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REGIONAL ECONOMIC INTEGRATION IN A GLOBAL FRAMEWORK

G-20 WORKSHOP
22-23 SEPTEMBER 2004

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Published by:
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ISBN 92-9181-657-4 (print)
ISBN 92-9181-658-2 (online)

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Foreword

It is widely recognized that the world economy has experienced an unprecedented intensification of economic and financial integration since the latter part of the twentieth century. Developments such as trade and capital account liberalization, as well as technological innovation in transport and telecommunications, have increased the international exchange of factors of production and final products. What is less often recognized is that the process of 'globalisation' has been accompanied by the strengthening of economic and financial linkages within geographic regions. Indeed the world economy is simultaneously becoming more 'regionalized' and more 'globalized'. The trend towards regional integration has been supported in many areas by regional policy initiatives, particularly in the field of trade. The result is a proliferation of regional agreements that vary widely in breadth and depth.

Reflecting the diversity of economies and their histories, regional integration follows markedly different patterns across the world. Europe has a long history of regional integration, underpinned by a strong institutional framework. North America has chosen a free trade area arrangement that does not foresee the creation of supranational institutions. In Latin America, Mercosur's initial objectives of a common market and co-ordinated economic policies have suffered setbacks caused by financial turbulence in the region in the late 1990s, and the grouping is yet to recover momentum. In East Asia, trade integration has progressed at a rapid pace based on the exploitation intra-regional comparative advantages. Only since the 1997-98 Asian crisis has this market-led process been accompanied by closer inter-governmental coordination, which however, is embracing monetary and financial spheres as well as trade.

In order to discuss developments in regional integration and the diversity of experiences around the globe, a G-20 workshop, organised jointly by the People's Bank of China and the European Central Bank, was held in Beijing in September 2004. The G-20 was an ideal forum for this topic, since it comprises a wide variety of member economies in terms of integration into a regional bloc and level of development. The workshop brought together experts from a wide range of institutions from member countries, including academia, finance ministries, and central banks. The views expressed by participants, the main ideas emerging from the workshop and the key papers that were delivered by leading academics are presented in this volume.

The workshop facilitated an ample discussion of regionalisation and its institutional, economic, financial and monetary dimensions. These facets prompted a number of pertinent questions, e.g. are there necessary preconditions for institutional integration? is there an optimal sequencing of integration?, how can the process best be supported by political initiatives? does economic integration necessarily lead to financial and monetary integration? what is the interaction between economic and institutional integration? and do regional initiatives assist or undermine global integration? Such issues were debated by the representatives of the group of 20 advanced and emerging market economies that comprise the G-20. The key points are collected in the first chapter of this volume. Notwithstanding the range of views aired, participants were in agreement over the relationship between regionalisation and globalisation: whether as a consequence of globalisation, or as a response to the shortcomings in the pace of globalisation, it remains imperative that policy efforts to foster regional integration should be complementary – not harmful – to the process of global integration, since the same principles of openness and non-discrimination should be complied with at both levels to reap the gains from economic integration.

We are pleased to offer this volume as a contribution to the current debate on regionalisation. We would like to thank all participants in the workshop, and especially the authors of the papers in this volume, for their insightful contributions. It is our hope that the reader finds this collection of views on regionalisation in a global framework from such a broad and diverse forum as the G-20 both stimulating and useful in the development of their ideas.

YI Gang
People's Bank of China

Tommaso Padoa-Schioppa
European Central Bank

The G-20 Workshop on regional economic integration in a global framework

Beijing, 22-23 September 2004

Introduction

The Group of Twenty (G-20) is an informal forum, set up in 1999, with a mandate to discuss current international economic, financial and monetary issues that influence the international monetary and financial system. It serves as a platform for discussion among countries at different stages of economic development to facilitate consensus-building on international economic developments and on the action to take. As such, the G-20 brings together representatives of two-thirds of the world's population and of economies that generate over 90% of world GDP and approximately 80% of world trade. Members of the G-20 include, primarily, the finance ministers and central bank representatives of the G-7 economies as well as a group of emerging market economies.[1] Representatives of the IMF and the World Bank also attend meetings and workshops organized under the aegis of the G-20 to facilitate interaction between the informal G-20 process and the formal decision-making procedures of the Bretton Woods institutions. Since 2002, the G-20 presidency has rotated annually between developed and emerging market economies. The Group's work agenda is coordinated by a troika comprising the delegations holding the previous, current and future presidencies of the Group (Germany, China and Australia, respectively, for 2005).

As part of the 2004 work programme agreed with the G-20 German Presidency, the European Central Bank (ECB) and the People's Bank of China (PBC) co-organised the G-20 Workshop on regional economic integration in a global framework that took place in Beijing on 22-23 September 2004. The workshop provided a review of recent developments in regional integration as part of the ongoing process of globalisation and confirmed the policy relevance of this topic for the G-20. The main areas of potential consensus were identified and synthesised in the Communiqué published after the meeting of finance ministers and central bank governors in November 2004 in Berlin. In the document, the ministers and governors i) agreed that regional cooperation and integration constitute important steps for national economies in opening up to global trade and financial flows and in achieving gradual improvements in competitiveness; ii) emphasised that regional arrangements should be designed with due regard to multilateral objectives; iii) highlighted the formation of regional integrated financial markets for bonds and financial services, while acknowledging that trade had historically been the initial step of regional integration; iv) agreed that the reduction of barriers to foreign direct investment in the financial sector, within the necessary regulatory framework, can, if appropriately sequenced, enhance the efficiency and stability of national financial systems; and v) recognised that the G-20 countries, as

[1] The G-20 comprises Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union, and, as observers, the International Monetary Fund and the World Bank.

systemically important economies, have a special responsibility in their regions. Finally, they also undertook to play a leading role in advancing regional and global integration.

The next section is an informal record of the proceedings of the workshop, including the main debates and contributions. It follows the programme of the workshop, i.e. there is a summary of the five presentations by academics, the main arguments advanced by the two discussants in each session, and the exchanges of views that took place.

Summary of proceedings

General Overview

Here the main findings of the G-20 Workshop on regional economic integration in a global framework held in Beijing on 22-23 September 2004 are summarised. Subsequently, for each session of the workshop, the main arguments put forward first by the academics and then by the G-20 representatives are presented.

Regional integration in East Asia is well advanced and unique in character. The process of trade and financial (mainly FDI) regional integration has developed significantly since the early 1990s, as shown by standard indicators of economic interdependence, the levels of which are comparable to those recorded in Europe. Given that economic integration has not been accompanied – and even less, driven – by a commensurate institution building process to facilitate regional cooperation, the Asian experience was seen as mainly market-led. Another specific feature of East Asia's economic integration has been the predominance of intra-industry, rather than inter-industry, cross-border trade flows. This reflects the development of vertical production sharing networks within the region, as large corporates have been exploiting significant disparities in economic development and comparative advantages across countries in East Asia.

While East Asia and Europe differ with respect to the role played by regional institutions in supporting economic integration, political awareness of the need for stronger regional cooperation has been heightened in the aftermath of the 1997-98 Asian crisis. A number of initiatives in the trade (e.g. free trade arrangements) and financial (e.g. the Chiang Mai initiative) areas have been launched as a result. This strengthened regional institutional framework remains of an intergovernmental and "soft law" nature. However, the need for closer regional macroeconomic surveillance in the face of common shocks and synchronised business cycles, as well as the objective of removing non-tariff barriers to cross-border trade and financial flows, may well call for more robust institutional arrangements in the period ahead.

Experiences in Europe alone illustrate how regional integration may take very different forms, both in terms of depth (i.e. Balassa's five stages of regional integration[2]) and breadth (i.e. the number of countries concerned). There exists, for example, the euro area, the European Union and the European Free Trade Association/European Economic

[2] The five stages are free trade area, customs union, common market, economic and monetary union and full political union.

Area. A major factor behind progress in regional interdependence is sustained political will. At the same time, sufficiently robust institutional arrangements have been instrumental in supporting political objectives and locking in progress in regional integration. Which integration model is the most appropriate depends on the political objectives pursued by the countries concerned and the related institutional mechanisms that countries are able to put in place to attain them.

The increased reliance in the recent past on market-led, rather than institution-led, processes of regional integration is partly explained by progress in economic liberalisation and the widespread adoption of market-oriented policy frameworks (see Session I). As regards trade, the ongoing process of global integration under the auspices of the World Trade Organization (WTO) may have become too protracted and complex. Regional arrangements are used more frequently than in the past to foster integration at a faster pace and in areas (e.g. financial services) of particular relevance for the countries concerned. Whatever the respective merits of regional and global trade integration, regional arrangements can, under certain conditions, enhance economic efficiency by reducing protectionist practices among participating countries (Session V).

Transnational institution building needs to be distinguished from political momentum towards regional integration (Session III). Close political cooperation is not always a precondition for fostering regional institution building and economic integration. Irrespective of the strength of political commitment and "hard rules", well-designed transnational institutions can facilitate information exchanges, monitor existing agreements, adjudicate conflicts and create room for cross-area bargaining among the countries concerned, as the scope of arrangements increases. As such, regional institution building is likely to interact positively with economic integration.

