

Sequencing Asian Regionalism: Theory and Lessons from Europe

Richard Baldwin

Graduate Institute, Geneva University

Abstract

Massive intra-Asian economic integration has been accompanied by very little institution building. This paper considers whether Asia needs new institutions by drawing lessons from the EU's supranational integration sequence and EFTA's intergovernmental sequence. Sequencing theory is presented and used to structure historical narrative of Europe's and Asia's sequencing and then used to draw implications of the analysis for future efforts to bring regional institutions to Asia.

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• **Keywords:** Regional Integration Sequencing, Feedback Mechanisms, Juggernaut Effect, Domino Effect

I. 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 what I call 'Factory Asia' – a manufacturing powerhouse that turns out millions of products at world-beating prices. That's the

*Corresponding address: Richard Baldwin; International Economics, Graduate Institute of International Studies, 11a Ave de la Paix, 1202 Geneva, Switzerland. Tel : 41 22 908-5900, Fax : 41 22 733-3049.
E-mail : richard.baldwin@graduateinstitute.ch

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wonder.¹

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 European Free Trade Association (EFTA)'s more traditional intergovernmental sequence. After the introduction, the paper starts with sequencing theory (Section II and III) before turning to the historical narrative of Europe's and Asia's sequencing in Section IV. Section V draws lessons from the integration sequences. Section VI considers the implications of the analysis for future efforts to bring regional institutions to Asia; Section VII presents concluding remarks.

A. 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 a mistake. Balassa's 1961 article never uses the word stages. What many scholars seem to have done is to assume that, since Balassa listed them in order of increasing depth, they were in some ill-defined sense steps on the stairs to higher levels of regional integration. In fact, he was discussing the various alternative models for European integration; he never implied or stated that they were in any sense stages of integration, i.e. a clear ordering of steps.² Empirically, I can think of no regional integration arrangement that followed his 'stages'.

Beyond this misperception of Balassa's early work, there has been remarkable little thinking about exactly how and why one form of integration would lead to another. The earliest and one of the most influential thinkers on sequencing is Ernest Haas (especially Haas 1958). His thinking, which launched the Neofunctionalist School of International Relations, was influenced by his work in the US military intelligence from 1943-1946 and his observation of European elite in the post-war chaos as they worked their way intellectually from trying to re-establish "business as

¹Baldwin (2006a p.1), eventually published in Singapore Economic Review in 2008.

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

usual” in Europe to embracing a truly miraculous level of supranationality.

Haas’ formative observations took place at a time when institutions seemed to be shaping political actors in ways that induced the actors to embrace deeper integration. Haas was not an economist and did not focus on political economy channels of influence; he focused on politics, ideas and meetings of political elite. As a result, the Neofunctionalist School focused mainly on political spillovers to create chains of events whereby regional integration, once started, became a self-powered mechanism. Neofunctionalists posited that national interest groups would transfer allegiance from national to supra-national institutions (without explaining very clearly the political economy of this reorientation) and that technocratic processes would become even 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 survived the elimination of these parallel, but national reflections. As the thinking was reflected in committee discussions, Haas may have formed the opinion that it was the contact among the elite that was shaping their opinions rather than third factors that they all faced in common – for example, Soviet aggression in Central and Eastern Europe, Euro-communism at home, and US pressure.

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 to 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 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 the economic policy reality 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.

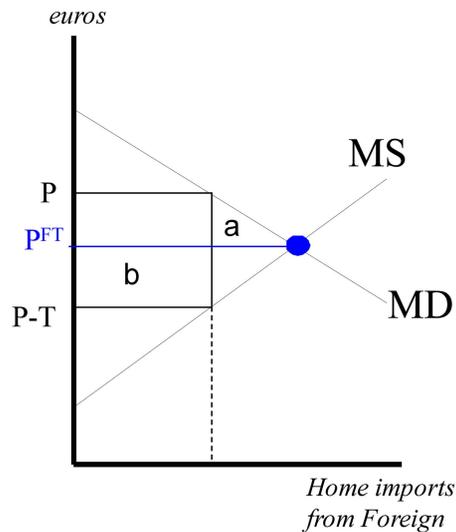
II. Theory: Sequencing and Feedback Mechanisms

Consider whether there can be anything like an optimal sequence of regional integration. 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 inter-temporal 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 the trade in goods. 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.

