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SEQUENCING REGIONALISM: THEORY, EUROPEAN PRACTICE, AND LESSONS FOR ASIA

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ABSTRACT

Sequencing regionalism: Theory, European practice, and lessons for Asia*

Feedback mechanisms are the key to sequencing when it comes to regional integration. Feedback mechanisms 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 towards integration – even when these steps are not politically optimal from today's perspective. After outlining the theory, the paper uses feedback mechanisms to organise 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 institutionalise 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.

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Sequencing regionalism: Theory, European practice, and lessons for Asia

Richard Baldwin

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 non-existent (with the important exception of ASEAN and more recently 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 EU's supranational sequence and EFTA's 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; Section 6 presents 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) 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, that 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, i.e. a clear ordering of steps.[2]

What observers seem to have done is to assume that since Balassa listed them in order of increasing depth that they were in some ill-defined sense steps on the stairs to higher levels of regional integration.

There has been remarkable little thinking 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 Europe's discussions in the 1950s of alternative regional integration forms that might have been adopted – a discussion that is quite *sui generis* as Section 3 argues.

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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 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 Ernst Haas (especially Haas 1958). His thinking, which launched the neofunctionalism in international relations, was influenced by his work in the US military intelligence from 1943-1946 and his observation of European elite in the post-war chaos as they worked their way intellectually from trying to re-establish "business as usual" in Europe to embracing an 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 elites. As a result, the neofunctionalism 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 supra-national institutions (without explaining very clearly the political economy of this reorientations) 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 were the only items to survive the eliminations taking place in 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.

As concerns the theory, the shortcomings of Haas are twofold. First, he was not clear about the mechanisms through which the 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 EU case – led to a 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). As concerns the spreading of regionalism as opposed the deepening, there are many contributions including Kemp and Wan (1976), Baldwin (1993), Deardorff and Stern (1994), Bergsten (1995), Frankel and Wei (1995), Frankel et al. (1997), and Oye (1992). More recent work by Plummer and Wagnaraja (2007) and Estevadeordal and Suominen (2008) also provide important contributions to the analytics.

The literature on why nations cooperate in the trade agreements is much broader, but it does not get at the heart of the sequencing issue. The key to sequencing is the notion that one type of cooperation will change economic policy environment in a way that makes other forms of cooperation possible in the future when they were not possible initially. In short, some sort of feedback mechanism is what we need to focus on if we want to think about 'stages of economic integration'. The next section presents a number of 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 shall 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 intertemporal issues do not affect the feasible sequence, i.e. there is no feedback mechanism in operation 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.

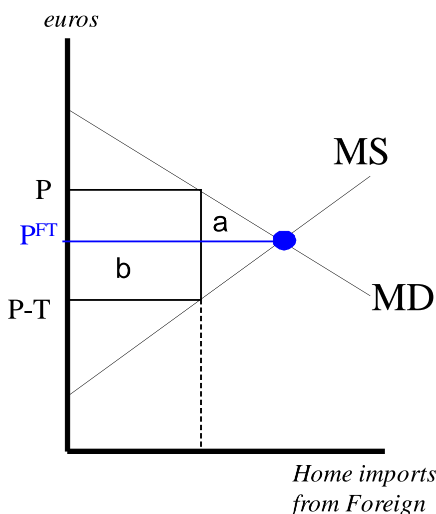

Figure 1: Tariff cooperation

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 S1and 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 liberalisation 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. Since 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 intersectoral reallocation of labour as possible, i.e. to minimise adjustment costs. Or maybe the objective function would favour sequences that attain free trade with as little change as possible in the distribution of world income. Even in our highly stylised 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 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 influences the economic environment 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 a adopt, in period 2, a policy that they found it 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 liberalisation as a sequencing problem in our two nations 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 liberalisation begets trade liberalisation; once the liberalisation ball starts rolling it is difficult or impossible to stop. The basic logic is simple to

[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 formalisation.

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 tariff protection that is too high.

Starting from this situation, 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 realise 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 the objective function of all nations in the MTN.

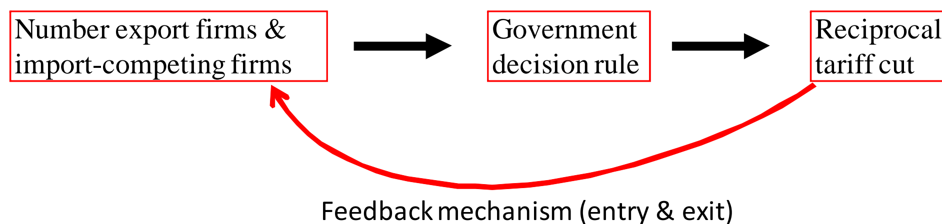

Figure 2: The juggernaut theory's feedback mechanism.

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 zero. The point is if the tariff initially balanced supply and demand for protection when the exporters were politically inactive, then adding the pro-liberalisation exporter to the political equation will surely mean that all governments find it politically optimal to lower tariffs from their pre-MTN levels.

This is not the end of the story. The tariff cuts will feedback 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 the 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 liberalisation-induced entry and exit will feedback into policymaking. A few years down the road, when another MTN is launched, reciprocity again re-aligns 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-liberalisation 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:

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

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. (Since 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 crystallise the logic, we need to fill in some details. Government choices are determined by the maximisation 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).

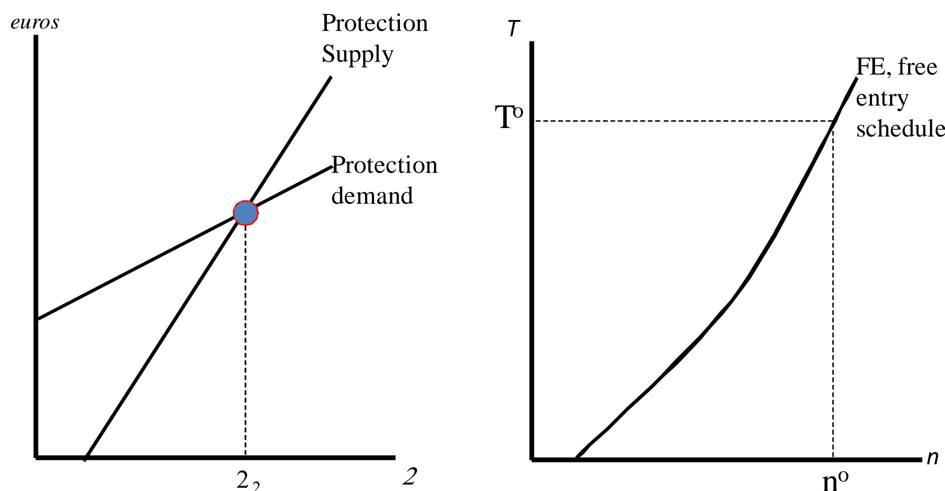

Figure 3: Supply and demand for protection, unilateral case.

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 associate with it). The supply of protection intersects the horizontal axis in the positive tariff range since 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 since 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, i.e. whether:

$$G[T_1, n_0; T_1] \geq G[T_0, n_0; T_0]$$

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:

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

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. Feedback of period 1 tariff cuts on period 2 decisions by 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 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 the governments' 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 liberalisation of barriers needs no international coordination (as in the first example). The mutual liberalisation 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 liberalisation, 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 liberalisation 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 who have access to superior trade-credit services. Thus the juggernaut will have liberalised trade in such 'infrastructure' services (i.e. 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 agreements among governments.

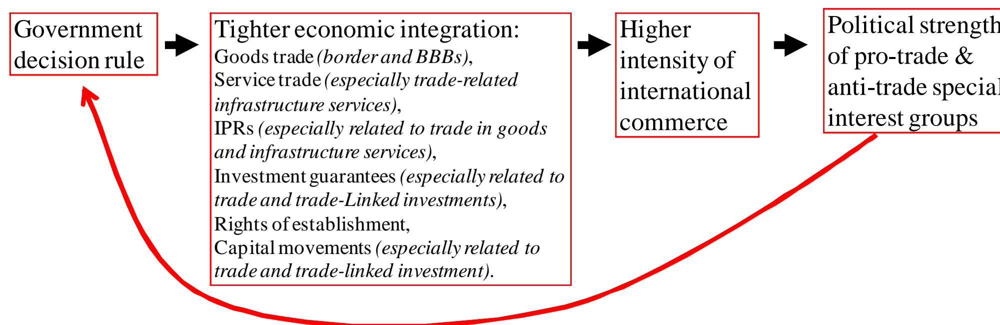

Figure 4: The Generalised juggernaut feedback mechanism.

Trade/BBB feedback

Reciprocal tariff and quota liberalisations 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, i.e. 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 cartelised distribution networks. Removing these is harder since 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 regulation – health, safety and environmental product standards – with good-governance motives. They want to protect citizens, the environment, etc. However these good intentions are typically subverted by ubiquitous political economic pressures to favour domestic actors 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 and away from their 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 liberalisation.

All this goes to explain why governments across the world turned first to tariff liberalisation and only later to BBB liberalisation. The GATT, for example, spend its first 20 years on tariffs, turning the BBBs (or a specific variety called TBTs) only in the Tokyo Round.

As far as sequencing is concerned the point is that tariff liberalisation does not make BBB liberalisation 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 liberalise the BBBs while simultaneously reducing the size/power of the groups resisting BBB liberalisation.

Trade/finance feedback mechanism

This is a minor feedback mechanism, but one that was critical in 1950s Europe. 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 (dollars and Swiss francs) and gold were marshalled to pay for essentials, like food and fuel (Eichengreen 2007, p. 60).