The experience under the North American Free Trade Agreement (NAFTA) – which has a lower degree of formal institutional cooperation than the EU – raises questions about the dynamics of the mutually reinforcing effect of institutional cooperation and economic interdependence. The arrangement has been beneficial to Mexico, among others, through the adoption of a strengthened policy framework in the 1990s that has complemented the ability of the authorities to lock in major domestic economic reforms. Increased cross-border trade flows have contributed to a greater synchronisation of Mexico's business cycles with those of the United States and Canada. In the financial sector, the significant share of the Mexican banking system owned by US banks has contributed to closer financial linkages. As trade, economic and financial interdependencies have intensified, the need to strengthen cooperative institutional arrangements might also arise at some point in the future. To this extent, the issue of consistency between regional and global rules and institutions arises. In order to ensure that regional financial arrangements (e.g. the Chiang Mai initiative) are compatible with existing rules at the global level, the International Monetary Fund (IMF) could consider adopting a provision equivalent to Article XXIV of the General Agreement on Tariffs and Trade (GATT). This would go beyond the steps already taken by the IMF to conduct Article IV surveillance at the regional level (e.g. the euro area, East Caribbean Currency Union and African monetary unions).

In terms of regional financial cooperation, East Asia has made significant strides since the 1997-98 crisis. This progress reflects heightened awareness of regional interdependence and is widely regarded as a concrete step in fostering regional integration (Session IV). While stressing that the Chiang Mai initiative, the Asian Bond Fund (ABF) and the Asian Bond Market Initiative (ABMI) are very positive responses to the 1997-98 crisis, the authorities in East Asia have acknowledged that these are only the first steps towards enhanced regional cooperation. As regards mutual financial assistance in the context of Chiang Mai swap arrangements, the European experience has shown that regional monitoring and surveillance, as well as conditionality when needed, are more important than liquidity support. With respect to domestic bond market development in East Asia, the lack of market liquidity and relative stability of the region's currencies against the US dollar have limited the attractiveness of its bond markets as a diversification opportunity.

Regarding closer regional exchange rate cooperation, the incentives for East Asia are not so clear-cut. Differences in GDP per capita, which are much greater than in the euro area, were seen as a strong argument against a stabilisation of nominal exchange rates within the region, since this would significantly complicate real exchange rate adjustments required in countries engaged in economic catching up. At the same time, it was argued that excessive volatility of nominal exchange rates is detrimental to trade and financial regional integration. This notion helps explain the efforts made by East Asian countries to stabilise their currencies against one another. However, it may give rise to competing policy objectives, namely the desire to foster external trade by means of stable intra-regional currencies and the desire to develop domestic and regional financial systems, which may be impeded by the lack of diversification opportunities arising from regional currencies that barely move against the US dollar or among themselves.

Regional free trade areas (FTAs) have become so prevalent that they cannot be ignored. They offer advantages in terms of scope and flexibility compared with global trade agreements negotiated in the context of WTO multilateral rounds (Session II). They are, for example, more easily negotiated owing to the fewer parties involved, and hence offer a way forward when multilateral negotiations have stalled. At the same time, they need to be compliant with certain minimal conditions in order to be welfare enhancing, not only for the countries concerned but also at the global level. One specific risk to be addressed is the so-called "spaghetti bowl" effect of multiple regional FTAs, which refers to complex webs of preferences that are subject to different rules of origin. There is a need to ensure the compatibility of regional arrangements with basic rules set at the global level. The WTO principles of "most favoured nation", non-discriminatory practices and open nature of negotiation processes should be applied to ensure global welfare. Further work on simplification and standardisation of rules of origin is needed to enhance the compatibility of both regional and global processes of trade liberalisation. Since trade in financial services is becoming a major area of negotiation in a number of regional FTAs, G-20 finance ministers should be more involved in this matter. As regards East Asia, a two-country (China and Japan) hub-and-spokes scheme was considered to be a potentially sub-optimal outcome for the region, even if this remains a moot point at this stage.

A review of regional integration processes unfolding under different arrangements confirmed that there is no single template for regional cooperation (Session VI). While the workshop reviewed a number of regional arrangements, discussion focused on NAFTA, the European Union (EU), Mercado del Sur (MERCOSUR), the Confederation of Independent States (CIS), the Southern African Development Community (SADC), the Gulf Cooperation Council (GCC) and the Association of South-East Asian Nations (ASEAN). Ten years after its inception, NAFTA has generated positive effects in terms of significantly increased cross-border trade and financial flows and less macroeconomic volatility (domestic output and consumption). Despite greater synchronisation of business cycles among the three member countries, closer monetary cooperation is not deemed necessary and existing exchange rate flexibility is seen as fully appropriate. By contrast, the cohesion of MERCOSUR has been severely strained by diverging economic policies and performances among its member countries. A series of conditions have to be met if renewed progress towards regional cooperation is to be made. These include i) more balanced domestic macroeconomic conditions; ii) flexible exchange rates combined with stability-oriented monetary policies that should contribute to lower exchange rate volatility within the region; and iii) openness to trade outside the region (e.g. an FTA between MERCOSUR and the European Union) as a complement to regional trade integration. Developments in the CIS, SADC, GCC and ASEAN were briefly discussed and did not give rise to extensive exchanges of views.

Keynote speech

Presented by Mr Tommaso Padoa-Schioppa.

Mr Padoa-Schioppa presented the view that regional integration, as evidenced by the experiences around the globe, has been instrumental in promoting growth, stability and peaceful relations between countries. He noted that the starting point and driving force for regionalisation was the rapid increase in economic and financial activity across borders since, within this process, economic activity tended to evolve in regional clusters. At the same time, he hypothesised that the initial motivation for regional integration was usually a major catalytic event fostered by the shortcomings of independent national action in effectively managing economic and financial developments. In pointing out the very different experiences across the world that reflect regional characteristics, and the momentum developed as a result of dynamic linkages among trade, exchange rates, financial markets, institutions and policies, he called for the adherence of regional initiatives to the process of strengthening global arrangements.

Session I: Preconditions for regional integration arrangements

Presented by Professor Eisuke Sakakibara.

Professor Sakakibara's presentation drew on a review of the early stages of regional integration in Europe and East Asia to identify the drivers for integration in both regions. While the forces behind the processes of regional integration in Europe and East Asia were initially very similar, i.e. they were political in nature, ex post the implementation and outcomes of the process have differed in several ways. As highlighted by Professor Sakakibara, the EU model of integration corresponds more to the policy-driven model of regional integration: institutions and governments have ended up guiding the process, as the number of regional institutions and regional agreements shows.

The East Asian model, in contrast, better fits the market-driven integration process scheme. The market and corporations-driven process in East Asia has been encouraged by the development of both regional and global cross-border production networks. Intra-industry trade in parts and components and foreign direct investment – conducted by corporations and encouraged by significant liberalisation – have been and continue to be the key driving forces of the established production-sharing scheme, of the evolution of these cross-border networks and of the fostering of regional cooperation and integration.

China plays a major role in the region's production-sharing scheme as the specialist in assembly trade. Since it is a major importer of parts and components from its neighbours, China is a key driver of the current ongoing production-sharing network and of East Asia's regional integration process. In ten years' time, Professor Sakakibara expects China to be as important to the East Asian networks as Japan is at present, albeit in a different capacity (as the major recipient rather than originator of regional investment). It should be added that the regional process is not seen as undermining global economic linkages, given that economic relations with the United States and the European Union have strengthened over the last few years.

While East Asia and Europe differ with respect to the role played by regional institutions in supporting economic integration, political awareness of the need for stronger regional cooperation has been heightened in the aftermath of the 1997-98 Asian crisis. Compared with Europe, Asia remains a newcomer in the cooperation arrangements trend. Regional trade cooperation arrangements are in fact a relatively recent and limited phenomenon, as East Asian economies have been involved in only 16 out of a total of 160 arrangements (bilateral, regional and inter-regional), most of which were introduced between 1980 and 2003. However, progress is being made, and a number of recent regional cooperation initiatives in East Asia have been launched by regional groups. This is the case in ASEAN, the Asia-Pacific Economic Cooperation (APEC), the Asia-Europe Meeting (ASEM) and the Bangkok Agreement, among others.

Even if the institutional process is lagging in East Asia, in a market-driven integration process, cooperation among national governments and their informal policy initiatives are still considered important. So far, the lack of an institutionalised framework in Asia has been "substituted" by a non-institutional framework that is mostly of an intergovernmental and "soft law" nature, which has given rise to a decision-making process that operates under an ASEAN-style consensus. Interestingly, within the context of this "soft" intra-regional cooperation, several concrete bilateral initiatives have emerged. Moreover, in the process of strengthening the current framework, unilateral initiatives to promote trade relations have been launched, such as the easing of trade barriers. Other factors that have facilitated the operation of a regional production network in East Asia include stable economic and political environments, access to a skilled labour force and good infrastructure. Moreover, the development of a non-negligible middle class in the region is encouraging the deepening of domestic markets for both intermediate and final products.

Discussants: Mr Giorgio Gomel and Mr Joong-Kyung Choi.

