains.”

The second point is that deeper trade integration—the removal of commercially important behind-the-border barriers such as idiosyncratic product standards—might well provide large economic benefits. But the European experience shows that it also requires supranational institutions.[26] For example, harmonizing product standards in the automobile sectors of Japan, the Republic of Korea, and the PRC would yield substantial gains from economies of scale. It would, however, almost surely involve a relocation of final auto sales—which would preclude any form of intergovernmental cooperation on the matter. Progress would require, as in Europe, majority voting, and this is not a realistic option for Asia in the foreseeable future.

Strong regional institutions—strong in the European sense of sovereignty transfers—in Asia seem unrealistic in the foreseeable future. Moreover, given the variety of monetary preferences and economic divergence in Asia, such an arrangement would very likely soon start operating asymmetrically—just as the supposedly symmetric EMS ended up operating as a deutschmark zone. However, this would not really provide large political economy gains. To take a hypothetical example, if everyone pegs to the renminbi and the renminbi largely tracks the dollar, how much economic gain would there be compared with the current situation where most of Asia track the US dollar?

Here an important and often overlooked distinction must be made. When it comes to the trade/ER-stabilization feedback effect, one should net out parts and components trade. If country A sells only parts to country B, and B turns the parts into final goods and sells them to country C, then A and B are, in fact, just selling to country C; Freiden’s political economy pressures in both A and B will be to stabilize their exchange rates with respect to country C. The bilateral A-B rate will also be stabilized, but this is a side effect of the underlying political-economy forces—efforts to cajole A and B to stabilize their bilateral exchange rate as a priority will be working against the feedback mechanism, not with it.

A fourth lesson is how to sequence trade and monetary integration. Europe’s experience (and there is abundant econometric evidence) shows that there is a two-way relationship between higher trade flows and more stable exchange rates. But the relationship is not symmetric. An increase in bilateral trade has an important, first-order effect on bilateral

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[26] See Baldwin (2000) for a detailed study of ways in which technical barriers to trade have been eliminated in various regions of the world.

exchange rate stability (due to domestic political-economy forces). Exchange rate stability, on the other hand, has only a modest pro-trade effect, even if stabilization leads all the way to currency union. In short, stabilizing exchange rates may trigger a feedback mechanism that favors future trade integration (stability promotes trade that—a la juggernaut—alters government views of further trade liberalization), but it is very weak. Trade integration, by contrast, has a strong effect on incentives for further trade integration and monetary integration (at least of the "spontaneous cooperation" type).

5. What to Do? The Feedback Sequencing Perspective

When thinking about the way forward on Asian institutions, three points are a logical starting point.

The European experience very clearly shows that nations will only accept losses of policy autonomy that are in line with the economic and political-economy gains. Turning around the old exercise dictum, the lessons of Europe tells us: "No gain, no Pain." Applying to today's situation in Asia, we have to observe that economic integration is, de facto, already quite advanced in East Asia, so the gains from standard regional integration—the elimination of tariffs on intra-regional trade—would be modest. These modest political economy gains tell us that any institutions must be modest in terms of sovereignty loss. Or, to rephrase the reversed adage, when it comes to institutionalizing Asian regionalism: "modest gains, modest pains".

The second point is that moving goods market integration significantly beyond its current state—for example creating an "Asian Single Market" along the lines of the EU's Single Market, or the European Economic Area agreements—would require Asia to pursue one of two paths: (i) adopt supranational institutions fostering policy harmonization and approximating national laws, standards, norms, and regulations—as noted, this is impossible given today's Asia; and (ii) pursue hegemonic harmonization of product and regulatory standards. All East Asians could, for example, agree to adopt the standards of Japan, the Republic of Korea, or the PRC. This path is quixotic to say the least. This leads us to the conclusion that deep economic integration in Asia—namely the systematic removal and behind the border measures—is not yet in the cards. Such harmonization and standardization may, nevertheless, go forward in certain sectors, driven by market-led forces—witness the standardization of electronic components. Great standardization of auto parts, for example, would also seem possible.

The final point is that the rapid unilateral liberalization of East Asian trade has created a gap between policies nations want to pursue against policies committed to in formal, international agreements. For example, much of the impressive autonomous liberalization of applied MFN tariffs has not been bound in the WTO or in any other agreement.

5.1 The Way Forward

How should Asian regionalism be institutionalized? The perspective stressed in this paper is that some forms of integration and some forms of institutions trigger feedback mechanisms that transform the political economy realities in participating nations in a way that makes deeper integration more politically acceptable in the future. This is the real meaning of sequencing.

When it comes to Asia, we can start from the proposition that all acceptable institutions will have to be strictly intergovernmental. Even something as ambitious as an Asian EFTA has limits given the wide divergence of preferences, levels of economic development, and the fact that a very high level of integration has already been attained by “spontaneous cooperation.”