The stage 1 policy was a clearing mechanism that multilateralised the bilateral deals. This allowed all sorts of Pareto improving trades which in turned allowed production to rise and export earnings to rise. 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 the 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 policies. 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. Since 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 made the foreign sale. Such foreign affiliates naturally have access to foreign banking, and financial services and markets. Since this access can be manipulated that the parent company, the firewall between capital and trade transaction can melt away.[5]

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[4] 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, so in effect the buyer is borrowing pounds short term in the process of buying the book. Indeed if the order is cancelled and the pounds refunded, the buyer will have ended up speculating on the franc-pound 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 problems gets more severe as the flow and sophistication of transactions increases.

[5] In a classic example of this, trading companies can 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.

What this tells us is that deeper trade and investment ties reduce the effectiveness of capital controls. 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 became more tiresome and costly. At the same time cost-competition became more intense. In such a situation, exporters and importers began to press their governmental for a liberalisation of some capital controls – basically as a pro-business deregulation.

The feedback mechanism here is absolutely clear. Heighten trade and investment flows – themselves triggered by trade liberalisation – change the political realities facing governments when choosing capital market restrictions. The direction of change is systematically pro-liberalisation. One could suppose that the causality was two-way (i.e. loosening capital restrictions fostered cross-border trade and investment flows), but one-way causality is all that the feedback mechanism requires and it is the one that is clearly shaping the world. Even an authoritarian regime like China is having trouble enforcing capital controls.

2.2.2. Domino feedback

The feedback mechanisms discussed so far concern the impact of policies chosen by the cooperating partners. There can, however, be spillovers of these policies. The domino mechanism describes the political economy logic of one such spillover, namely trade diversion.[6] In this feedback mechanism, it is the choices of other countries in Period 1, than alter third-nation situations in Period 2 in such a way that the third nations find it politically optimal to adopt integration policies that they had eschewed 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, the assertion is that 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 that 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 the liberalization that membership would imply as well as non-economic objections to membership that are not observable to the econometrician. Consumers and taxpayers are taken as interest groups of second-order importance for the usual "Olsen's asymmetry" reasons.

Given an initial political equilibrium, an idiosyncratic shock that deepens or enlarges the customs union generates new political economy forces in non-members. Non-member 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 non-member nations as the liberalization implied by membership is heightened. If the industrial output of export sectors is systematically larger than the output of import-competing sectors (as is usually the case since the export sector produces for both domestic and foreign consumers) and sectors' political power is linked to their size, the shock raises the pro-membership forces more than the anti-membership forces. For outsiders that

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

were previously close to indifferent to membership (politically), these changes shift the domestic political economy equilibrium to the pro-joiners camp.

The second stage starts, if one non-member actually does join the customs union. The enlargement implies that discrimination facing the remaining non-members expands and this again heightens 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 membership in the customs union obtains.

If the world was marked by perfect information and synchronized periodicity in political decision-making, the membership bids would be perfectly coordinated, and bloc enlargement would happen in a step-like fashion. Uncertainty, imperfect information and mismatches of decision timings suggest that the new political economy equilibrium may be reached only gradually, i.e. during the transition it might look like regionalism was spreading like wildfire.

Asymmetric lobbying

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 to 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, i.e. sunk costs. Entry into most industries and markets involves large unrecoverable investments in product development, training, brand-name advertisement and production capacity. In such situations, established firms can earn positive profits without attracting new firms, but only in as far as these profits constitute a fair return on the entry investments, i.e. sunk costs create quasi-rents. Given that firms in an industry will have already incurred the sunk costs, deepening of an existing trade bloc, or formation of a new one, will generate new forces on the government to redress this new discrimination. Joining the bloc would be the most direct path of redress, 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.[7] See Baldwin and Jaimovich (2009) for a formal model that relies on this effect to extend the domino logic to FTAs.[8]

2.2.3. Trade/ER stabilisation feedback

The trade/exchange rate mechanism concerns the way that deeper trade relations alters governments' stance on exchange rate stability. This logic has been discussed by Freiden et al (2005). It has also been documented empirically by Devereux and Lane (2003), and Broda and Romalis (2003). While Freiden (1996) is quite explicit about posing the effect 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 care about the exchange rate and are also politically organised 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 labour, capital and technology – all of which are priced in the domestic currency – into goods that they sell

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

[8] Baldwin (1994) studied the customs union case only.

abroad for foreign currency. Depreciation lowers the price of their inputs relative to the price of their outputs and thus raises the profitability of their foreign sales. In short, exporters like depreciations and this preference intensifies as the exported share of the production rises.[9] 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 their output, so a stronger currency boosts their bottom line. In short, domestic firms like appreciations and this preference strengthens as their imported-input shares rise. A third group are the import competitors for whom appreciation is like a subsidy to their foreign competitors.

Consider the dilemma facing monetary authorities. If they let the currency drop in value, the exporters will cheer them, but the domestic firms will scream. A rise in the currency's value elicits the opposition reactions. Keeping the exchange rate stabile is a way to avoid this dilemma.

The key to this feedback mechanism is the strengthening of both the anti-depreciation and the anti-appreciation political voices as the nation becomes more open to trade. In short, trade liberalisation alters the political environment in which a government chooses its exchange rate policy and makes the government more interested in stability. The more open is an economy, the greater is the political-economic pressure to stabilise the exchange rate.

Two important corollaries follow from this logic. First, nations tend to stabilise their bilateral exchange rates with their major trade partners since these bilateral exchange rates tend to elicit the largest special-interest group reactions. Therefore, preferential liberalisation that shifts a nation's trade towards its regional partners tends to make governments more interested in the stability of bilateral exchange rates among those regional partners. Second, as small nations tend to be more open, the monetary authorities of small nations are more likely to face pressures to stabilize their exchange rates. Since small countries, at least in Europe, often have very lopsided trade dependence on a few (often one) nearby, large partners, these nations often fix their exchange rates to those of their large neighbours. In extreme cases, like Ireland, Lichtenstein, Luxembourg, Morocco, Andorra, etc, exchange rate stability manifested itself in the polar form of a currency union even before the war.

In a nutshell, the trade/ER stabilisation 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 stabilisation policies ranging for unilateral pegging to a currency union.

This feedback mechanism works both ways – trade makes policymakers want to stabilise exchange rates and stable exchange rates stimulate trade – but these two ways are very asymmetric in terms of magnitudes. The trade-to-ER stability direction is strong (Devereux and Lane 2003). The ER-stability-to-trade link is weak, as recent research has shown, revising the early, flawed research (Rose 2000) that showed large effects.[10] Thus liberalising bilateral trade can foster the adoption of policies that stabilise bilateral exchange rates (up to and including a currency union), but stabilising bilateral exchange rates does not, per se, foster bilateral trade liberalisation.

[9] This assumes that, as is the typical case, the nominal depreciation is not immediately offset by the rise in the domestic currency price of their inputs. Such offsetting price changes have happened in several cases when workers figure out that the depreciation was a roundabout means of lowering their wages relative to those of foreigners, and demanded higher wages. Wage indexing does this in an automated fashion but often with a lag.

[10] See Baldwin et al (2008) for a review of the evidence.

2.2.4. Institution/institution feedback

Institutions, once established, rarely die; they adapt. In particular, if the institutions prove useful to the participating nations, problems revealed during their operation can result in solutions that involve more institutionalisation. Section 3 provides several examples.

National governments often make agreements that subsequent governments come to regret. In intergovernmental cooperation, such situations almost always end in one party reneging on its commitments. Knowing that this might happen, the EEC – but not EFTA – established supranational institutions that could induce them to maintain the original bargain. This is a feedback mechanism, since 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.

One 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 recognised in the 1957 Treaty of Rome; Article 100 requires "approximation" (Euro-speak for harmonisation) of national regulations for the "proper functioning of the common market".

In the late 1960s, the European Commission tried to cajole the EEC6 into liberalising BBBs, to no avail. The members did not find BBB liberalisation 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 liberalisation was subject to an intergovernmental process of cooperation, not a federalist process, and the EECers just did not want to cooperate. (Neither did the EFTAns, by the way.)

The supranational institutions set up in 1957 could not accept this failure, since the European Court of Justice and the European Commission were duty-bound to enforce the Treaty. EU law and EU Court decisions are supreme, and ECJ 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, idiosyncratic standards. Indeed, as lax standard 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 spectre 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.

These institutional actions represent 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/ER-stabilisation feedback mechanism

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

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

This is a feedback mechanism since the Period 1 choice of capital market liberalisation 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 liberalisation triggers capital market liberalisation, which in turn triggers exchange rate cooperation of some form – perhaps ultimately a currency union. The European Monetary System of 1979 provides a good example; given the close trade ties, European nations had to replace the bilateral exchange rate stability that had previously been provided by the IMF's Bretton Woods system.

2.2.6. The RTB unilateralism feedback mechanism

After 1945, the main vehicle for tariff liberalisation among the world's rich nations was reciprocal trade agreements –multilateral and regional. 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 getter access to rich nations' markets without having to face down their own import-competing industries. This is why the juggernaut did not work 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 such liberalisation will diverge from the juggernaut mechanism, which relies on reciprocity. The key is to explain why governments find it politically optimal to remove tariffs that they previously found politically optimal to impose. One mechanism is "race to the bottom unilateralism" I developed in Baldwin (2006). The trigger for this mechanism is the spatial unbundling of the manufacturing production process.

Developing nations had traditionally maintained high industrial tariffs, aiming to stimulate domestic industrial production via 'infant industry' logic (as it had in North America, Europe, and Japan in the 19th century). With few exceptions, the later high tariffs failed to create substantial industry and where tariff protection did promote industries, few progressed beyond the protected-infant stage. However, following the success of the "four tigers" (South Korea, Taipei China, Singapore and Hong Kong) 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 in export industries (Greenaway, Morgan and Wright 2002, Ando and Kimura 2004).