Mr Gomel reviewed stylised facts about trade in East Asia and pointed to the growing dynamism of intra-industry and intra-regional trade and the importance of China in this process. The market-driven development of intra-regional trade has fostered a debate over the need to strengthen the integration process through preferential trade agreements and other policy interventions. Indeed, even if East Asian supranational institutions are not yet developed, national governments have started to play a greater role in the process. Mr Gomel argued that a purely market-based integration process led by multinational firms and confined to assembly trade leaves aside the benefits of genuine integration in terms of reduction of transaction costs in a wide range of sectors. As long as the full benefits of market integration are not exploited, including spillovers to other fields, the pursuit of a more multilateral approach can provide greater benefits for East Asia. However, given the time and the effort needed for large multilateral negotiations and the opportunity offered by China's recent WTO accession, Mr Gomel advocated that the best strategy would be some form of nuanced multilateralism, through a more comprehensive regionalism that might include, along with ASEAN partners, China, Korea and Japan. The need for coordination to cope with common shocks, reap spillover gains and take account of more synchronised business cycles will probably encourage a gradual and explicit institutionalisation of integration. According to Mr Gomel, therefore, an institutional framework, albeit perhaps without the creation of supranational entities such as in Europe, will endogenously emerge in the region to consolidate the achievements of the current informal process of integration.

Mr Choi divided his intervention to cover three major aspects of integration. First, he discussed the benefits and costs of regional integration. As regards benefits, he highlighted the efficient allocation of national resources, savings in terms of transaction costs, and elimination of foreign exchange variability, and the reduction of risks associated with the integration process. Among the costs, Mr Choi cited the intensification of competition and attendant winner-takes-all outcome, the existence of significant constraints to monetary policy independence and the loss of seigniorage (the latter applying only if a single currency is adopted). Second, Mr Choi examined the preconditions for regional economic integration in ASEAN + 3, putting the emphasis on the long-term perspective and forward looking criteria, the importance of political momentum, and the need to take due account of the implementation requirements involved. Finally, Mr Choi referred to the motivations for regional integration among the ASEAN + 3 economies. In his opinion, the rationales are to be found in increased intra-regional trade (accounting for 22% of the region's external trade in 1985 and 45% in

1999), deepened inter-dependencies in monetary policy and increased intra-regional capital flows, and in the need for crisis prevention and crisis resolution mechanisms. The Asian Bond Market Initiative was designed, among other reasons, to address the difficulty in channelling Korean savings to domestic investment. It is paradoxical that investment opportunities in Korea, for example, tend to be financed by international investors (who earn a premium on account of the risk involved), while Korea's large savings are invested abroad (often in low-yielding instruments).

General Discussion

The following main points and remarks were made:

i) NAFTA and the European Union were mentioned as examples of processes characterised by different patterns of economic integration. Unlike the case of the European Union, free financial flows between Canada and the United States preceded free trade and NAFTA's lightly institutionalised integration. ASEAN provides yet another model, insofar as its integration has mainly been market-driven.

ii) Since transaction costs can accrue in the presence of vertically-integrated cross-country production schemes, there may be gains from harmonising laws and regulations and enhancing transparency measures on the regional and global levels.

iii) To complement macro-level regional institutions that are concerned, inter alia, with intra-industry trade and exchange rate stability, there is a need to develop micro-level institutions that focus on corporate governance issues, standards, and other market micro-structures.

iv) Economic development disparities are an important driver of vertical intra-industry trade.

v) Important to the regionalisation process are institutions for mediation and arbitration in cases of conflicting national interests (such as the European Court of Justice) and as a mechanism to provide compensation to parties that benefit less from economic integration (such as the Structural and Cohesion Funds of the European Union).

Session II: Processes of regional integration: a desirable sequencing or a "menu approach"?

Presented by Professor André Sapir.

Professor Sapir started his presentation by underlining that integration is a gradual, virtually open-ended process of eliminating discriminatory policies and other obstacles to trade among partners, which is facilitated by clearly defined objectives. There are five main considerations to ensure the success of a process of integration: i) put in place clear and shared objectives; ii) proceed step by step, with the right initial step; iii) define clear and feasible deliverables; iv) be mindful of derogations granted to members as they are not free from costs; and v) have a framework that allows parties to cope with shocks.

An orderly integration process requires the implementation of a set of sequential steps. The first step is to choose the level of integration to be pursued, with clear ultimate objectives and a well-defined starting point. This step implies choosing from among the five different degrees of integration (see Balassa) ranging from a free trade area – the least ambitious objective – to full integration – the arrangement that imposes the most stringent requirements on members. The second step of integration requires the selection of the partners to be part of the arrangements, based, among other criteria, on their size and degree of heterogeneity. The third step consists of selecting the degree of convergence of the process. In the European Community (EC) experience, trade integration moved along with social cohesion (i.e. EU Structural and Cohesion Funds), whereas monetary integration moved alongside nominal economic convergence. More generally, though, it is not clear whether convergence is a precondition for integration or rather, at least partly, a consequence of the process of integration itself. Ultimately, parties need to define the degree of flexibility characterising the process. The options available include integration "à la carte", multi-speed models, core/periphery models and full flexibility. The EC experience draws on the multi-speed framework, under which successive enlargements have been accommodated, and on the flexible setup, as reflected in open partnerships.

In relation to the first step (i.e. the definition of the objectives to be pursued), Professor Sapir stressed that the choice between a free trade area arrangement and a customs union arrangement represents the key decision parties need to make. This is because this fundamental choice works as a de facto test of political will, on account of the loss of sovereignty implied and the implementation difficulties. In practice, free trade areas prevail in the world economy, while there are very few partial customs unions – not to mention fully-fledged ones. Moreover, Professor Sapir argued in favour of the sound implementation of an FTA and of then moving towards an FTA+ (one which eliminates barriers but does not consider the creation of common policies and common institutions), rather than being more ambitious and proceeding with a poorly implemented customs union arrangement.

Professor Sapir also referred to the conditions necessary for the outcome of integration to be resource-efficient. They relate to the type of products and degree of liberalisation covered under the integration process: i) a broad product coverage; ii) a high degree of internal liberalisation; and iii) a low degree of external protection. These provisions are enshrined in Article XXIV of the GATT regarding regional trade arrangements.

To illustrate his assessment, Professor Sapir used the European integration model, first defined in terms of a successful customs union that deepened, enlarged and diversified over time, until it converged first towards a common single market and then towards today's Economic and Monetary Union. The pillars of the European customs union were i) the elimination of barriers to trade; ii) the creation of common policies, differentiating between allocative policies (such as single market, competition and industrial policies), redistributive policies (related to the agricultural and regional chapters) and macroeconomic stabilisation policies (monetary and fiscal policies); and iii) the creation of common institutions (namely the Council as a legislative body, the Commission as an executive body, the Parliament as a co-legislative body and the Court of Justice as the judicial body). These three pillars were implemented progressively in line with achieving incremental stages of integration. For instance, under the customs union phase, the removal of barriers covered the elimination of tariffs and quotas on goods.

Discussants: Mr Michael Patra and Mr Nick Bridge.

Mr Patra deemed that a regional approach to trade liberalisation is a response to a perceived failure of the multilateral process of trade negotiations and that the recent rise in regional FTAs does not reflect a political momentum towards closer regional cooperation. Moreover, Mr Patra noted that evidence suggests that the greatest benefits of the ASEAN + 3 arrangements are generated by trade with the "+ 3" members rather than by intra-ASEAN trade[3]. Finally, Mr Patra mentioned the inescapable choice between rules and discretion and the need to set the goals first, while acknowledging that countries participating in a regional arrangement have different needs and preferences. It is for this reason that political convergence in Asia is not considered to be a credible option at this stage.

Mr Bridge highlighted the benefits of the single market to the United Kingdom. While the United Kingdom has converged in nominal and real terms since 1999, differences remain, as exemplified by institutional features of the housing market and non-compliance with the five tests designed by HM Treasury. The endogenous character of the integration process helps explain that even if ex ante disparities are substantial, over time these differences diminish and business cycles tend to become more synchronised. Financial liberalisation plays a major role in this convergence process. However, Mr Bridge emphasised the need to liberalise capital flows in a gradual fashion in the presence of underdeveloped or weak domestic financial systems.

General Discussion

The discussion started with the observation that there are alternatives to political union to remove barriers and foster trade. These include informal arrangements such as those operating under the European Free Trade Association (EFTA), agreements on specific areas such as investment, or the Generalised System of Preferences (GSP) mechanism. It was also mentioned that, as part of Japan's policy of strengthened cooperation, Japanese authorities have engaged in negotiations with Singapore and Mexico, which may result in free trade arrangements with a limited degree of institutional formalisation.

There were differences of opinion on the likelihood of a successful conclusion to ongoing multilateral trade negotiations and on the notion that regionalism should be seen, primarily, as a way forward in the face of protracted multilateral trade negotiations. The need for international institutions to adjust to recent developments and, in particular, to focus more on regional surveillance was recognised. Similarly, support was voiced for the need to give the multilateral system greater flexibility, while complying with the WTO basic economic principles of non-discrimination and openness.

[3] ASEAN + 3 economies comprise the ten members of ASEAN (Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) as well as the "+3", namely China, Japan and South Korea.

It was also noted that markets now play a much greater role than at the beginning of the EU integration process, which means that the sequencing of integration is less controllable than in an institution-driven environment. Moreover, liberalisation and regionalism are different concepts and these processes are not free from costs (in terms of increased complexity, for instance), evident especially in the area of services. Liberalisation of goods was deemed comparatively easier.