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

Figure 1. Tariff cooperation.

where both governments only care about the sum of their citizens' welfare, then stage 2 is feasible only if T is large enough to make area 'a' in Figure 1 larger than area 'b' (in this case, the shift to unilateral free trade is politically optimal). In this case, S2 is obviously also feasible, as the two nations are symmetric. Of course if S1 and S2 are feasible, so is S3. However, if the tariff is lower to begin with, area 'a' will be smaller than area 'b', so unilateral 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.

This simple thought experiment shows that optimality cannot be a general proposition. 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, leaving optimality as a subject for future research.

A. Feedback mechanism analysis

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

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

(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 illustrate with historical examples. In 1947, when the GATT entered into force, tariffs were very high, almost as high as they were in the ‘terrible ‘30s’. When tariffs were set in the 1930s they balanced the supply and demand for protection in the political market inside each nation with little or no concern for spillovers. The demanders of protection we focus on are import-competing firms and the workers they employ; the government is also concerned with general welfare, so it is reluctant to grant too high of a tariff protection.

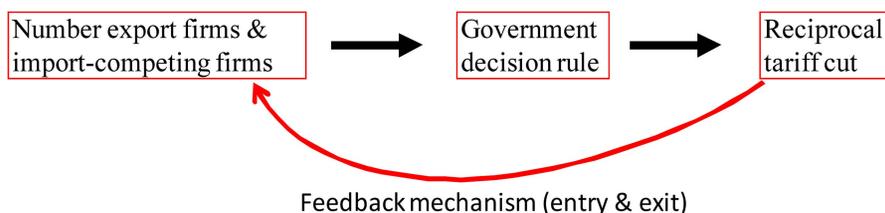
Starting from this situation, the announcement of multilateral trade negotiations (MTN), based on the principle of reciprocity, alters the array of political forces inside each participating nation. Reciprocity is the key. Rather than being bystanders in the tariff debate (as they were prior to MTN), 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 this in all nations in the MTN.⁴

This re-shaping of the political-economy landscape inside each nation makes each government want to cut tariffs below the initial level, but not necessarily to zero. The point is that, even though the tariff initially balanced supply and demand for protection when the exporters were politically inactive, 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).

³The 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 (2007) for a formalisation.

⁴See Baldwin and Robert-Nicoud (2007) for the maths of this.

Figure 2. The juggernaut theory's feedback mechanism.

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.

B. 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 vector describes the number of firms in the import-competing and exporting sectors in nation- i in period t and $t-1$, and $f[\cdot]$ 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 of 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, χ_1 and χ_2 . To keep things

concrete, we assume a simple objective function that ranks 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.

The number of firms is endogenous and related to the tariff; 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:

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

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. The feedback of the period 1 tariff cut on the period 2 decision of the governments is formally captured by the law of motion.

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

This simple example shows a way of thinking about the sequencing of regional integration. The central element is that 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.

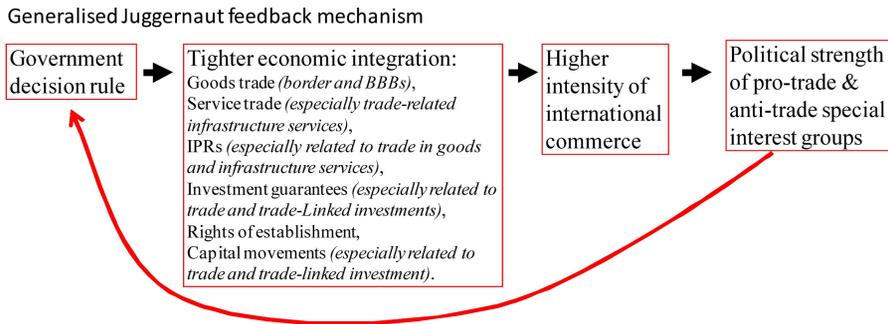
III. Several Notable Feedback Mechanisms

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

A. 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 3 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 maintaining 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 3. The Generalised juggernaut feedback mechanism.