The exogenous shock that disturbed this high-tariff political-economy equilibrium was the information and communications technology (ICT) revolution. Beginning in the mid-1980s, advances in ICT dramatically reduced the cost of organising complex activities over distances and these were amplified by deregulation and the rapidly falling costs of computing power.

The upshot of these ICT-led changes was the rapid development of international supply chains. Cheap and reliable telecommunications combined with information management software and hardware transformed the difficulty of organising 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 unbundled and off-shore some stages (especially labour-intensive stages) to nations whose low productivity is more than offset by their low wages.

There were many low-wage nations ready to welcome off-shored jobs and investment, producing intense locational competition. Competition often centred on parts and component tariffs – in particular on the imported intermediate goods that these offshored factories imported.

The political economy forces engaged in this sort of liberalisation are quite different to those described in the juggernaut feedback mechanism. There are three key differences.

- First, unilateral tariff cutting typically involved goods where there was little domestic production. Importing an advanced Japanese gearbox to be assembled into an exported Toyota automobile platform generates little domestic opposition.
- Second, many such imports are re-exported after having been assembled with other parts: importing and exporting is organised by the same firm. As such, the traditional indifference of exporters to domestic import barriers vanishes and with it the need for reciprocal trade agreements to assemble a pro-liberalisation coalition.
- Third, competition among developing nations for offshored jobs accelerated the process. Offshored manufacturing jobs from technologically advanced nations provide large gains for the developing nations receiving such jobs. Since removing tariffs makes export-processing activities (trade and investment) easier and more profitable for the offshoring company, companies asked for such tariff cuts. As there were many nations competing for such investments, it was difficult for any individual nation to resist call for unilateral tariff liberalisation.

Feedback effect

The feedback part of this mechanism comes from the manner in which this unbundling and offshoring of production shifts the nature of competition in manufactures. If some firms, for example, Japanese firms, obtain their parts and components from an efficient international supply chain, nations that continue to source domestically will be placed at a disadvantage. Thus competition among final good producers pushes them all to unbundle their value-added chains and source parts from the lowest nation suppliers. In short, after a single nation starts 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, this main example concerns exchange rate stabilisation. The effect resembles the political economy mechanism that drives the 'Trade/ER stabilisation feedback' mechanism. Namely, central banks typically face pressure to stabilize bilateral exchange rats with their main trade partners. In the case of a sub-set of EU members, this mechanism fostered participation in formal, exchange-rate cooperations such as the ERM and Eurozone. For many other EU members, and some non-EU West European nations, the pressure resulted in spontaneous cooperation.

Switzerland and Austria (before EU membership) are good examples. Their economies are thoroughly integrated into the EU economy. As a result, their central banks face pressures to stablise with respect to EU currencies – especially the deutschmark—through 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 cutting on parts and components and stabilisation of bilateral exchange rates via unilateral pegs to 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 abundantly to the actual sequence of regional integration sequences in Europe and East Asia. History doesn't really make sense; the key decisions are almost always messy compromises among dozens of interests with each of these walking away from the key meeting with different understandings of what transpired. To say "Britain applied to the EEC in 1961 because …", or any similar assertion on every other turning point in European integration is inevitably an oversimplification. Such oversimplifications, however, are necessary if we are to use the past to inform future choices. The approach taken here is to make the oversimplifications using a systemic and explicit theoretical framework – the feedback mechanism approach introduced above.

Feedback mechanisms, however, do not start on their own. They can be thought of as "political economy momentum" that explains why things continue to move, but not why they started to move. The first issue then is to identify the kick-start mechanism in Europe (this is done in the section 3.1). The evolution of European integration and the role of feedback mechanisms are then laid out in Section 3.2 and 3.3. The kick-start and subsequence feedback mechanisms in East Asia are discussed in Section 3.4.

Europe's twin integration sequences

As noted in the introduction, it is critical to realise that Europe saw two sequences launched in the late 1950s – one with deep institutions and one only lightly institutionalised. As such,

Europe provides a controlled experiment when it comes to studying the role of institutions in regional integration sequences.[11]

More specifically, 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, i.e. those where they are outvoted explicitly or implicitly in the Council of Ministers.[12] Member State courts do not have the final word on cases pertaining to their own laws that deal with Single Market or the currency union issues; on such matters the European Court of Justice's opinion is supreme and its decision have direct effect in Member States legal systems.

The other sequence started with purely intergovernmental institutions that resemble those adopted in later regional initiatives around the world. Until the EU essentially forced EFTA to set up the EFTA Court as part of the EEA in the mid 1990s, EFTA was basically an occasion for members' ministers to talk about common matters. EFTA was strictly about trade as evidenced by the fact that it did not require its members to be democracies (Portugal was ruled by the dictator Salazar from 1932 to 1968).

3.1. Initial conditions and experimentation

Initial conditions matter, as the previous theoretical section argued (and any scholar of human events will confirm). In Europe, the key initial conditions are all related to World War II 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 path at least up to the late 1960s.

3.1.1. The first plan, its abandonment, and replacement

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

1. The uncoordinated pursuit of recovery plans produced a tangle of new trade barriers – especially bilateral balance-of-payments-linked quotas limited much of European trade to barter arrangements; these stymied the recovery.
2. The USSR's action in Central and Eastern Europe showed that it was bent on pushing Communist regimes to power in all the European nations it occupied in 1945, and perhaps on into West Europe.

By the late 1940s, it was clear to all that Plan A was defunct – 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 that Germany became a strong ally and economic partner, rather than a potential foe and economic rival. But Plan B had two versions.

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[11] Interested readers can find the full discussion in Baldwin (2009), Baldwin and Wyplosz (2009), or, on some aspects related to EFTA, O'Rourke (2009).

[12] Many Council decisions are decided by 'consensus', i.e. no formal vote is taken, but 'shadow voting' still occurs. Nations decide whether the measure will pass despite their negative 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.

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

This was accepted by nations that can be called the "federalists". The citizens of nations most affected by WWII in terms of human and economic costs felt that the governance system they had been used to hereto was deeply flawed – prone to warfare and economic collapse. 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 many of the Central European nations.

- Plan B2 involve economic cooperation of the traditional intergovernmental variety, i.e. where nations were only bound by policies that 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 in nations with governments that had somehow managed to avoid foreign occupation, fascism, and catastrophic loss of life tended to maintain their 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 UK, Denmark, Norway and Iceland as well as the neutrals: Ireland, Sweden and Switzerland.

As we shall see, the two groups repeated 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 subsidised by US taxpayers.

3.1.2. The first phase: EPU and experimentation

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

The result was a number of experiments and many proposals that were never adopted. Indeed, 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, specifically it clearly illustrates the critical point that successful initiatives must strike a positive balance between political economy gains and pains. The list of failed 1950s proposals 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.

Fanco-Italian Customs Union Treaty, ECUSG and ECSC

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 to the economic gains from integration. The discussions, however, showed that real economic integration in Europe would be difficult. The core of the

problem was that governments at the time intervened in their economies so thoroughly that simply removing tariffs might do little more than unbalance a stable situation. The liberalising impact of each tariff cut could be offset by a string of murky behind-the-border barriers. To prevent such offsets, the French and Italian negotiators put very deep disciplines into the treaty, disciplines that would have required them to pool a great deal of economic policy sovereignty.

The second initiative was a West Europe-wide custom union. This was discussed by all 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 its 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 require 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 arrangement (it transitioned from irrelevance to inexistence in 2002), it was proved 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 economies and crucial a national military strength. 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 supranationalism.

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, a group that became known as 'The Six'). Intergovernmentalists shared the Benelux 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: EDC and EPC

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'.[13] By the time the ECSC was up and running in 1952, Europe was a very different place than it was in 1945. The highly favourable 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 Defence 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 the defence burden to Europeans), the Six signed the Treaty establishing the EDC in May 1952 which called for 40 divisions sharing the same uniform and operating under a

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[13] French viewed it as a counterbalance to US-UK influence, and a way of assuring Germany's recovery did not threaten modernisation 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. Beneluxer were overjoyed with anything that lessened the prospects of a new Franco-German war.

supranational command. Political guidance was to come from a Commissariat of nine members, a Council of Ministers, and an 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 un-elected and highly idealist ECSC Assembly) strikes today's reader as idealistic in 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 labour across all sectors of the economy. The ECSC Assembly adopted the EPC by a near-unanimous vote in March 1953.[14] 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 WEU (October 1954), and finally agreed to West German sovereignty in 1955; in the same year, Germany joined NATO, established a new army, and rearmed in earnest with US assistance.

3.2. European integration takes off

The Marshall-Fund-driven EPU triggered rapid European economic recovery and rapid industrialisation that spread to Europe's traditionally more agrarian nations (e.g. France and Italy). This rapid growth of trade, industry and incomes created initial conditions that favoured further economic integration; it worked via the generalised juggernaut mechanism. But there was also a key political issue that drove European governments to launch integration initiatives that went far beyond the Marshall Plan and EPU.

To understand the political motive, compare Europe 1955 to Europe 1945. In 1945 the plan was to return Europe to the prewar situation 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 fresh in the mind, 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 to in their "frontal assault" of directly setting up a European Army, European Defence Community and European Political Community, attention turned to backdoor of 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 liberalisation and vice versa, so this economic miracle fostered a political environment that favoured further trade liberalisation. Specifically, this juggernaut feedback

[14] 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 the European parliamentary body proved to be radically more federalist than the Member State governments. The EPC sank along with EDC.

mechanism was triggered by Intergovernmental integration – primarily the EPU and to a lesser extent the GATT tariff cutting Round in 1947, 1949, and 1951.