Session III: Interaction between actual economic integration and institutional integration at the regional level

Presented by Professor Randall Henning.

Professor Henning's presentation addressed the interaction between actual economic integration and institutional integration processes. The discussion revolved around the direction of causation between integration of markets for goods, services and capital and the creation of regional institutions.

The concept of institutions used by Professor Henning encompasses formal bureaucratic organisations, decision-making procedures, informal consultative fora, patterns of cooperation and informal agreements among states that facilitate cooperation and international exchange. It does not cover economic policies and regulations, private-sector networks, elite networks and transnational political and technocratic alliances. Economic integration leads to the building of institutions, as defined above, through different channels. Two of these channels are trade and investment flows. Exporters and investors exert pressure on national politicians to sign regional agreements and eliminate trade barriers. In addition, politicians use cooperative agreements as a way of avoiding pressure from domestic lobbies.

According to Professor Henning, while regional institution building might require political agreement on economic integration, it does not require a commitment to political integration or political union. In his presentation, he highlighted the case of Europe, where ambitions for political integration are often substantially overrated as a driving force for economic integration. He made special reference to the United Kingdom and Denmark, where the political factor has been much less relevant.

The European Union, according to Professor Henning, constitutes a paradigmatic case in the reciprocal interaction between economic and institutional integration processes. In the EU, there has been a readiness on the part of governments to establish legally-based institutions and hard rules to underpin the expansion of markets. By contrast, in East Asia, despite an increasing number of economic agreements and the growing number of institutions, there is less political will to legally formalise cooperation at the regional level. Whether the economic integration already achieved in the region will encourage institutional deepening remains unclear.

Strict rules are useful not because they are enforced (they are often violated) but because they alter the environment in which negotiations take place. Among the most important elements that foster integration among willing governments are information, monitoring and cross-issue bargaining. The development of "hard laws" is not seen as essential, provided there is a supportive institutional framework.

Regionalism is a process that intensifies when multilateralism stagnates. In other words, regional cooperation fills the gaps left where global cooperation fails and serves to strengthen the process of liberalisation. Professor Henning argued that weaknesses in the multilateral system had historically played a key role in motivating regional cooperation and in designing the agenda. Moreover, he argued that multilateral institutions can be safeguarded by introducing provisions in the regional arrangements that foster complementarity. He also encouraged the IMF to consider adopting the financial equivalent of Article XXIV of the GATT, which would clearly specify regional financial arrangements that are consistent (and inconsistent) with members' obligations in the Fund.

Discussants: Mr Marc-Olivier Strauss-Kahn and Mr Ricardo Ernesto Ochoa Rodriguez.

Mr Strauss-Kahn's presentation revolved around three main ideas. First, there are two broad alternative patterns of integration – market (demand-led) and institutional (supply-led) – that are both necessary and that interact with each other. Second, despite its initial endogenous nature, a market-led process may well converge towards an institutionalised integration framework operating under rule-based mechanisms (such as the Stability and Growth Pact or the Exchange Rate Mechanism from an EU perspective). Third, the European experience should be considered only as an illustration and not elevated to the status of a model. While there are different recipes for integration, Mr Strauss-Kahn identified certain main ingredients of the EU "experiment" that other regions may find worth considering. These include the identification of key country-players in the process, similar levels of development and ambitions of members, local roots of regional institutions (e.g. the Eurosystem) and a step-by-step approach. In conclusion, Mr Strauss-Kahn noted that regional integration may be considered as a necessary complement to the process of globalisation. In a nutshell, his recommendation was to "play global, think regional and act local".

Mr Ochoa acknowledged that NAFTA has a narrower institutional scope than the European Union and pointed to the fact that each member country had different motivations when entering into the arrangement. In practice, though, NAFTA goes beyond cross-border trade promotion and investment facilitation, in that the heightened awareness of members' respective policies has led to a degree of policy convergence. Mexico has benefited considerably from NAFTA, as it has shifted from a virtual import-substitution-led closed economy towards an export-oriented liberalised economy. Despite the lack of a strong and comprehensive formal institutional framework, NAFTA has contributed to synchronising business cycles of its members' economies and resisting a reversal of liberalisation reforms in periods of economic stress. However, Mr Ochoa added that more intensive cooperation in the regulatory field would have helped foster financial integration in the region and that this is now being considered as a further development.

General Discussion

The discussion began with the proposal that, in order to ensure that regional financial arrangements (e.g. the Chiang Mai initiative) are compatible with existing rules at the global level, the IMF should consider adopting a provision equivalent to Article XXIV of the GATT. In response to the proposal, a number of remarks were made about the inappropriateness of comparing trade and monetary (or financial) integration, since they differ from one another in terms of the type and extent of supportive legal or regulatory frameworks required. However, the IMF confirmed that it is looking at ways of placing greater emphasis on regional issues through its surveillance activities. Another participant proposed the use of IMF credit facilities to foster the development of regional arrangements and greater transparency in regional processes.

From the perspective of the Asian economies, the EFTA was seen by some as a more suitable framework than the EU's more demanding institutional set-up. The role of the US dollar as Asia's implicit or explicit external anchor was considered by some to be a barrier to institutionalised integration in the Asian region. For others, a lack of political will to cooperate within the region represented the main obstacle. Market-led integration should be seen as one way to overcome this perceived obstacle.

Some further issues were raised about the nature and evolution of integration in different regions. The roles of China and Japan as axes for regional integration in Asia were discussed. It was acknowledged that the sequential approach applied in the European Union, from trade to economic and financial integration, is not a rigid template. In terms of evolution, institutional progress and trade integration were seen as mutually reinforcing. Finally, it was remarked that strong political backing is required if a move towards deeper integration, such as monetary integration, is to be achieved.

Session IV: Not only trade: regional monetary and financial integration

Presented by Professor Yu Yongding.

The benefits of monetary integration (i.e. the adoption of a single currency) are directly linked to the gains resulting from enhanced economic efficiency and to those deriving from the attendant financial integration stimulus generated, which in turn foster institutional harmonisation. According to economic theory, economic efficiency gains are, in turn, the outcome of the reduction in foreign exchange uncertainty and risks and the lowering of transaction costs. The reduction in transaction costs has a direct impact on consumer income, as it increases transparency in pricing and encourages intense competition among producers, which forces consumer prices down and consumption up. The removal of currency uncertainty, in turn, leads both to lower operational costs and to reduced real interest rates in the economy. All in all, these effects translate into higher growth and greater prosperity. However, these gains are not without cost. The adoption of a single currency severely reduces monetary policy autonomy and increases vulnerability to shocks through, inter alia, the synchronisation of business cycles and enhanced cross-border transmission channels.

What are the preconditions for a successful monetary and financial union? The answer to this question is usually based on the optimal currency area (OCA) criteria. An economic region is said to be an optimal currency area if, among other things, labour markets adjust to price changes, if economies have a "significant" degree of trade and financial inter-linkages among them, and if there is a degree of synchronization of production cycles in the region. Evidence shows that, as measured by the intensity of intra-regional trade among its member economies, the presence of a production network, the existence of close financial linkages and the co-movement of economic cycles, East Asia fits the definition of an optimal currency area. However, according to Mundell's labour mobility criterion, the region fails to qualify as an OCA. Factor mobility is almost non-existent in the ASEAN + 3 economies. Professor Yu argued, though, that strong political momentum and will are key, as financial, trade and factor integration are, indeed, endogenous processes that, while constituting preconditions for achieving monetary integration, are also consequences of it.

The institutionalisation of monetary and financial integration in Asia should encompass two areas: the development of a regional financial architecture and the strengthening of regional foreign exchange arrangements. As regards the first area, steps should be taken to foster greater transparency in domestic policy-making in countries in the region, enhanced cooperation in the supervision and regulation of cross-border capital flows, and sounder infrastructure to provide technical assistance needed to monitor and mitigate risks and to coordinate actions and provide financing in the face of market pressures. Professor Yu favoured the creation of an Asian Monetary Fund, as an institution that would initially contribute to strengthening regional surveillance by assessing Asia's economic developments and, at a later stage, develop policy advice to manage adverse economic developments and market pressures.

With respect to the second area, closer cooperation in managing foreign exchange regimes in the region would require further progress in strengthening the region's economic fundamentals and analytical work to design appropriate coordination mechanisms. Such a strategy would involve improved consultation procedures to facilitate consensus-building on regional issues (e.g. on the importance given to regional exchange rate stability), the development of regional cooperation to further monetary and financial integration (such as the Asian Bond Market Initiative) and the establishment of a regional investment bank. The ultimate goal would consist of establishing an Asian exchange rate mechanism (AERM) operating under the umbrella of an Asian Economic Union.

Discussants: Mr Makhlani and Mr Sumio Kusaka.

Mr Makhlani upheld the implementation of a flexible menu supported by reinforced regional surveillance and crisis prevention mechanisms. He briefly reviewed the three main financial cooperation arrangements in place in the Asian region: the Chiang Mai initiative (bilateral and multilateral arrangements), the ABF and the ABMI, and proposed making the Chiang Mai initiative a more effective tool for crisis prevention. Mr Makhlani also referred to the need to give the road map for integration clear objectives and a time frame for implementation stages. The stages would follow the order of domestic financial liberalisation, capital market liberalisation, capital account liberalisation and, lastly, financial integration. He also supported the use of a multilateral approach and the role of the Asian Development Bank in encouraging Asia's cooperative efforts towards regionalisation.