B. Trade/BBB(Behind the Border Barriers) 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, etc. 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 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, spent 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 negotiating/quantifying 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.

C. 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 have become 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.⁵ Moreover tight trade integration often takes the form of intra-firm trade. That is, the home-based firm sells its products to a foreign-based affiliate which in turn makes the foreign sale. Such foreign affiliates naturally have access to foreign banking, and financial services and markets. Since this access can be manipulated

⁵To take an example for today's world of how trade and financial transactions 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 become more severe as the flow and sophistication of transactions increases.

by the company, the firewall between capital and trade transaction can melt away.⁶

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 becomes more tiresome and costly. At the same time cost-competition becomes more intense. In such a situation, exporters and importers begin to press their governments for liberalisation of some capital controls – basically as a pro-business deregulation.

The feedback mechanism here is absolutely clear. Heightened 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.

D. 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.⁷ In this feedback mechanism, it is the choices of other countries in Period 1, that 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

⁶In a classic example of this, trading companies can speculate on a devaluation by leading and lagging payments for imports and exports; or they can get money out of the country by having the foreign subsidiary bill the parent company for intangible headquarter services.

⁷See 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.

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 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. Empirical evidence for the effect is found in Baldwin and Jaimovich (2010).

E. Trade/Exchanges rate stabilisation feedback

The trade/exchange rate mechanism concerns the way that deeper trade relations

alter governments' stance on exchange rate stability. This logic has been discussed by Freiden *et al.* (2005) and in earlier work dating back to the early 1990s. It has also been documented empirically by Devereux and Lane (2003), and Broda and Romalis (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 both care about the exchange rate and are 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 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 (because nominal prices are sticky). In short, exporters like depreciations and this preference intensifies as the exported share of the production rises.⁸ 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 opposite reactions. Keeping the exchange rate stable is one way for the government and/or central bank to avoid this dilemma.

The key to the feedback mechanism is that the magnitude of both the anti-depreciation and the anti-appreciation political voices get stronger as the nation becomes more open to trade. In short, trade liberalisation alters the situation in which a government chooses its exchange rate policy in a manner which systematically makes the government more interested in stability. The more open is an economy, the

⁸This 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.

greater is the political economic pressure to stabilise the exchange rate.

Two corollaries of this logic are both important and obvious. 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. Plainly then, 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 the regional partners. Second, as small nations tend to be more open, the monetary authorities of small nations are more likely to face pressures to stabilise 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 (ER) stability manifested itself in the polar form of a currency union even before the Eurozone.

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 from unilateral pegging to a currency union.

Importantly, 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 by Rose (2000) that showed large effects; see Baldwin *et al.* (2008) for a review of the evidence. Thus liberalising bilateral trade can foster the adoption of policies that stabilise bilateral exchange rates (up to and including a currency union), but stabilising bilateral exchange rates does not, per se, foster bilateral trade liberalisation.

F. Institution feedback

Institutions, once set up, rarely die; they adapt. In particular, if the institutions prove useful to the participating nations, the problems revealed during the operation can result in solutions that involve more institutionalisation.

National governments often agree things that subsequent governments come to regret. When it comes to intergovernmental cooperation, such situations almost always end in one party reneging on its commitments. Knowing that this might

happen, the European Economic Community (EEC) – but not EFTA – established supranational institutions that could induce them to stick to the original deal. This is a feedback mechanism since the Period 1 establishment of supranational institutions 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.

Of course governments and special interest groups are forward looking so really long-lasting, and really important transfers of sovereignty to regional institutions are rare. Indeed, apart from a few examples involving small nations, the EU is probably the only case of this getting started in an irreversible way.