3.2.1. Messina and the Treaties of Rome

The month that Germany joined NATO, Benelux nations 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 favoured 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 the signing on 25 March 1957 of two treaties. The first created the European Atomic Energy Community (Euratom) – something like a modern version of the ECSC but one that never function as expected.[15] The second created the European Economic Community (EEC). The Treaties of Rome were quickly ratified by the six national parliaments and the EEC came into existence in January 1958.

3.2.2. EEC 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.[16] 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 (e.g. a common competition policy, a common production subsidies policy) some of which were to be implemented by executive decisions of the supranational European Commission.

There were, however, even deeper elements sprinkled around 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 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 supra-national institutions in the ECSC, the EEC was clearly expected to go deep. This was driven by a combination of practical mercantilism, European idealism, and the need to solve the "German question". As far as mercantilist motives are concerned, the governments of the Six believed that removing tariffs alone could lead to cheating. They required assurances that each others' opaque behind-the-border-barriers (taxes, subsidies, exclusive producer or distribution

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[15] 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. Since France was developing atomic power, but 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.

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

cartels, dual pricing of rail transport, etc.) could not be used to nullify the market access created by the removal of tariffs and quotas. As far as European idealism is concerned, the Treaty of Rome inspired a whole generation of European to dream of an end to overt nationalism (a dream that has largely become a reality in today's Europe). As concerns the "German question", the fact that the Treaty of Rome's strong institutions embedded a rearmed Germany into a supranational European construction rendered it even more attractive. In particular, the depth explicitly agreed and the open-ended nature of the commitment to an ever closer union seem to hold out the promise that Germany would forever eschew its 1870-1945 role as rival and conqueror and henceforth become an ally and economic partner.

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.

3.2.3. 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 feedback effect. Britain first renewed efforts to negotiate a shallow but OEEC-wide trade agreement, an option steadfastly refused by the Six.

The EEC introduced a powerful new force into the political economy of European integration– discrimination. Before the EEC, trade liberalisation (orchestrated by the OEEC) did not discriminate against OEEC members.[17] The EEC promised to remove *all* trade barriers on a discriminatory basis and impose a common tariff against non-members. This pending discrimination from a large and fast growing market left other OEEC members – most of them small – on the sidelines. Fearing the discrimination and marginalisation 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 co-ordinated response was greatly facilitated by the UK's leadership.

Domino effects: 1961-1973

The 1960s saw the trade liberalisation 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 customs union (CU) formation, the EEC's share in its members' 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, at the same time that EFTA members moved to integrate with 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.

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

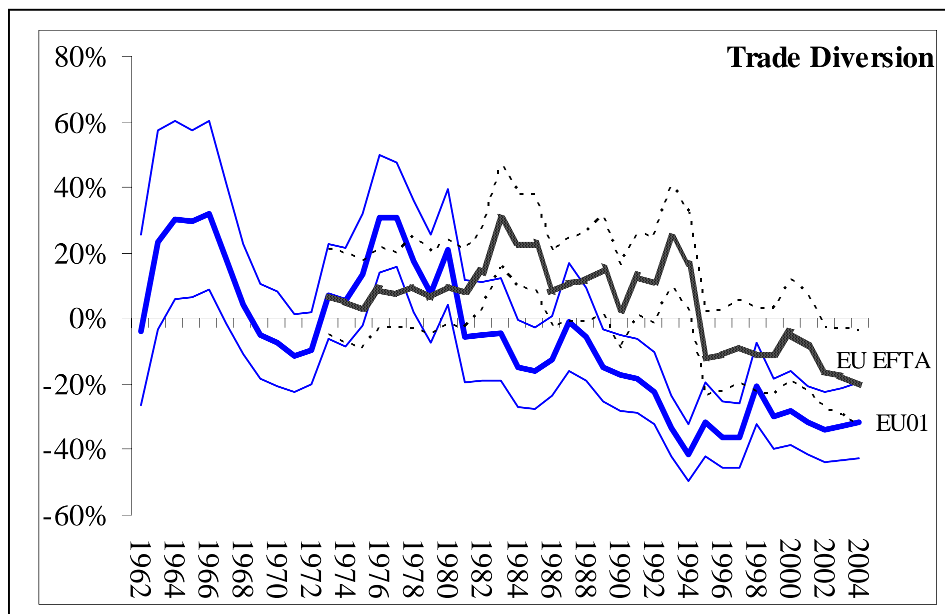

Figure 5: Trade diversion in EU and EFTA, 1962-2004.

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 EFTAns. EUEFTA is the effect facing EU nations.

Source: Baldwin and Rieder (2007).

Trade diversion and the domino effect feedback mechanism generated new political economy forces for lowering between-group trade barriers. 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 EFTAns 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.)

This move requires some explaining as Britain had decided to withdraw from the Common Market discussions just five years early. The reason – according to the Domino feedback mechanism – is that the impending discrimination posed by the formation of the EEC's custom union shifted Britain's domestic politics. Specifically, UK exporters lobbied harder to avoid the looming loss of competitiveness. Although 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 EFTAns still found the EEC's depth of integration too high a price to pay for redressing economic discrimination by the EEC.)

French President De Gaulle unilaterally vetoed the UK's application in 1963 and again in 1967 after the same four EFTAns 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.

The impending departure of four EFTAns to the EEC triggered a third domino effect. The departure was anticipated well in advance and would have resulted in new barriers being constructed between the new EEC members and the remaining EFTAs (the EEC is a customs union so new members have to abandon their old FTA commitments). Moreover, it would have heightened discrimination by widening the range of EFTA competitors that enjoyed the

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 EFTAn 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, represents a virtual free trade area for industrial products – the concatenation of three types of agreements – the Treaty of Rome for intra-EEC trade, EFTA's Stockholm Convention for intra-EFTA trade, and the EEC-EFTA bilateral FTAs for trade among the two groups. The inner circle was the EEC's Common Market.

3.3. Deeper economic and monetary integration

European integration's take-off produced an initial decade of remarkable growth in incomes 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.

3.3.1. Behind the border barriers

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

After completing the customs union, the European Commission, which is institutionally obliged to ensure that Treaty commitments are honoured, embarked on BBB liberalisation. It adopted a plan in May 1969, called the General Programme.[18]

The Commission's 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 regulation – health, safety and environmental product standards designed protect citizens. Given the ubiquitous political economic pressure to favour domestic actors, many of these new rules and standards favoured domestic firms. The protectionist content of the new BBBs was incidental to their purpose, but far from accidental. The impact of these on trade flows can be seen in Figure 5 as EFTA-to-EU trade diversion rises again in the 1970s.

The same changes affected EFTA governments, but they reacted quite differently. Addressing technical barriers to trade – e.g. health standards for food – requires discussion of policies traditionally considered the exclusive purview of nation-states. Although EFTAn 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 internationalisation of product standards, thereby reducing their protectionist content.

[18] 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, 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 liberalisation. The approach adopted relied on detailed technical regulations for single products or groups of products implemented by unanimously agreed directives. See Lauwaars (1988 p.152), or Pelkmans (1989) for details.

The International Standards Organisation, which had been set up in 1947, had languished up to the late 1960s, but one of EFTA's big industrialised exporters, Sweden, pushed for its reinvigoration with the appointment in September 1968 of Olle Sturen, an appointment supported by the Swedish Standards Institute. As the ISO's first Annual Review in 1972 described : '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.

3.3.2. Exchange rate stabilisation: EMU I

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

From a European perspective, Bretton Woods was inadequate. It stabilized rates against the US dollar with a band of fluctuation. 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 Bretton Woods central rates were also decided by a body dominated by the US, not by the EEC6. Both of these features made Bretton Woods an imperfect policy response to the rising pressures for exchange rate stabilisation 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 without the anti-Federalist Charles De Gaulle (he was replaced by the new, pro-European French President Georges Pompidou), called for a 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 received only a vague mention 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 the dominant currencies, the dollar and the pound. However, the plan for economic and monetary union (EMU) 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's central bank governors was established 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 the 1969 when the French franc was devalued in 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 dollars – and the US's ability and willingness to transform dollars into gold – was the heart of the system.

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[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 a intergovernmental cooperation; indeed, its meetings were held at the Bank of International Settlements in Basle 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 transaction for the Marshall Fund's EPU.

3.3.3. Shock and reaction

Extremely poor macroeconomic performance in the early 1970s forced the EEC to shelve Warner Plan, but the 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 liberalisation of 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 a monetary union would not be possible.

Although EMU was off the agenda, the trade/ER feedback mechanism was still in operation, 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 stabilisation system called the "snake" whose purpose was 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 their exchange rate stabilisation by setting up a European Monetary System (EMS) in 1979. This was akin to the Bretton Woods system with the European Currency Unit (a weighted basket of all EEC currencies) as the anchor instead of the dollar. By stabilising against the ECU, the grid of EEC bilateral exchange rates was stabilized.

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 macroeconomic 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 comes back into the story in the 1990s.

3.3.4. Intergovernmentalist reactions to the Bretton Woods shock

The breakdown 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 labelled 'fortuitously coordinated unilateralism'. Since the EFTAs had roughly similar trade patterns – namely they all traded a great deal with the EEC9 – their individual stabilisation efforts

mimicked the effects of the more institutionalised and Federalist EEC schemes. Indeed some of the EFTAs (Austria and Switzerland) were core members of the DM bloc and thus were unilaterally shadowing Germany monetary policy and thus stabilising their bilateral exchange rates at least as effectively as some formal members of the EEC monetary arrangements (e.g. 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.