Mr Kusaka explained that following the 1997-98 Asian crisis, closer financial cooperation has reflected heightened awareness of regional interdependence and has been seen as concrete steps towards fostering regional integration. While stressing that the Chiang Mai initiative, the ABF and the ABMI have been very positive responses to the 1997-98 crisis, he admitted that these are only preliminary steps towards enhanced regional cooperation and that the pace of progress is not as fast as he would wish. Currently, there are six ongoing working groups under the ABMI, which will be reporting to finance ministers by spring 2005.

General Discussion

Asia and the European Union are at different stages of development, a feature that also applies at an intra-regional level in Asia (e.g. the case of China and Japan). This situation implies that a uniform set of policies is unlikely to be appropriate for all of the countries in the region. Since disparities are considerably greater than in Europe, reliance on endogenous convergence may not be an optimal recommendation. In this respect, one participant referred to the notion of endogenous convergence to fulfil the OCA criteria and the lack of evidence on the impact of institutional integration on convergence of economic fundamentals.

Asia is facing dynamic changes that require a degree of policy flexibility. In particular, Asia has set itself two main financial objectives: stabilisation (supported by the Chiang Mai initiative) and the deepening of domestic financial markets (supported by the ABMI and the ABF). There is also a need for policy consistency under the "Impossible Trinity" framework[4], in addition to the OCA criteria, as a means to foster trade and real integration. The notion of having a single currency in Asia remains elusive on account, among other things, of the demanding nature of the political requirements.

Session V: Regional and global integration: stepping stones or stumbling blocks?

Presented by Professor Richard Baldwin.

Professor Baldwin addressed the ambiguity of regional trade liberalisation as a process that can help or hinder multilateral negotiation efforts. Liberalisation on a regional basis encompasses the positive effects linked to the removal of barriers to trade, but also accounts for the discriminatory components associated with the regional approach. The dual nature of regional liberalisation has supported the two current opposite trends: regionalism viewed as a stumbling block to multilateralism, as opposed to regionalism viewed as a building block and, indeed, a tool that encourages the multilateral dimension. The first trend stresses the discriminatory component, whereas the second emphasises the liberalisation component.

[4] The "Impossible Trinity" refers to the impossibility of having simultaneously unrestricted capital flows, autonomy of monetary policy and a fixed exchange rate.

Professor Baldwin's domino theory of regionalism asserts that accession to preferential arrangements works as a magnet that triggers wider liberalisation. The dynamics of the process emanate from the pro-integration forces resulting from closer integration and from the increasing costs of being a non-member. The trade diversion costs associated with closer integration within a bloc will encourage non-members to engage in pro-integration political activity, a process that works independently of the multilateral process.

Moreover, reciprocal liberalisation strengthens pro-trade political and economic forces, especially in terms of North-North and North-South regionalism. The principle of reciprocity encourages domestic exporters to lobby for lower domestic tariffs as a way to lower foreign tariffs, thereby counteracting protectionist pressures from importers. In this context, the role of authorities is to arbitrage local importers and exporters and, as a result, the process of liberalisation is such that any sector included in reciprocal trade talks will eventually be liberalised.

The current process of regionalism in East Asia, according to Professor Baldwin, will most likely come to resemble a "hub-and-spokes" regionalism pattern in which China and Japan are the two natural hubs of the region. However, this "twin–hub" scenario is economically inferior, as i) it is likely to be characterised by conditions being imposed on small-market nations (in return for market access), which reduce their attractiveness for industrial location; ii) it implies unbalanced bargaining power and iii) it exacerbates the "spaghetti bowl" problem. Thus, the "twin-hub" scenario can become a real stumbling block to the multilateral liberalisation process.

As a slightly better solution for East Asia, Professor Baldwin proposed two plans: Plan A, consisting of an East Asian Free Trade Union – an economic area for the region that resembles an Asian "EFTA" – and Plan B, consisting of a Free Trade Area union which is less ambitious and envisages putting in place several FTAs, each with their own rules of origin.

Discussants: Ms Heather Smith and Mr Zhang Wencai.

Ms Smith was of the opinion that the scope of FTAs goes much further than trade issues, also covering institutions, services and security. The presence of two hubs in the Asian region, according to Ms Smith, is already a fact. She referred to the currently more defensive trend of liberalisation and stressed the risks associated with a "spaghetti bowl" regional scheme. Her position was not as positive as that of Professor Baldwin when referring to the benefits associated with regionalism, for example owing to the need to harmonise rules of origin.

Mr Zhang's intervention addressed three main issues. First, on multilateralism versus regionalism, Mr Zhang stressed the similar motivation underlying both processes, i.e. freer flows of goods, services and capital with a view to enhancing efficiency. Second, regarding the domino effect associated with regionalism, which generates strong pressure to join existing arrangements with limited membership, he posed an open question on the conditions needed to encourage open regionalism. Third, he emphasised the role of international institutions in the process of liberalisation and referred to the fact that the gains from preferential arrangements are not necessarily spread evenly across participating members.

General Discussion

The discussion focused on the difficulties encountered in harmonising rules embedded in regional arrangements and highlighted the less than obvious benefits of regional arrangements to be reaped by small economies. It was also mentioned that the text of Article XXIV is somewhat unclear and questions were raised about the strength of trade diversion effects. There was support, however, for the introduction of restrictions to growing complexity and lack of transparency of FTAs, in particular through the multiplicity of rules of origin. Other participants also confirmed the lack of evidence supporting trade diversion effects and encouraged the introduction of the rules of origin chapter in Article XXIV of the GATT.

Session VI: Policy panel discussion: evaluating different experiences in the world

Panel 1: General discussion on advanced economy experiences

From a Canadian perspective, Mr Murray (Bank of Canada) looked at the state of play at NAFTA, an arrangement that reinforces economic linkages that already exist. He also referred to the presence of border effects and emphasised that Canadian provinces trade about 22 times more amongst themselves than with the United States, due, among other factors, to taste biases, trust and social networks and legal uncertainties in foreign courts. From a US perspective, Mr Freeman (Federal Reserve Board, USA) gave a positive assessment of the ten years of NAFTA and spoke in greater depth about the financial services incorporated under NAFTA. He referred to the critical role of the domestic industry in the countries concerned, in encouraging further progress.

Mr van der Kaaij (Ministry of Finance, Netherlands) summarised the European Union's path to its current situation and stated the two goals that the Union has set itself at present: the integration of the new Member States and the real and nominal convergence of Member States and newcomers. He recalled that although political motives had been important drivers of European integration, this integration would not have been sustainable without economic benefits. Furthermore, policy convergence had been of the utmost importance in furthering monetary integration in Europe. Mr Schönberg (Deutsche Bundesbank) pointed out asymmetric institutional arrangements in the European economic integration process with respect to monetary and fiscal policies. As political union is not on the agenda, the Stability and Growth Pact is designed to forge commitment to responsible fiscal policy, which, along with the single monetary policy, is a crucial component of a stability-oriented policy framework.

Panel 2: General discussion on emerging economies' experiences

Mr Meyer (Ministry of Finance, Brazil) deemed that time would be needed to deepen cooperation in the context of MERCOSUR and make further liberalisation progress in the region. As a way to foster such progress, he advocated greater convergence towards sound domestic policies in all member countries. Mr Benvenuti (Ministry of Economy, Argentina) recognised the positive initial results recorded by MERCOSUR, but also the lack of effective mechanisms to deal with major tensions among member countries that has led to a reversal of the integration process in the region as measured by lower intra-regional trade. He called for time, highlighting the need for political will, the adoption of more resilient policy frameworks and the need for domestic fiscal and financial consolidation. He advocated moving towards a Free Trade Area rather than a customs union.

Mr Tatarinov (Bank of Russia) argued that in the CIS, progress was gradually being made on a number of different levels and at different paces. Mr Al-Gebreen (Saudi Arabian Monetary Agency) commented on the numerous integration measures taken by GCC countries. In 2003 a customs union was established, although intra-regional trade remains at low levels owing to similar resource endowments. In addition to trade, labour and capital are also freely mobile among GCC countries. Members' exchange rates have been anchored to the US dollar and progress is being made towards the launching of a common currency by 2010. Mr Monyake (South African Reserve Bank) provided a brief review of the African experience of integration and encouraged a process of regional cooperation. Mr Basci (Central Bank of the Republic of Turkey) recalled the customs union agreement between Turkey and the EU signed in 1995 and outlined the importance of EU membership for Turkey as a catalyst for the country's modernisation efforts. He emphasized that, in this process, Turkey would benefit more from rules rather than discretion, citing for example the credibility gains Turkey hoped to achieve by bringing public finances into line with the current Stability and Growth Pact.

Preliminary conclusions

Reviewing the workshop, Mr Padoa-Schioppa identified the following four main points that may provide the basis for consensus.

First, regional economic integration is a positive process at work in the world economy, as it acts as an effective vehicle for trade and economic and financial globalisation, thereby fostering growth. Second, the diversity of regional experiences is unavoidable and welcome, since the respective roles of markets and institutions are bound to differ according to regional initial conditions and historical traditions. Third, institutional arrangements designed to consolidate and further regional trade and financial integration should be compliant with non-discriminatory rules adopted at the global level, otherwise regional arrangements will not fully generate their positive effects neither for the countries concerned nor for the global economy. Fourth – and related to the third point – global multilateral institutions, such as the IMF or the WTO, should recognise the significance of regional arrangements and make better allowance for them when designing their policies.