The classic example concerns BBBs. Even as tariff barriers were being phased out, Europeans began to erect new trade barriers, detailed technical regulations and standards that fragmented European markets. While the extensiveness of such barriers was new, the idea was not. Their trade-inhibiting effects were 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 EEC into liberalising BBBs, but 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 EEC members just did not want to cooperate.

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

imposed on domestic products.

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

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

G. Trilemma/Exchange rate-stabilisation feedback mechanism

The final feedback mechanism is more involved, explaining how the removal of capital controls can affect nations' choice of exchange rate regimes. The mechanism is founded on the famous trilemma. This states that a nation cannot attain the following trinity of policy freedoms: freedom to set exchange 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 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. 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 – possibly all the way to a currency union. An extreme example of this mechanism can be seen in Ecuador’s unilateral dollarisation and Argentina’s strict currency board, although of course both of these were unilateral moves, not cooperative moves, and Argentina’s did not end well.

H. The RTB (Race to the Bottom) unilateralism feedback mechanism

The main vehicle for tariff liberalisation among the world’s rich nations was reciprocal trade agreements – both multilateral and regional – in the 1950s, 60s, 70s and 80s. Developing nations did not participate in the GATT tariff-cutting exercise as the GATT’s principle of ‘special and differential’ treatment allowed their exporters to free-ride, gaining better access to rich nations’ markets without having to face down their own import-competing industries. This is why the juggernaut never worked in Asia outside of Japan. Tariff cutting came much later and in a very different way to most emerging markets and developing nations – including most of those in Asia. The vehicle was unilateralism, not regionalism or multilateralism.

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

Developing nations traditionally maintained high industrial tariffs hoping that these would stimulate domestic industrial production via the ‘infant industry’ logic (as it had in North America, Europe, and Japan in the 19th century). With few exceptions, the high tariffs failed to create substantial industry and where it did few progressed beyond the protected-infant stage. However, following the success of the “four-tigers” (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

(Greenaway, Morgan and Wright 2002, Ando and Kimura 2004).

The exogenous shock that disturbed this high-tariff political-economy equilibrium was the ICT revolution. Beginning in the mid-1980s, advances in ICT dramatically reduced the cost of organising complex activities over distances. Deregulation and technology teamed to decimate the price of telecommunications and computing power. New forms of communication appeared and rapidly transformed the workplace. Faxes became standard equipment. Cellular phones caught on and telecommunications networks became denser and more reliable even as they became cheaper. Above all, the internet – first email and then web-based technology – revolutionised the sharing of information over distance. Interacting with cheaper communication costs was due to the spectacular fall in the price of computing power. Things that required a Cray super computer in 1984 could be performed on a high powered PC by the mid 1990s. This encouraged the development and widespread use of information-management software (ranging from excel spread sheets to sophisticated database programmes).

The upshot of the ICT revolution was the rapid development of international supply chains. Cheap and reliable telecommunications combined with information management software and hardware transformed the difficulty of 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 unbundle 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 the off-shored jobs and investment, so locational competition was intense. One element of the competition took place on parts and component tariffs – in particular on the intermediate goods that these offshored factories imported.

The feedback part of this mechanism comes from the manner in which this production unbundling and offshoring shifts the nature of competition in manufactures. If some firms, say Japanese firms, are getting their parts and components from an efficient international supply chain, nations that try to source everything domestically will be at a disadvantage. Thus competition among final good producers pushes them all to unbundle their value-added chains and

source parts from the lowest cost nation suppliers. In short, once nations start the unbundling processes, other nations must follow or lose jobs. The effect in East Asia was to destroy the viability of the dual-track development strategy – production unbundling turned import substitution into a one-way street with only one destination – uncompetitive industry.