3.3.5. Institution/institution feedback

The first years of the EEC revealed problems in the functioning of the European institutions. The most obvious problem 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 the EEC's 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 the Council of Ministers. However, the power of initiative, i.e. the power of agenda setting, 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 since it met at the Ministerial level, not the Head of State level, and its agenda was largely shaped by the Commission, not the member governments.

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 formalisation of these meetings into the European Council. This body, which was entirely outside the EU's formal structure until the 1990s, works 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 puts a limit on the power of vetoes.

A third example came with the 1970s Budget Treaties that put the EEC's financial on a firm institutional basis. Hereto, the budget obligations were meeting by annual, ad hoc contribution from members – an exercise that always created tensions, especially as the CAP became increasing expense.

A fourth example is the creation of the Committee of Governors of the Central Banks of the Member States of the European Economic Community in May 1964. The Treaty of Rome was vague on the extent to which member's macroeconomic policies should be integrated. It said that exchange rates should be a matter of common concern, but it did not provide any institution for addressing these matters. Various episodes of exchange rate changes – which affected intra-EEC trade – convinced EEC leaders that more cooperation and coordination was necessary. In essence the institutions that accompanied deep trade integration created a setting that fostered the creation of new "flanking" institutions to address policies that had

spillovers on the cooperation already agreed. While similar issues arose among EFTA nations, no similar flanking institution was established by the EFTA governments.

3.3.6. 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 the harmonising standards required unanimity in the Council of Ministers under the 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.

More specifically, the juggernaut mechanism raised political economy pressures on member governments to tackle behind the border barriers, but the magnitude of these political economic gains did not outweigh the political economy gains involved in altering domestic regulations in the necessary fashion. Indeed, the outcome of this balance of costs and benefits has prevented all other trade arrangements around the world to tackling BBB liberalisation with the sole exception of the Australia-New Zealand Closer Economic Relationship (Baldwin 2000).

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 – decisions that had direct effect in 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 such justifications.

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 spectre 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 the EFTAns as they had no supranational institutions and in any case had not pledged themselves to BBB liberalisation.

[20] The general legal basis for removing BBBs in the EU 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." See Sykes (1995) for details.

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' the BBB liberalisation. 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 the auto sector, air transport and energy.

It is important to realise 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 your exporters' competitiveness. In short, the EU Court pulled the rug out on that 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.

The point bears repeating. Before mutual recognition, cooperation on standards meant <u>decreasing</u> national control over its standards. Mutual recognition destroyed this status quo, making cooperation was the best way of <u>increasing</u> 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 member states' national policy processes.

3.3.7. 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', i.e. moving production to the EU. As Figure 6 shows, foreign direct investment boomed in the nations joining the Single Market (Spain and Portugal, who were 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.

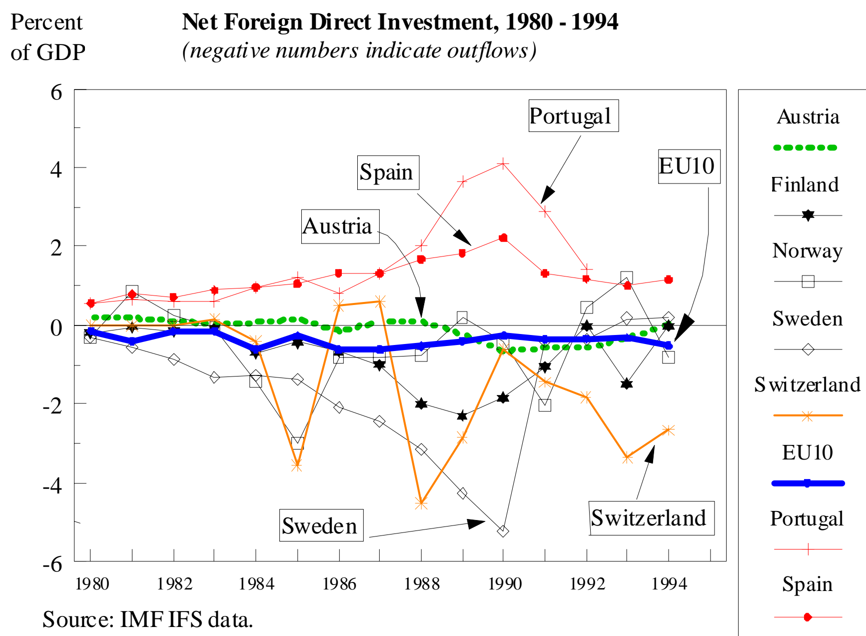

Figure 6: Investment diversion and the Single Market

Source: Baldwin, Forslid and Haaland (1996).

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 as concerns future EU legislation.

In essence, it forces the EFTAns to accept all future EU Single Market legislation without granting them any formal input into the formation of 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 in order to simplify the task of keeping the Single Market homogeneous. Second, the EFTAns had resisted such 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 on the EEA, 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 Federalist to join the EMS and Intergovernmentalists to adopted 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 costly. At the same time cost-competition became more intense. Exporters and importers began to press for a liberalisation of some capital controls as a pro-business deregulation.[21] As a result, nations around the world, including those in Europe, began to relax capital controls (Wyplosz 2001).

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 (e.g. 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 and a Council decision in 1989 moved the deadline up to July 1990 and labelling 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 liberalisation pace. See Wyplosz (2001) for the timing of this liberalisation for EC and EFTA nations.

Trilemma/ER-stabilisation feedback mechanism

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

[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, so in effect the buyer is borrowing pounds short term in the process of buying the book. Indeed if the order is cancelled and the pounds refunded, the buyer will have ended up speculating on the franc-pound 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 problems gets more severe as the flow and sophistication of transactions increases.

Of course the trade/ER-stabilisation mechanism was still in force, so governments found it politically optimal to stabilize bilateral exchange rates with their 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, the workers continue to press for higher wages so a recession is necessary to force firms to restraint price rises. Yet with prices rising less quickly than wages, real wages rise and firms must fire some workers to bring labour productive 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; it had maintained its anti-inflation policy throughout the stagflation period. The Federalist participants in the EMS and the Intergovernmental shadowers came to view the defence of their bilateral exchange rate with the DM as an extremely effective way of demonstrating to workers, firms and markets that they 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 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 favourable macroeconomic performance in the 1980s. Inflation was falling and growth was rising – stagflation in reverse.

This stable equilibrium was rocked by the fall of the Berlin Wall. West Germany essentially annexed the newly independent East Germany and to smooth the unification, the German government cranked up spending. However, in an effort to keep unification politically popular in the western Lander, 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 its inception and was not at all happy about the deficit spending). One can argue about the appropriateness of this policy mix for Germany, but for the rest of the Europe, it was an unmitigated disaster. EMS members and EFTA shadowers imported restrictive German monetary policy without the offsetting fiscal expansion. An unnecessary and unwanted recession soon followed.

This shock ended European complacency regarding their position in the trilemma. 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-stabilisation 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 subordinated their monetary policies to Bundesbank decisions, so for them, a single, joint central bank would be like putting a fellow national on the Bundesbank decision-making committee. Once again *de jure* and *de facto* sovereignty has got flipped around. From the perspective of the late 1980s and early 1990s, monetary union involved a gain in sovereignty for everyone except Germany.

Intergovernmentalists who saw the logic but could not face the prospect of losing *de jure* monetary sovereignty (e.g. the UK, Denmark and Sweden), chose to switch angles in the "impossible triangle". They abandoned their formal exchange rate peg and went back to using monetary policy for domestic stabilisation (although with a firm eye on the exchange rate).

3.3.8. Single currency and BW II

The 9 November 1989 fall of the Berlin Wall was also a 'political earthquake' that destroyed the status quo in the EU and opened the way to the next giant step in European economic integration – creation of the Eurozone. The storyline is somewhat circuitous.

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, i.e. 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 spectre 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 – that was the grand bargain.

On 3 October 1990, Germany unified and the Eastern Lander entered the EC by fiat; three weeks later the European Council completed preparations for two sets of Treaty-writing talks known 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 labelled. The IGC on Economic and Monetary Union was about monetary union: necessary institutions, entry criteria and 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, a tidying up exercise.

The significant changes discussed were:

- Decision-making procedures (extending the range of topic 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 that has yet to be ratified at the time this was written.

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

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

The big European nations had cooperated on defence 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 member has grown, some EU members seem firmly resistant to joining. 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: BW 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, i.e. there was not trade diversion of the type observed with discriminatory tariffs or BBB liberalisation (Baldwin 2006d).

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. Indeed a very large number of governments around the world have decided that they cannot trust themselves and have handed monetary-policy sovereignty to independent, unelected officials in their central banks. 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. The effect has been something like Bretton Woods II. That is, since the US Fed was pursued something like an inflation targeting strategy (as least up until the 2008 crisis), and nations around the world either pegged to the dollar are pursued similar inflation targeting strategies, bilateral exchanges rates were largely stabilised. This example of spontaneous cooperation has gone a long way toward allowing individual nations to replicate the currency and exchange rate stability effects of more formal monetary cooperation (e.g. the EMS or Eurozone).

3.4. Feedback mechanisms and sequencing in Asia

As noted in the introduction, Asia experienced remarkably little *de jure* regional economic integration 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 liberalisation, the margins of preference on the remaining lines were small. … less than five per cent of intra-regional trade takes place at the preferential rate."