In conclusion, Mr Padoa-Schioppa summarised competing or complementary aspects of integration that might warrant further consideration:

- Markets versus institutions: markets require institutions (i.e. sets of laws and rules) to operate at both the regional and national levels;

- Economic versus political dimension: the economic rationale for integration among free market economies must be compatible with the political economy of institutional convergence;

- Real versus monetary integration: ultimately, economic integration leads to monetary union, since the plurality of currencies is likely to result in market failures (e.g. free banking in the United States in the nineteenth century);

- One model versus several models: various regional experiences provide useful lessons, even if there is a need to follow rules and approaches that have already worked;

- Regional versus global integration: conditions have to be met to ensure that regional and global processes are compatible and mutually reinforcing;

- Regional integration as an engine or by-product of growth: since geographical proximity matters for openness, and since growth is spurred by cross-border flows, regional integration is more than a by-product of growth; and

- Over-ambitious versus under-ambitious aims: policy-makers must set reasonable objectives – at the same time they must not be exceedingly risk averse and shun proactive approaches.

Regional economic integration in a global framework

Tommaso Padoa-Schioppa

It is a pleasure to welcome you on behalf of the European Central Bank to this G20 Workshop on “Regional economic integration in a global framework”. In my view, regional economic integration is among the topics in the international arena whose importance is currently rising fastest. Even some five years ago, we would probably not have had a major workshop devoted exclusively to this issue, but today regional economic integration and cooperation are considered in many instances to be among the keys to stability and prosperity in a global context. Indeed, regional cooperation is recognised as one of the key policy issues not only in Asia or Europe, but also the Middle East, Africa and several other parts of the world. Moreover, policy makers are recognising that such cooperation is stretching far beyond trade agreements that were the focus of regional cooperation in earlier times, and now includes a full consideration of monetary, financial and financial stability issues.

European monetary union with the successful launch of the euro may be one source of the new dynamics in this field, but I believe that the process of globalisation and the regional emphasis that it entails, as I will argue, is actually much more important. I consider it particularly suitable to hold this workshop in Asia, because it is one of the regions where the issue of closer regional cooperation has been most pressing over the past few years and where we could see significant changes over the medium term. Within Asia, China obviously plays a pivotal role, as it has become an important, if not the most important, hub for international processing trade within the region, buttressed by massive intraregional foreign direct investment. I would therefore like to warmly thank the People’s Bank of China for hosting this important G-20 workshop in Beijing, and for welcoming us in this beautiful State Guest House. I would also like to thank the PBC staff as well as the German G20 Presidency for the very efficient organisation and cooperation with my ECB colleagues in Frankfurt in setting up this event.

In this opening lecture I will try to set the scene for our discussions in the coming two days, looking at the overall picture of regional integration across the globe. In doing so, let me recall the starting point and driving force for this process, which is globalisation. Globalisation, the rapid increase in economic and financial activity across borders leading to a more integrated global economy, is best evidenced in international trade. For over three decades world trade has grown on average 3.5 times faster than world output, and the annual value of goods and services trade reaches around USD 10 trillion, close to the total GDP of the United States. Yet, trade patterns are far from being distributed around the globe evenly. Over half of total global trade volume is intra-regional trade. This regional clustering has come to replace the north-south links that characterized the early part of the last century, when the industrialized countries of the northern hemisphere traded with, and invested in, the commodity-rich countries of the southern hemisphere. In some way, therefore, regional clustering is a relatively new phenomenon, whose macroeconomic, monetary and financial policy implications still need to be fully understood.

If you allow me to use a metaphor, I would say that global economic exchanges resemble a house, with each floor signifying a level of economic linkage. In this case, the architecture of the global economy would have five floors. The first three floors make up the country level, which has for centuries been the main reference for economic exchanges and policies: they comprise the local, federal and national level of economic relations. On top of that is not – as we perhaps would have thought even some years ago – the global level, but an intermediate, mezzanine level. It is this mezzanine fourth floor – between the national and the global – of interaction within global regions or continents, that constitutes a very important layer in the structure of global economic exchanges. For one thing, international trade turns out to be heavily clustered in regions. As I mentioned, over half of global trade is within the world's main regions. For another thing, several macroeconomic and financial spillovers have a strong regional focus, for better or for worse. And finally, a number of relevant policy tools, including regular consultations and policy cooperation, are often seen as most realistic to implement at a regional level. Against this background, I would consider our aim in the workshop to be to explore the economic and policy relevance of this fourth floor in the global economic architecture and investigate its interrelations with the national and global spheres.

To start this exploration, we have to ask ourselves what explains the phenomenon of regionalisation and what defines a region. Gravity models, despite their relatively weak theoretical basis, have focused attention on both tangible and intangible factors. At their core, they emphasize the importance of proximity and the relative economic size of partners in accounting for international trade patterns. They evaluate the role of transportation costs, common borders, regional similarities in tastes and habits, cultural affinity, and a common history or language. Another approach is taken by optimum currency area theory, which seeks to gauge the economic and financial linkages among countries with the objective of identifying groups suited to monetary integration. Yet, the degree of cohesion among countries in a region may vary widely, and the edges of a grouping can be fuzzy.

Having said that, there is increasing evidence of a self-reinforcing mechanism to regional integration, which, as it gathers strength, relies increasingly on political and institutional support in order to develop. Increasing trade links between countries foster the opening of financial channels, thus pushing towards the gradual liberalisation of the capital account. As trade and capital integration within a region increases, the exchange rate plays an increasingly important role. It may act as a barrier through the transaction costs it imposes or, more importantly, on account of the uncertainty and instability it may generate. The authorities' decision on their treatment of the exchange rate will necessarily have implications for the conduct of monetary policy. This is the logic of the so-called "inconsistent quartet": if a country opts for free trade and capital mobility, it must choose between fixed exchange rates and monetary policy autonomy, since the two cannot be successfully pursued simultaneously. A high degree of regional trade therefore ultimately provides a strong case for some management of the exchange rate, and the greater is regional interdependence, the stronger is such a case. Exchange rate management can vary from unilateral measures to stabilise the exchange rate (as witnessed for example by Mexico within NAFTA), to unilateral but similar national solutions – such as exchange rate policy in Asia – up to a monetary union with supranational institutions and the pooling of sovereignty in monetary affairs as in the euro area. What this illustrates above all is the overlapping spheres of influence of trade, finance and currencies; how integration in one area releases forces for integration in the others; and how in turn, the role of policy and an institutional framework become increasingly important as integration deepens.

Let me now turn to some concrete experiences with regional integration. There have been numerous examples, virtually on every continent, that show how regional integration is not just an isolated event, but nowadays a truly global phenomenon. What is remarkable about this phenomenon is that it has taken very different and distinct forms in different regions. But it is precisely this diversity of experience that allows us to better understand the motivations, the gains and the future prospect for global integration and the role that the different actors will play in this process.

Looking at all the different regional integration experiences together, let me propose a hypothesis that I believe is common to most if not all efforts over the past half a century or more: the initial motivation for regional integration has almost always been a major catalytic event – a political or military conflict, a financial crisis, the transition from socialist to market economies, or common endowments related to common shocks, to name only a few – which made us understand that nation states individually are no longer capable of dealing with important economic and political developments in isolation. In other words, it is often major catalytic events that have provided the impetus to regional integration, that explain many of the differences in regional integration and that will also continue to shape the process in the coming years and decades.

EU neighbouring regions

Let me start with the EU's Neighbouring Regions and look at the Commonwealth of Independent States (CIS), which has undergone dramatic changes over the past decade. What these states, and also some of the ten new EU member states, have in common and what has shaped the integration process is their similar economic and political system for more than 40 years and a rather stony transition process from planned to market economies after the dissolution of the Soviet Union in the early 1990s. However, given the different speeds in the transition period it is not surprising that the extent of integration of the CIS countries is rather disparate. The CIS' stated objective is to create a common market for goods, services, labour and capital. But the integration activities so far have been more pronounced at the sub-regional level, such as among Russia, Ukraine, Belarus and Kazakhstan. These regional policy initiatives, overall, have not brought about tangible results, since countries have not yet implemented the steps required for the creation of a common market. However, I am optimistic that the integration process in this region will gain pace in the coming years as higher macroeconomic stability – partly due to high commodity prices and faster economic growth – provides more breathing space for institution building and an intensification of regional cooperation.

For the region south and southeast of the EU, comprising economies in the Middle East and North Africa, economic integration has traditionally been low for economic and political reasons. Since export structures are very similar across countries and goods are mostly sold on the world market, there is little reason for fostering intra-regional trade. At the political level, the occurrence of regional conflicts has impeded a stronger regional economic infrastructure. As in the CIS region, there is one overarching regional arrangement, the Arab League that plans the creation of a Pan-Arab Free Trade Area by 2005, and a number of associations at the sub-regional level.