I. 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 departs from the same basic political economy mechanism that drives the ‘Trade/ER stabilisation feedback’ mechanism. Namely, central banks typically face pressure to stabilise bilateral exchange rates with their main trade partners. In the case of a sub-set of EU members, this mechanism fostered participations in formal, exchange-rate cooperation such as the European Exchange Rate Mechanism (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 engaged in the EU economy almost as thoroughly as Germany’s. As a result, their central banks face approximately the same pressures to stabilize with respect to EU currencies – especially the deutschemark. This is spontaneous cooperation. They adopt policies that are pro-integration (reducing bilateral exchange rate volatility promotes bilateral trade) but there is no formal agreement, no *quid pro quo*.

In Asia, the primary examples of spontaneous cooperation are unilateral tariff cutting on parts and components and stabilisation of bilateral exchange rates via independent stabilisation *vis-à-vis* the US dollar.

IV. Historical Sequences: East Asia

The European integration history has been told many times and needs not be repeated here (see O’Rourke 2011). When it comes to East Asian integration, it is

useful to distinguish three phases (Baldwin 2006a).

- Phase I, Rampant 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. Mahathir's vision, however, was much broader and rather exclusive.

The US feared that an Asian-only economic bloc might come to involve or even be dominated by communist 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 the Asian Pacific Economic Cooperation (APEC) in 1993 – a new twist on the old strategy of undermining one 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 postponed and replaced by the oxymoron "Open Regionalism."

- Phase III, Rampant Regionalism:

In November 2000, Chinese Premier Zhu Rongji triggered a domino effect by suggesting that China might be interested in an FTA with the ASEANs. This idiosyncratic initiative faced excluded nations with a new situation which in turn strengthened pro-FTA political forces in the excluded nations, especially Japan and Korea. The result was domino effect that continues to operate today.

The November 2000 Chinese initiative came as something of a surprise to the ASEANs, but it was generally well received. It was immediately clear to most ASEAN leaders that preferential access to the large and fast growth Chinese market would be an enormous boost to the attractiveness of their own economies as places to locate Factory Asia jobs, although they of course 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, however, set off alarm bells all around Asia, but especially in Japan and Korea as the combined ASEAN-China market accounted for a large and fast growing fraction of their exports. 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.

Japan followed the first option by engaging with ASEAN for an FTA. It also revived discussions for a possible Japan-Korea FTA. 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 exports arising from a Japan-Korea FTA would substantially counterbalance the possibility of the ASEAN-FTA (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 and seem to have been revived in reaction to advances of the Trans-Pacific Partnership.

Japan also followed the second option, that of forming an alternative arrangement. In Japan's case, this road led them to seek an FTA with ASEAN as a whole as well as with individual FTAs with the most economically important ASEANs (Singapore, Malaysia, Thailand, Indonesia, the Philippines and 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 ASEAN-Japan FTA talks actually began in 2005. In parallel with, but slightly preceding these, 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.

V. 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 Asia's

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

- Lesson #1: Supra-nationalism is out of the question in Asia.

European nations agreed to historic sacrifices of national sovereignty in a highly unusual setting – a time when large segments of European voters distrusted their governments which had so badly handled affairs in the 1914-1945 period and its aftermath. Most governments in Asia find themselves in an almost diametrically opposed situation. While there have been tough times like the 1997 crisis, these governments are the authors of the “East Asian Miracle.” Most East Asians today enjoy living standards that are many times higher than those 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 initiatives of 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. Since 2010, however, the US has started to emerge as a potential leader with its Trans-Pacific Partnership. While at the time of writing, it involved only the US and 8 fairly small nations (four of which already have FTAs with the US), if Japan joins, the dominos may start to fall, eventually bringing in Canada, Mexico, and all the remaining ASEANs.

- Lesson #3: Spontaneous cooperation on exchange rates.

As in Europe, the trade/ER-stabilisation feedback mechanism induced East Asia to unilaterally stabilise 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 European Monetary System 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 stabilises the grid of bilateral exchange rates in the region.

There are two important caveats. The first one is that initial conditions matter. Conditions in Asia today and conditions in postwar Europe are about as different as can be imagined.