This section considers the sequencing of regional integration initiatives in Asia, organising the narrative using the feedback mechanism approach. The focus is on East Asia since 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 from those that induced tariff cutting in Europe. In Europe reciprocity was the key (generalised juggernaut effect); in Asian reciprocity played almost no role. Before turning to the political economy feedback mechanism, it is therefore necessary to describe key differences between East Asian regionalism and European regionalism.

3.4.1. The development of "Factory Asia"

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

- Differences in national economic scale (Japan was the only large economy);
- Disparities in levels of development (Japan was the only advanced economy), and
- 'Dual track' development strategies that actively discouraged imports of most manufactured goods, especially those produced by East Asian economies. All East Asian governments aimed to produce and export the same products, especially mechanical and electrical machinery (and specifically electronics).

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

ICT revolution and the second unbundling

Economic integration in the region was kick-started by a technological shock. Specifically, East Asia was set on a new course by the ICT revolutions that began in the mid-1980s (Baldwin 2006a).[23] Around this time, the US and Japanese manufacturers began to geographically unbundle their manufacturing processes, offshoring 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 such possibilities and competition pushed firms over the threshold – especially large Japanese firms. In essence, the processes that were formerly organised in one of the production bays of large factory were organised in free-standing factories set up in locations that had factor prices better suited to the particular needs of the particular production processes. "Factory Asia" is the name I gave to this spatial fragmentation of manufacturing in Baldwin (2006a).

[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 for why the production unbundling and unilateral liberalization started in North American and Latin America at the same time it started in East Asia.

The interesting of the offshoring companies (mainly Japanese) fit in nicely with the export-track of the dual-track development strategies of many East Asian nations. Developing Asian nations' desire to host these new factories triggered the RTB unilateralism feedback mechanism. To attract such investment, the members of ASEAN unilaterally reduced their tariffs on triangle trade; to use the jargon of international tax competition, this 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 Figure 7 which shows the number of auto and electronics plants placed by Japanese firms in East Asia from 1975 to 2004. Towards the end of the 1990s, when China decided to join the world economy, the unbundling accelerated – attracted by the very low, productivity-adjusted cost of labour in China.

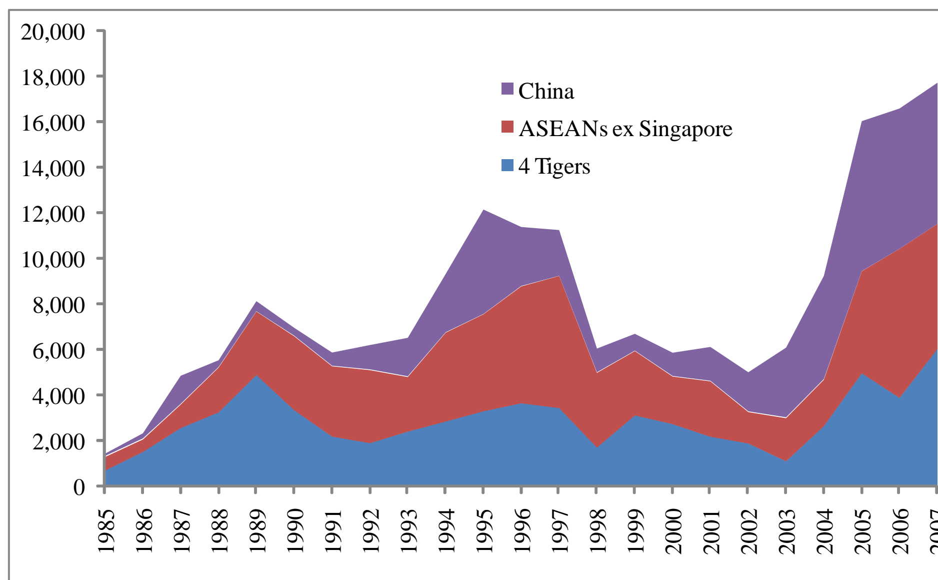

Figure 7: Placement of Japanese plants in East Asia, 1985 – 2007

Source: OECD online data.

Rapid industrialisation

The development of Factory Asia was accompanied by a spectacular re-orientation of developing Asians' export composition. A 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 big ASEAN economies relied primarily on commodity exports in the mid 1970s. There was a marked change towards manufactures in the subsequent decade, but by the mid-1980s, more than half of their exports consisted of primary products. Radical reorientation came after the mid-1980s. As the last column shows, manufactured goods accounts 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, trade in manufactured goods within East Asia is trade in parts and components. More specifically, one can think of East Asian nations as two groups: headquarter economies (Japan, Korean, Taipei China, Hong Kong and Singapore) and factory economies (China and 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. The factory economies tend to specialise in producing various segments of the value added chains.

Table 1: Nations' non-oil export composition (% of total non-oil exports)

	1976-7	1983-4	2003-4
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%
Vietnam			
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 the main ASEANs import and export. In the image of Asia Factory, these nations import parts in, say, electrical equipment add some value and the re-export the parts. This is largely the case as Table 2 shows.

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

Table 2: ASEAN parts and components imports and exports by sector, 2003-04, (% of total parts and component trade).

	Malaysia		Philippines		Thailand		Vietnam		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
P&C trade	100	100	100	100	100	100	100	100	100	100

Source: Athukorala, Prema-chandra (2006).

China contrasts with the big ASEANs

After China joined the world economy, particularly after its accession to the WTO, the nature of Factory Asia became more differentiated. The 'headquarter' economies – Japan, Korea, Taipei China, Singapore and Hong Kong – engaged in parts and components processing in the larger ASEAN economies (Indonesia, Malaysia, the Philippines, Thailand and more recently Vietnam) and assembly in China. This pattern can be seen in Table 3.

Table 3: Development of Factory Asia: Role of parts and components (P&C)

	Japan		NIE3		ASEAN4		China	
	1990	2005	1990	2005	1990	2005	1990	2005
P&C machinery to EA	7%	16%	9%	25%	7%	17%	5%	5%
P&C machinery to RoW	19%	18%	8%	12%	7%	11%	2%	16%
Final machinery to EA	8%	8%	7%	8%	3%	7%	9%	16%
Final machinery to RoW	41%	29%	17%	17%	5%	12%	3%	14%
Sum machinery in total exports	76%	70%	42%	62%	22%	47%	19%	50%

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

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

East Asian markets for final machinery have *not* become more important for East Asian exporters. For Japan, the Newly Industrialised Economies (NIE3, South Korean, Singapore and Hong Kong), and the ASEAN4 (Indonesia, Malaysia, the Philippines, and Thailand), the share of final machinery sales to East Asia has remained steady at under 10% of their total exports. The exception is China, which has almost doubled the share of its total exports accounted for by 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 China – the role of P&C exports to East Asia has almost tripled from 1990 to 2005. China has seen its share of P&C exports to the region stagnate at 5%. The region's preponderant and growing reliance on the exports of machinery 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 summary, Factory Asia involves mostly trade in parts and components among East Asian nations with the exception of China; China is an important importer of parts from East Asia and an important exporter of final machinery to the region.

3.4.2. The muted role of institutionalised cooperation

Formal regional trade agreements have only recently begun to matter in East Asia. A more extensive historical narrative can be found in Chapter 4 of the final report; here we present a highly stylized historical sequence based on Baldwin (2006a). It is useful to distinguish three phases of East Asian regionalism.

Phase I, Competitive Unilateralism: From the mid 1980s to 1990, tariffs on intra-regional trade came down but this was due to unilateral tariff cutting 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 China's emergence heightened the competition among East Asians for jobs and investment linked to the ever-expanding Factory Asia. Formal regionalism was kick-started by former Malaysian Premier Mahathir with his East Asian Economic Community (EAEC), which led to the ASEAN Free Trade Agreement (AFTA) in 1992. However, little preferential liberalisation occurred – ASEANs were cutting tariffs, but on a non-preferential basis. As a consequence, few firms bothered to apply for preferences under AFTA and so although it existed on paper, it was almost unused.

Mahathir's vision for East Asia was much broader that trade alone, and it had a very clear element exclusion as an Asian-only club. The US feared that an Asian-only economic bloc might come to involve or even be dominated by China, a nation whose economic resurgence caused concern (the US was still quite uncertain about Chinese motives in the early 1990s). The US countered Mahathir's vision by backing Australia's idea of Asian Pacific Economic Cooperation (APEC) in 1993 – a new twist on the old strategy of undermining on preferential trade arrangement by proposing a larger one (as UK did in the 1940s and 1950s). This diversionary tactic worked and the 'exclusively Asian' aspects of Mahathir's vision were replaced by the oxymoron "open regionalism."

Phase III, Resurgent Regionalism. In November 2000, Chinese Premier Zhu Rongji triggered a domino effect by suggesting that China would negotiate an FTA with ASEAN.[24] This idiosyncratic initiative faced nations outside ASEAN with a new situation which in turn strengthened pro-FTA political forces in the excluded nations, especially Japan and Korea. The result was a domino effect that continues to operate today.

Domino effects in Asia

The November 2000 Chinese initiative came as something as a surprise to ASEAN but it was in line with China's behaviour in the 1990s. One key element of the Chinese economic development strategy of the 1980s and 1990s was the desire to avoid the antagonising its regional neighbours. Since China's success in attracting industrial jobs and investment was increasing viewed as a threat by ASEAN, the Chinese government decided to make a gesture that would assuage ASEAN concerns about competition from China.

Although the initiative was surprising, it was generally welcomed by ASEAN. It was immediately clear to most ASEAN leaders that preferential access to the large and fast growing Chinese market would be an enormous boost to the attractiveness of their own economies as sites for Factory Asia, although they had reservations about liberalising their 'sensitive sectors.' The concrete result of the Chinese surprise initiative was the establishment of a study group on the FTA idea.