The most advanced of these separate groups is the Gulf Cooperation Council (GCC), comprising six countries located on the Arab peninsula including Saudi Arabia, which already last year established a customs union. The example of the Gulf Cooperation Council is an interesting one in that it underlines the hypothesis I formulated earlier on. What the six member states have in common is a strong dependence on oil, and thereby an almost identical business cycle and a large and synchronous exposure to external shocks. As oil exports to the rest of the world dominate trade, the degree of intra-regional trade has remained relatively low. But the GCC is realising the need to deepen regional cooperation, not only to foster regional economic cohesion but also to help diversify the economies and become together more attractive for foreign direct investment by offering a larger domestic market. As a consequence, the GCC plans the establishment of a common market by 2007 and has even set the very ambitious target of creating a single currency by 2010.

East Asia

For South-East and East Asia, the key catalytic event to propel regional cooperation has been the Asian financial crisis of 1997-98. The crisis has played such a pivotal role because it has made the Asian countries realise, no doubt in a painful way, that they are closely tied together economically. It also made us understand that economic interdependence often intensifies in difficult times and that contagion may in some cases even affect economies that have relatively sound and sustainable economic policies. As in the case of many other regions, Asia's policy makers have responded to the Asian crisis in part by intensifying regional cooperation. Part of the focus today is on forming the types of institutions that would best serve the interests of the region as a whole as much as the interests of the individual economies. Currently, two organisations stand out: ASEAN, the Association of Southeast Asian Nations, and APEC, the Asia-Pacific Economic Cooperation.

Prior to the Asian crisis in 1997, regional integration efforts were largely centred on trade liberalisation. The founding of AFTA – the ASEAN Free Trade Area – in 1992 was partly caused by the concern that the emergence of other trade blocs – the EU, NAFTA and MERCOSUR – might re-direct resources away from East Asia. The agreement, which was later extended to other liberalisation measures, called for a substantial reduction of tariffs within 15 years. However, when the Asia-Pacific Economic Cooperation (APEC) soon afterwards decided to establish a free trade agreement within two years, AFTA's tariff agenda was moved up by 5 years.

In the aftermath of the Asian crisis the focus shifted towards creating more financial and monetary co-operation in the region. It was realised that a necessary step to prevent future crises, or at least to reduce the often catastrophic effects the crisis had on some economies, is to strengthen regional integration and cooperation. An important step taken to prevent such an event from re-occurring was to incorporate China, the Republic of Korea and Japan in an informal association, the so called ASEAN *Plus Three*. These economies have been the driving forces in the area of monetary co-operation, notably in the Chiang Mai Initiative that provides for mutual assistance consisting of swap arrangements in the event of a financial crisis. Other efforts to render the region's financial markets more stable by moving from purely bank-based systems to a greater degree of bond financing comprise the Asian Bond Fund initiatives I and II of the EMEAP Group of central banks and monetary authorities, and, correspondingly, the Asian Bond Fond Market Initiative of the ASEAN Plus Three group of countries.

But these initiatives are more than just a first step towards greater cooperation, they have also created important fora for an ongoing policy dialogue at the level of finance ministers and central bank governors. Nevertheless, financial and, in particular, monetary co-operation is still at an early stage in East Asia. While there has been talk about possibly aligning national monetary policies so as to minimise the disruptions that volatile bilateral exchange rates cause, monetary cooperation or common regional surveillance are still being developed. In a sense, the current configuration of exchange rate arrangements in the region is not unlike the European Monetary System that existed before the euro was introduced. In both cases, exchange rates were *de facto* aligned with an anchor currency, previously the Deutsche Mark in the EU and today the US-dollar in East Asia, the difference being, of course, that the former was an integral part of the system while the latter is an outside currency. While a distinct merit of greater exchange rate co-ordination consists in providing an order in intra-regional economic relations, such a step would entail a certain loss of national sovereignty in conducting monetary policy. And in this area of co-operation, as on many related issues, the question is not so much whether it would benefit the region and its individual member countries, but rather whether policy makers have the necessary will and courage to engage in closer co-operation.

Latin America

Turning to the Western Hemisphere, economic integration in Latin America is arguably the most heterogeneous among all regions I have been reviewing here. To be sure, there is no shortage of sub-regional arrangements in Latin America, ranging from the Central American Common Market and the Caribbean Community and Common Market to the Andean Community and MERCOSUR, which was created only in the early 1990s. Nevertheless, these individual associations differ widely as regards their policy coverage and institutional cohesion. The Andean Community, for example, is modelled after the EU in that it has developed a number of supranational institutions over time, including the Andean Parliament, a Court of Justice, a reserve fund and a regional development bank. By contrast, MERCOSUR is still intergovernmental in nature without permanent, treaty-based institutions. While the strong will of the four countries comprising MERCOSUR has sufficed to create an early customs union, it has proven inadequate to prevent strongly diverging economic policies within the trade bloc and the temporary withdrawal of some commitments. This became especially apparent after the Asian crisis when Brazil's devaluation of the real suddenly rendered Argentine exports to Brazil much less competitive, thereby creating strong tensions within MERCOSUR.

The reasons for the relatively low degree of economic integration become visible when looking at the substantial structural divergences within the region. While the region as a whole is not very open to trade compared to economies in other emerging market regions, the degree of openness is also quite different within Latin America. This is not surprising since the region features large domestic markets such as Argentina and Brazil, whose trade openness is less than 30% of GDP, as well as a number of medium-sized open economies whose trade intensity is roughly comparable to that of their Asian counterparts. Looking ahead, there are two main risks for Latin American regional integration that has been stalled in the aftermath of the Argentine crisis of 2001-02. First, the creation of financial and economic stability may bring about a more permanent increase in economic integration than is currently anticipated. Second, the success of the two main integration arrangements will critically hinge on increasing intra-regional trade in the case of the Andean Community and in the case of MERCOSUR a deepening of institutional integration beyond the current level.

Despite the diverging set-up of institutional arrangements for trade facilitation, the region appears to have developed a preference for deeper integration mechanisms, given that all major associations now aim to establish a common market. At the regional level, the willingness to eliminate barriers to trade has been manifested in the process of establishing the *Free Trade Area of the Americas* (FTAA) that is going to link North American to Latin American economies. According to the time schedule, the FTAA negotiations are to be concluded by January 2005. While the eventual outcome of the ongoing negotiation rounds is not yet clear, it is already apparent that the FTAA will have to account for the sizeable differences in the levels of development through special provisions and mechanisms, which may also mean that countries assume different levels of commitments. It also remains to be seen how the FTAA will square with the existing sub-regional integration arrangements.

European Union

As the last stop of my tour d'horizon of regional arrangements, let me turn to the European experience. Just like in so many of the other arrangements that I discussed, the initial impetus for European integration was a catalytic event, in the European case the two world wars. The first efforts at building a common European "house", as the former German Chancellor called it, was therefore aimed primarily at reconciling the European nations. In fact, much of the objective of European integration over the past fifty years can be understood as en effort to ensure that a military conflict will ever again originate in Europe.

But as with many integration processes, the European experience gradually evolved into something much larger. After close to fifty years of integration, political cooperation and institutional integration has resulted in Europe now having a government with well-established executive, legislative and judiciary branches. This institutional achievement has been going hand in hand with economic integration in Europe, which culminated in the introduction of our common currency, the euro, in January 1999 and a common monetary policy.

Despite these achievements, let me stress that the integration process has in no way been easy, and indeed has not been without setbacks. After almost three decades of very uneven progress, the breakthrough towards economic integration came with the European Act of 1985 that paved the way to the single market eight years later. It is interesting to note that monetary integration evolved in line with advances in trade and market integration. Accordingly, the process of creating the common market was soon complemented by the decision to take first steps in the direction of monetary union. Nevertheless, the path towards European integration is not complete yet and many challenges are still ahead of us. Further steps in the deepening of regional integration can be envisaged, specifically as regards labour mobility, harmonisation of national structural policies, a further deepening of capital market integration and the co-ordination of macroeconomic policies not yet unified. In this sense, the euro is by no means the endpoint but rather a milestone on the way towards comprehensive economic integration within Europe.

Some policy considerations

Having completed this brief global review of experiences with regional integration over the past decades, what policy issues do we draw from it? In my view, the experience so far strongly suggests that regional integration has played an important role in promoting growth, stability and a peaceful coexistence around the globe. The experience also shows clearly that there is no single best way of achieving regional integration, but that there are many distinct ways and that successful integration needs to take into account the characteristics and peculiarities of each region. But I also believe that regional integration is only one step for achieving closer cooperation and integration at the global level.

In this sense two key policy issues arise in my view: The first policy challenge we are facing, and we will continue to face, is how to actively use regional integration to foster global integration, and how to ensure that both processes co-exist and support each other rather than stand in conflict with one another. Here, we have to call upon those fostering regional arrangements to ensure that they are open to and compatible with broader global cooperation initiatives and settings. This is key to avoid regional cooperation turning into regional bastions hampering progress at the global level. One way of ensuring this compatibility is to recognise it explicitly in the setting of up the regional framework. For example, when in Europe the Treaty of Rome was signed in the 1950s, it included a specific reference that the initiative was compatible with the ongoing process in the GATT. This is one way of very effectively recognising and ensuring mutual compatibility.