Europe started from a tangle of bilateral trade restrictions that was crippling intra-European trade, so gains from cooperation were great. Economic integration was desperately needed, yet the initial conditions and forms of the barriers meant that it could not be achieved by unilateral actions. Western Europe also faced pervasive external pressures encouraging, indeed requiring, Europe to set up institutional arrangements and economic integration schemes. The US with its Marshall Fund was willing to spend a great deal of money in facilitating the process – mostly driven by concern about spreading communism and Soviet behaviour in Eastern and Central Europe – concerns that were shared widely among Western Europeans at the time.

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

A second caveat is that Europe started with a political atmosphere where the citizens of many nations were in the mood for radical change. As a reaction to the dismal wartime performance of status quo governance systems, one large fraction of citizens and pressure groups wanted to embrace communism, another large fraction was willing to contemplate a pooling of sovereignty. The 'Soviet menace', as it was known at the time, ensured that the latter group's desires prevailed. Asian governments, by contrast, have performed economic miracles for the past decades. No large fraction of citizens or pressure groups wants radical changes in the allocation of sovereignty between the nation-state and regional institutions.

In short, Europe started its 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.

The third caveat addresses the issue of 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

Organisation for European Economic Cooperation 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 was 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.

On the trade side, the trigger was the technological changes that allowed the ‘second unbundling’ and development of Factory Asia (Baldwin 2006a). These changes created a political economy environment where ‘race-to-the-bottom unilateralism’ was politically optimal, at least for parts and components (Baldwin 2006a, c). Preferential trade liberalisation in the region took off when the announcement of a China-ASEAN FTA triggered a domino effect (Baldwin 2006a). For both reasons, but especially the ‘spontaneous cooperation’ embodied in the race-to-the-bottom unilateralism, intra-Asian trade shares rose rapidly bringing their export patterns even closer into line than they were to start with.

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 greater stability of 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 rates may trigger a feedback mechanism that favours future trade integration (stability promotes trade which, a la juggernaut alters a 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).

VI. What to do? The Feedback Sequencing Perspective

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

The European experience very clearly shows that nations will only accept losses of policy autonomy that are in line with the economic and political economy gains of doing so. Turning around the old exercise dictum, the lessons of Europe tell us: ‘No gain, no pain.’ Applying this 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 moving goods market integration significantly beyond its current state – for example creating an “Asian Single Market” along the lines of the EU’s Single Market, or the European Economic Area agreements – would require Asia to pursue one of two paths. The first is to adopt supranational institutions that would allow harmonisation of policies and approximation of national laws, standards, norms and regulations. As noted above, this is impossible in today’s Asia. The second 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 too is Quixotic to say the least. This leads us to the conclusion that deep economic integration in Asia – namely the systematic removal and behind the border measures – is not 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. This implication, however, could easily be reversed if the US-led Trans-Pacific Partnership started a domino effect that essentially led to hegemonic harmonisation to US standards.

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 that they have committed themselves to 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.

A. The way forward

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 liberalization 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 (i.e. the Asia-wide network of supply chains) by, for example, managing the massive unilateral and unbound tariff cutting that has gone on since the mid 1980s.⁹ 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 the tariff classifications beyond the HS 6 digit level. Finally, it could provide non-binding arbitration services for regional trade disputes, either state to state, or firm to state as well.

The old Haasian notion of functionalism, where institutional cooperation fosters greater institutional cooperation by altering the attitudes of the regional policy elites, is probably far too weak to explain Europe’s integration sequences, but it does seem to have had some effect. For example, the ECSC institutions, especially the Assembly, provided a venue where federalists could freely discuss their ambitions without 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 bringing Asian technocrats more frequently into contact with each other in the discussion of common problems that arise in the functioning of 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.

⁹This can be thought of as an extension of the ideas presented in my 2006 “Managing the Noodle Bowl” paper; Baldwin (2006a).

VII. Concluding remarks

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

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