China's surprise proposal to ASEAN set off alarm bells all around Asia, especially in the advanced economies, Japan and Korea. Export dependence figures reveal the reason. Table 4 shows the share of East Asian nations' exports to ASEAN and the ACFTA area in 2003. For Japan and Korea, AFTA discrimination in the ASEAN markets is relative unimportant since

[24] The formal proposal for a China-ASEAN FTA came from Prime Minister Zhu in November 2001, and ASEAN leaders accepted it in principle, agreeing to set up groups to study detailed questions. This led to a Framework Agreement on Comprehensive Economic Co-operation in 2002, which foresaw an ASEAN-China Free Trade Area (ACFTA) by the year 2010 along with some 'Early Harvest' liberalisation of agricultural goods. The talks concluded successfully in late 2004 and the deal being signed in November 2004.

Japan sends only 17% of its exports to the region (and most of those face low MFN tariffs as we saw); the figure for Korea is 13%. The ACFTA, however, changes the picture dramatically. ACFTA would imply that Japan-based and Korea-based firms would face tariff discrimination in markets covering 36% and 43% of these nations' exports 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 China and the ASEANs have relatively high MFN tariffs on many industrial goods, especially the finished products at which Japan and Korea excel, such as consumer electronics and autos.. ACFTA could be highly discriminatory, i.e. have very high margins of preference. Worse still, MFN tariffs of China and most ASEANs are either not bound or bound at rates that substantially exceed the applied rate. In other words, the ASEANs and China could – without formal repercussions in the WTO – raise their applied rates against Japanese and Korean exports.

Table 4: Actual and projected "exclusion indices"

	Japan	Korea	China	Malaysia	Thailand	Indonesia	Philippines	Singapore	Vietnam
2003									
ASEAN	17%	13%	8%	29%	22%	11%	19%	31%	15%
ASEAN+China	36%	43%	8%	43%	36%	22%	34%	45%	23%
Japan		10%	14%	10%	15%	25%	14%	6%	15%
Korea	8%		4%	4%	2%	8%	4%	4%	2%

Source: Trade data from Comtrade.

Given the message from Table 4, it should not be a surprise that China's demarche to ASEAN triggered flashing red lights throughout the region, but especially in Japan and Korea. If China and ASEAN were really going to implement free trade with each other on a preferential basis, Japan really had to have a plan for redressing the discrimination that might arise.

Moreover, Japan worried about 'missing the train.' In the 1960s, the UK was forced, in a commercial sense, to join an organisation whose foundations were set without its participation. The lessons from Europe were – get involved at an early stage and stay involved no matter what, and start an alternative.

Japan followed the first option by engaging with ASEAN for an FTA. It also revived discussions of a possible Japan-Korea FTA. As can be seen from Table 4, Korea is a significant destination for Japanese exports. More to the point, China would be only half as interested in ASEAN as it would be in the combined Japan-Korea market. The threat of tariff discrimination against ASEAN and Chinese ACFTA exports arising from a Japan-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 Korea launched FTA talks in 2003; these stalled in 2005.

Japan also followed a second option, forming an alternative arrangement. In Japan's case, this led to an FTA initiative with ASEAN as a whole as well as with individual FTAs with the most economically important ASEANs (Singapore, Malaysia, Thailand, Indonesia, the Philippines and Vietnam). Japan proposed an FTA with ASEAN (or rather a Closer

Economic Partnership, CEP, as Japan prefers to call it) in January 2002 and a Joint Declaration was signed by the parties in November of the same year. The level of commitment on both sides rose through 2003 through a complicated diplomatic dance of declarations, joint study groups and framework agreements; the 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).

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

The dominos continue to fall in East Asia as other trade partners such as the US, the EU, India, Australia and New Zealand seek FTA with ASEANs (in most cases) and China.

4. Lessons: Europe and East Asia

Using the perspective of the feedback mechanism approach to regional sequencing, a handful of clear lessons emerge from our analysis of European and Asian sequences. This section gathers the lessons, starting first with the European sequences.

4.1. Lessons from Europe’s twin sequences

Five lessons can be drawn from Europe’s twin integration sequences.

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 when the political economy benefit of doing so was sufficiently large compared to the perceived sovereignty loss.

The obvious examples here are the varied fate of the EPU, the EPC, the EDC, the ECSC and the EEC. Even inside the EEC, the trade off 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 was concerned, but not when it came to behind the border barriers such as product standards; the Treaty specified majority voting (federalist solution) on the former, but unanimity (intergovernmental solution) on the later.

Figure 8 illustrates the trade off involved in some of the many European initiative. On the vertical axis is displayed 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 everywhere below that of the Intergovernmentalists. 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, the UK went for the small-gains-small-pains option in the 1950s.

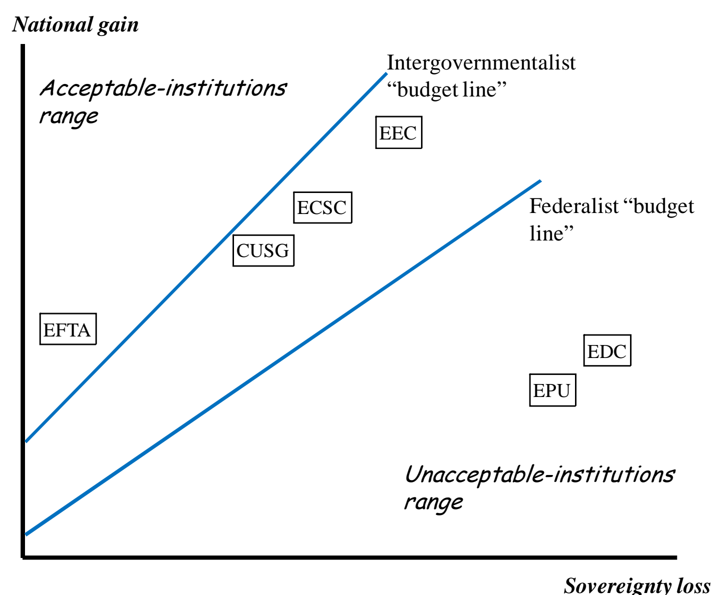

Figure 8: The gain-sovereignty 'budget line'

An important theme of this paper is that various feedback mechanisms – above all the domino effect – have the ability to shift national perception of the benefits of a particular scheme and to push a scheme 'over the line'. Again Britain provides a good example. By 1961, Britain reversed its judgement on EFTA versus EEC 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 later 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.

Lesson #2: Deep economic integration required supranational institutions

The experiments in the 1950s and the spreading of the Single Market via the EEA showed that 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 on which the Member State governments were represented;
- A Commission to act as an agenda-setting executive also charged with surveillance, implementation and enforcement; and
- A supranational Court to adjudicate disputes among Member States, among institutions and between institutions and Member States.

The need for some form of Parliament to represent the peoples of the Member States is clear, but the extent of its powers is 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. EFTAns either had to accept 'hegemonic supra-nationalism', i.e. simply accept new EU Single Market Directives without having any formal voice deciding them, 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 continue with the fiction of sovereignty over single-market matters while in fact they must adopt all new EU Single Market Directives without representation in the relevant decision-making bodies.

Lesson #3: Institutions matter

That institutions matter is very clear from two examples of the European integration sequences.

The integration behaviour of the two sequences (EEC and EFTA) was broadly similar up to 1968 when both achieved the elimination of 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, failed to appear. Due to strong resistance from Member States (or more precisely special interest groups in the Member States that benefitted from idiosyncratic product standards and other BBBs), the EU's attempt at deeper integration was a complete failure. Plans for a 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 the BBB liberalisation side and the monetary side. The Court instigated mutual-recognition principle destroying the deadlock on BBB liberalisation, 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 their differences by setting up the EMS.

In the late 1980s and early 1990s, the EMS hardened into a DM bloc, where most European (including some EFTAns) 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 DM 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 when it wanted to get East Germany into the EU without accession negotiations. For example, if Germany had been a member of EFTA instead of the EEC, other EFTAns would have had very little leverage of Germany when it requested that products from the Eastern Lander be granted duty free access in all EFTA markets. Surely not enough leverage to get Germany to give up its cherished deutschmark and Bundesbank.

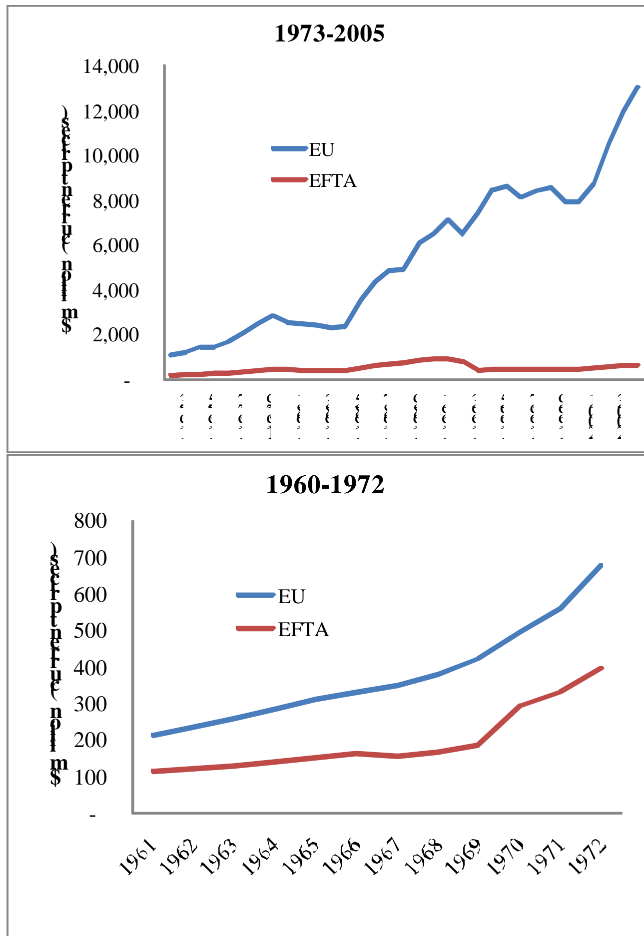

Figure 9: Incomes EEC versus EFTA, 1960-1972, and 1973-2005 (1990 dollars).