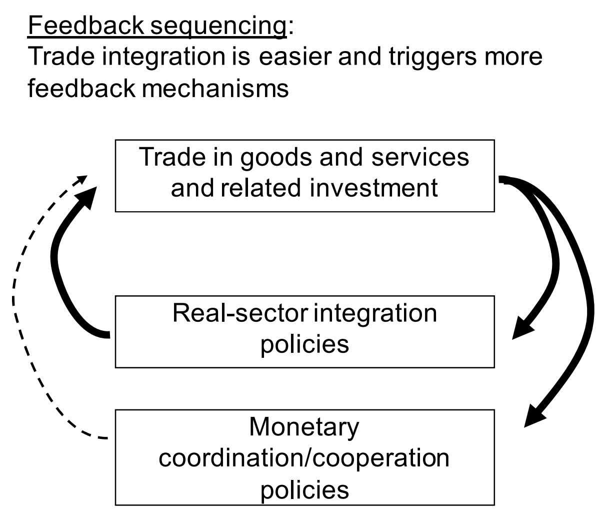
With this as a given, we are left with the choice of intergovernmental institutions concerning trade and investment flows, or institutions involving monetary coordination and integration. How does the feedback-sequencing perspective teach us to think about this choice?

First consider which of the two unleashes the greater feedback effects. The juggernaut effects operate from more intensive international commerce to more intensive liberalization of barriers to commerce. It also unleashes the Freidenesque trade/ER-stabilization feedback mechanism that induces nations to embrace “spontaneous cooperation” on monetary policy (or, if the setting is right, more formal exchange rate stabilization schemes ranging limited debate all the way to currency union). The monetary integration route, however, has only weak effects on trade and investment (according to European experience and empirical evidence from around the world). Trade integration, in short, unleashes more powerful feedback effects.

Next consider which of these is easier. As argued in Section 2, trade cooperation is intrinsically easier because the political-economy impact of removing barriers is much easier to gauge, making it much easier to piece together a package politically acceptable to all parties. Monetary cooperation is much harder, as the European experience in the 1970s and 1980s demonstrated.

With the trade route easier and more likely to trigger positive feedback mechanisms fostering deeper integration initiatives, trade seems to be the obvious choice for Asia.

Figure 11: Feedback Sequencing—Trade versus Money



5.2 Ideas on Where to Start: Institutionalize Asia's "Spontaneous Cooperation"

One of the lessons of Europe's experience is that institutions produce feedback effects that favor deeper institutions, even if these forces are not strong enough to induce the members to accept higher levels of supranationality. This suggests that there may be gains to getting the institutional ball rolling, even if the initial push is very small and the incline is not very steep.

Following this get-it-started logic, one obvious starting point would be to institutionalize, on a strictly intergovernmental basis, the existing "spontaneous cooperation" we have already seen on trade liberation and, perhaps, exchange rate stabilization as well.

The trade institution would not, in its first manifestation, be a free trade area (although that might follow). It would be a way of managing Factory Asia—the Asia-wide network of supply chains—by, for example, managing the massive unilateral and unbound tariff cutting since the mid-1980s.[27] The institution could document and provide some very weak lock-in (something short of WTO binding, but stronger than pure, uncoordinated unilateralism) of the autonomous tariff cuts to date. It could also, following ASEAN's lead, make progress on technical issues such as harmonizing tariff classifications beyond the HS 6 digit level. Finally, it could provide non-binding arbitration for regional trade disputes, either state to state or firm to state.

The old Haasian notion of functionalism—where institutional cooperation fosters greater institution cooperation by altering the attitudes of the regional policy elites—is probably far too weak to explain Europe's integration sequences. But it does seem to have had some effect. For example, the ECSC institutions, especially the Assembly, provided a venue where federalists could freely discuss their ambitions without the UK immediately pouring cold water on every idea. The astounding thing about Asia is that there are so few forums for such discussions. A modest institution with modest initial goals, might foster discussion of deeper economic integration by bringing Asian technocrats more frequently into contract with each other in the discussion of common problems that arise in the functioning of Factory Asia. In Baldwin (2008), I called this the "management committee" for Factory Asia, but here I would go further and add to it a formal role in disciplining Asia's massive autonomous liberalization. In time one can hope that this would help nations see the merit of the even firmer discipline that would come with WTO bindings.

[27] This can be thought of as an extension of the ideas presented in my 2006 "Managing the Noodle Bowl" paper; Baldwin (2008).

6. Concluding Remarks

Europe's founding fathers (and they were all men back then) did not start with grand designs. No one in the 1940s, for example, would have thought that starting with coal and steel was the obvious way forward. Europe's founders exploited windows of opportunity—situations where the alignment of national interests permitted establishment of long-lasting institutions that in turn fostered discussion and eventual adoption of deeper economic integration. It would seem that the vast tracts of "spontaneous cooperation" in Asia constitute one such window of opportunity.

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Feedback mechanisms explain how today's institutions alter the political-economy landscape in a way that makes future integration steps possible—even when these steps are not politically optimal from today's perspective. This paper uses feedback mechanisms to organize Europe's postwar integration narrative, and draws lessons for East Asian integration. The paper suggests that one starting point for Asian regional institutions would be to institutionalize the spontaneous cooperation that already exists on trade, services, and investment.

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