Source: IMF online database.

Lesson #4: Size matters

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

The 'gravitational' forces driving the domino effect explain why ongoing integration would raise incentives for EEC members to join EFTA, or EFTA members to join the EEC. The initial conditions, however, made this a very uneven "horse race". Figure 9 shows, the EEC's market started out almost twice as large as the EFTA market and it grew faster. As the EEC enlarged, the domino effects got stronger. Nowadays, the EU market is more than 20 times EFTA's.

In my reading of history, the EU's institutional model came to dominate Europe because it was applied to a larger market. If the EFTAns had started with EU like institutions and the

Six with EFTAn like institutions, it seems unlikely that supranationalism would have won the race.

Lesson #5: Formal monetary integration is extremely difficult

The European experience from the 1970s right up to creation of the Eurozone shows that formal monetary integration is extremely difficult, even in the presence of strong regional institutions. Even with the supranational institutions of the EU, monetary integration was asymmetric until an idiosyncratic shock permitted the ‘grand bargain’ that opened the door to the euro. There are two points here; the first concerns the sovereignty ‘cost’ of such an arrangement and the second concerns the economic benefits of it.

A formally symmetric exchange rate scheme, like the EMS where the nations on both strong and the weak side of a currency fluctuation were expected to intervene, requires supranational institutions. In particular, it requires nations to promise to use their reserves to help correct the consequences of other nation’s imbalances. For a variety of reasons, EU leaders set up the 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* DM 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. While the exchange rate crises of the 1990s suggested that governments would have to choose to harden the links or suffer exchange rate volatility proved exaggerated. As it turned out, make the central bank independent of the government and providing it with 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 sequence

Three lessons can be drawn from East Asia’s regional integration experience.

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 their governments, which had so badly handled affairs between 1914 and 1945. Most governments in Asia find themselves in an almost diametrically opposed situation. They are the authors of the “East Asian Miracle.” Most East Asians today enjoy living standards that are many times higher than that of their parents and prospects for their children look even brighter. The notion that most East Asian voters would support radical changes in the way their 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 initiative by the regional hegemon, or cooperation between two regional hegemons. In East Asia, however, no leader has emerged. The decade long debate over 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 is not negligible in trade terms and it has the enormous advantage of being operational and non-threatening to the larger nations in the region.

Lesson #3: Trade integration creates spontaneous cooperation on exchange rates

As in Europe, the trade/ER-stabilisation feedback mechanism induced East Asian to unilaterally stabilize their exchange rates against baskets of currencies. Given the similarity of their trade patterns, the composition of the baskets was/is similar. In particular, given the dominance of the US market in the export of final goods, the US dollar tends to dominate the baskets. This 'spontaneous cooperation' provided East Asia with a de facto monetary integration scheme; integration in the sense that it had the effect of coordinating East Asian monetary policies much as the EMS coordinated monetary policies in Europe in the 1980s. In Europe, the integration involved rules and institutional agreements de jure, but de facto operated as a DM bloc. Although East Asia has no de jure scheme, it is de facto operating as a dollar bloc and this stabilizes the grid of bilateral exchange rates in the region.

4.2.1. Key differences between the two regional sequences

Initial conditions matter and conditions in Asia today and conditions in postwar Europe are completely different.

- Post-war Europe was in dire straits economically, it faced a unifying external threat in the form of Soviet aggression, and the US was an avid proponent of deep European integration.
- East Asia is doing well economically, faces no common threat and has no superpower pushing it into regionalism.

In short, Europe started its twin integration sequences when the demand for regional institutions was unprecedentedly high and resistance to them was unprecedentedly low. Asia starts when the demand for regional institutions is modest and resistance is high.

Sequencing institutions versus sequencing integration

In Europe, the sequencing of institutions and the sequencing of integration were thoroughly intertwined because they started at the same time. 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 and achieved a high level of trade integration and a good level of exchange rate stability. This high level of economic integration has been achieved with remarkably few regional institutions. As a consequence, Asia has experienced almost none of the institutional feedback mechanism that was so crucial in taking European integration beyond duty-free trade. 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'.

4.2.4 Lessons for Asian institution-building from Europe's history

The first point is that European experience very clearly shows that nations will only accept losses of policy autonomy that are in line with the political economy gains of doing so. 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 institutionalising 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 European experience shows that it also requires supranational institutions.[25] For example, harmonisation of product standards in the Japanese, Korean and Chinese automobile sectors would yield substantial gains from economies of scale. It would, however, almost surely involve a relocation of final auto sales which would render impossible all forms 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.

The third point is that there is little to push East Asia to closer monetary and exchange rate cooperation. Even if an EMS-like arrangement could be agreed, the divergent monetary preferences and economic situations would soon led to an asymmetric operation of the arrangement – just as the supposedly symmetric EMS ended up operating as a DM zone. Such an outcome, however, would not really provide large political economy gains. To take a hypothetical example, if everyone pegs to the renembi and the renembi tracks the dollar, how much economic gain would there be compared to the actual situation where many Asian nations track the dollar?

Here an important and often over looked distinction must be made. When it comes to the trade/ER-stabilisation 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; the political economy pressures in both A and B will be to stabilize their exchange rate with respect to country C. The bilateral A-B rate will also be stabilized, but this is 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 concerns the sequencing of trade integration and monetary integration. European experience (and abundant econometric evidence) shows that there is a two-way relationship between higher trade flows and more stability exchange rates, but the relationship is not symmetric. An increase in bilateral trade has an important, first-order effect on bilateral exchange rate stability (due to domestic political economy forces). Exchange rate stability, on the other hand, has only a modest pro-trade effect, even for stabilisation going all the way to a currency union. In short, stabilising exchange rate may trigger a feedback mechanism that favours future trade integration (stability promotes trade which, a la juggernaut alters government's view of further trade liberalisation), but it is very weak. Trade integration, by contrast, has a strong effect on the incentives for further trade integration and monetary integration (at least of the 'spontaneous cooperation' type).

5. Asian alternatives: The feedback sequencing perspective

When thinking about the way forward on Asian institutions, three points constitute the logical point of departure.

First, as the political economy gains and pains must be commensurate and East Asia has reaped many of the gains without institutions, new Asian institutions must involve very modest political economy pains.

A second conclusion 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

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

Market, or the European Economic Area agreements – would require Asia to pursue one of two paths. The first is to adopt supranational institutions that would allow harmonisation of policies and approximation of national laws, standards, norms and regulations. The first point, however, argues that this is impossible in the today's Asia. The second path is to pursue hegemonic harmonisation of product and regulatory standards. All East Asians could, for example, agree to adopt Japanese, Korean or Chinese standards. This path to is unlikely for political reasons.

Examining these two paths leads to the conclusion that deep economic integration in Asia – namely the systematic removal of behind-the-border barriers – is not in the cards. Such harmonisation and standardisation may, nevertheless, go forward in certain sectors, driven by market-led forces – witness the standardisation of electronic components for example. Great standardisation of auto parts, for example, would not seem impossible.

The final point is that the rapid unilateral liberalisation of East Asian trade has created a gap between policies that nations want to pursue and policies to which they have committed in formal, international agreements. For example, much of the impressive autonomous liberalisation 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 institutionalised? 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 to start with. Even something as ambitious of an Asian EFTA is at the limits of acceptable 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'.

Taken this as given, we are left with the choice of intergovernmental institutions concerning trade and investment flows, or intergovernmental institutional concerning monetary coordination and integration. How does the feedback-sequencing perspective us teach us to think about this choice? As argued above, trade integration unleashes more powerful feedback effects, so trade should be the point of departure.

Next consider which of these is easier. As argued in Section 2, trade cooperation is intrinsically easier since the political economy impact of removing the barriers concerned is much easier to gauge and this makes it much easier to put together a package that is politically acceptable to all parties. Monetary cooperation is much harder, as the European experience in the 1970s and 1980s demonstrates.

With the trade route but easier and more likely to trigger feedback mechanisms that would foster a sequence of deeper integration initiatives, trade seems to be the obvious choice for Asia.

5.2. Institutionalise Asia's 'spontaneous cooperation'

One of the lessons of Europe's experience is that institutions produce feedback effects that favour 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 institutionalise – on a strictly intergovernmental basis – the existing 'spontaneous cooperation' that we already see with respect to trade liberation and, perhaps, exchange rate stabilisation 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 by, for example, managing the massive unilateral and unbound tariff cutting that has gone on since the mid 1980s.[26] 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 harmonising rules of origin. Finally, it could provide non-binding arbitration services for regional trade disputes both state-to-state and 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 federalist could freely discussion their ambitions without Britain 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 bring East Asian technocrats more frequently into contact without interference from nations that are not participating in Factory Asia. In Baldwin (2006a), 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 liberalisation. In time one can hope that this would help nations see the merit of the even firmer discipline that would come with WTO bindings.

6. Concluding remarks

Europe's founding fathers (and they were all men) 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 deeper economic integration. The vast tracts of 'spontaneous cooperation' in Asia constitute one such window of opportunity for East Asian leaders.

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

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