The second policy challenges is to ensure that also global institutions and arrangements recognise and give appropriate status to relevant regional arrangements. This is not always easy because these arrangements are changing over time and can evolve into complex cooperation landscapes. However, it is crucial that their value is recognised at the global level and that global institutions do not try to ignore or stand against further regional cooperation. Here I see the particular link to our workshop today: the G20 is becoming an important multilateral forum globally, and I therefore appreciate particularly the focus it is devoting to regional cooperation. This focus is in my view especially relevant as the G20 is unique in combining industrial countries with an important representation of emerging market economies where regional cooperation arrangements are particularly advancing at present. Therefore, the G20 could play a seminal role in addressing the challenge of interlinking cooperation at the regional and at the global level and interlinking the cooperation of industrialised economies and the rapidly growing emerging markets.

Ladies and Gentlemen, as my task this afternoon is to open our workshop on regional economic cooperation, it would be inappropriate to end my remarks with conclusions on the subject. Let me simply highlight two features which I would distil from my review of the current regional arrangements: first, regional cooperation is clearly intensifying in many parts of the world, both due to catalytic events and as a policy response to the general acceleration of economic exchanges beyond national borders. Second, we should welcome this process of regional cooperation and consider it as an important step towards closer global cooperation because a leap from national policy making to global policy making may be attainable more easily by passing through a regional network. Coming back to my metaphor on the individual levels in our global architecture: the way from the national level to the global level may very naturally pass through the fourth floor, the regional level, and will by no means stop there.

Thank you for your attention.

Market-driven regional integration in East Asia

Eisuke Sakakibara and Sharon Yamakawa

Regional integration can take many forms, and nowhere is this more evident than in the vastly different integration processes taking place in the regions of Europe and East Asia. The subject of this paper is regional integration as it has developed in East Asia with a focus on the drivers of that integration. While the paper is not intended as a direct comparison of integration in East Asia and Europe, it will include some comparisons between the two regions.[1]

Integration in East Asia has progressed very slowly and is still in an early stage despite that the process has continued for decades. In fact, it could be said that the process began centuries ago – even as far back as the 15th century.[2] By comparison, European integration has progressed steadily and has gradually deepened over the last 50 years to reach an advanced stage today with a common currency and well-developed regional institutions.[3] Thus, the speed of progression and the level of integration attained in the two regions are quite dissimilar.

In addition to these differences, the drivers behind the integration process in each region are different. In Europe, the origins of integration have been institutional in nature, and the development of institutions has been prominent throughout the process. Thus, regional institutions have been the driving force behind integration in Europe. In East Asia, the development of regional institutions has also occurred; however, progress in this area has been slow and the few existing institutions are fairly weak and ineffective. Nevertheless, regional integration is taking place in East Asia, but the driving force is the market rather than policy or institutions. Corporations and the production networks they have established are driving integration in East Asia.

The paper is organized as follows. We begin by reviewing the early stages of regional integration in both Europe and East Asia, and in so doing, identify the initial motivations for integration to be political in both cases. Then we examine two elements of policy-driven regional integration – regional institutions and regional agreements – in an effort to assess the degree to which policy has played a role in the integration of each of these regions. In this assessment we compare the well-developed institutions of the European Union (EU) with the much weaker regional institutions in East Asia, and we determine

[1] Occasionally comparisons with NAFTA and other regional arrangements will also be made.

[2] Intra-Asian trade developed long before Europeans arrived in Asia, and in the beginning, the ships and their owners, the merchants, and the goods traded were all Asian. For more on the historical perspective of Asia's regional and global trade see Sakakibara and Yamakawa (2003, Chapter I, pp.1-29).

[3] European integration is a complicated study, and this statement does not imply that the road along which it has traveled has been smooth or trouble free. In fact, there have been many difficulties and setbacks along the way. For a detailed analysis of the history of European integration since 1950 see Gillingham (2003).

the level of each region's participation in regional agreements. We then evaluate market-driven integration in East Asia by exploring the development of cross-border production networks beginning with a review of the region's trade and foreign direct investment (FDI) patterns as the key elements of these networks. Next, we use data on parts-and-components trade to assess the level of production sharing in the region, noting the special roles of Japan and China, and argue that production sharing in East Asia has grown not only on a regional basis but also on a global basis.

The motivations for regional integration

The motivations for regional integration in both Europe and East Asia were initially similar in that they were both political in nature. In Europe, economic interdependence was thought to be the most effective means to promote the political cooperation that was highly desired in the region after World War II. Therefore, economic means would be used to achieve a political goal. The early catalysts for the formation of the European Community included Hitler and the fear of Germany, the United States and its aid under the Marshall Plan, and fear of the Soviet Union and its spread of communism.[4] The Frenchman, Jean Monnet, first president of the European Coal and Steel Community (ECSC) and generally accepted principal architect of European unity, believed that unification would be best achieved through economic rather than military coordination. His proposal for a single high-level authority to supervise the development of the coal and steel industries in West Germany and in France led to reconciliation between those two countries, and this reconciliation was the basis for the European integration that followed.[5]

In East Asia, political cooperation was also a motivating factor in early regional integration efforts, particularly in the formation of the Association of Southeast Asian Nations (ASEAN), which is the earliest (still existing) regional forum in East Asia today. When ASEAN was formed in 1967, Southeast Asian nations recognized that the political environment in the region was changing, so they moved to align themselves in a way that would enable them to deal with it in a unified manner but at the same time would preserve their respective national interests. In fact, although the aims of ASEAN were created to focus on economic, social, and cultural development, the association played a significant role in fulfilling the political needs of Southeast Asian nations at that time. These political accomplishments included the restoration of amicable relations between Malaysia and Indonesia and the forging of an alliance among the non-communist members of the region.[6]

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[4] Leonard (2002) describes Hitler's role as one of unification "by the sword" in combination with the destruction of the self-confidence of Western European nations. He describes the roles of the United States and the Soviet Union as driven by self interest but benign in the case of the former and malign in the case of the latter.

[5] Gillingham (2003, p. 23) acknowledges that the ECSC was "important in the long run as a source of European reconciliation," but does not credit it with keeping the peace during the Cold War. He rather credits NATO with that accomplishment.

[6] Tan (2000, p. 11).

Although integration in both Europe and East Asia began for political reasons, thereafter the driving force for integration differed in each case. The drivers were governments and regional institutions (both political and economic) in Europe's case, and corporations and markets in East Asia's case.

Policy-driven regional integration

The degree of regional integration that is driven by policy or government initiative can be estimated in part by examining two elements of regional cooperation: regional institutions and regional agreements. Our examination of these elements for Europe and East Asia reveals that Europe has proceeded further in the development of regional institutions and in the adoption of regional agreements than has East Asia. These findings lead us to conclude that Europe's integration is driven by policy to a much greater extent than is East Asia's integration.

Europe's regional institutions

While European corporations have undeniably played an important role in furthering Europe's integration through their trade and foreign direct investment, the origins of integration in Europe were institutional in nature, and the regional institutions that were created have become a driving force for the deepening of that integration. Member states have delegated some of their decision-making power to these regional institutions so that decisions on specific matters of joint interest can be made through a democratic process at the regional level.[7]

The institutional origins of Europe's integration began in the early 1950s. Jean Monnet, often viewed as an institution builder, has been credited with nearly single-handed creation of Europe's first institution for integration, the European Coal and Steel Community. He was also the driving force behind the creation of the European Defense Community (EDC) and the European Atomic Energy Commission (EURATOM).[8] The five existing European institutions are shown in Table 1. Also shown are five other regional bodies that are not identified as "institutions" but that have important and specific functions in the integrated system that is the European Union.

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[7] The European Union called this process "pooling sovereignty" (European Communities 2003, p. 3).

[8] Gillingham (2003, p. 16). For a thorough discussion of the successes and failures of Europe's institutional origins see Gillingham (2003, Part I).

Table 1: Regional institutions and other bodies in the european union

Regional Institution/Body	**Role**	**Date created**	**Applicable treaty***
	Regional institutions:		
European Parliament	Legislative arm of the EU; represents the EU's citizens and is directly elected by them	1950s	Founding treaties
Council of the European Union	Legislative arm of the EU; represents the member states	1950s	Founding treaties
European Commission	Executive arm of the EU and initiator of legislative proposals; seeks to uphold the interests of the Union as a whole	1950s	Founding treaties
Court of Justice	Gives legal judgments on cases brought before it; upholds the rule of European law	1952	European Coal and Steel Community (ECSC) Treaty
Court of Auditors	Checks that EU funds are used properly	1977	N/A
	Other important regional bodies with specialized roles:		
European Economic and Social Committee	Represents civil society and the two sides of industry	1957	Treaty of Rome
Committee of the Regions	Represents regional and local authorities	1994	Treaty on European Union (Maastricht)
European Central Bank (ECB)	Manages the euro and EU monetary policy	1998 (Euro circulation from 1 January 2002)	Treaty on European Union
European Investment Bank (EIB)	Finances EU investment projects	1958	Treaty of Rome
European Ombudsman	Guards EU citizens and organisations against mal-administration	1992	Treaty on European Union (Maastricht)

Source: Compiled from European Communities (2003).
* Treaty under which each institution or body was created. See Table A.1 in the Appendix for information about these and other European treaties.

The European Union's decision-making process involves primarily the first three institutions listed in Table 1 (the European Parliament, the Council of the European Union, and the European Commission). This so-called "institutional triangle" is responsible for producing the policies and laws that apply throughout the European Union.[9] The next two institutions shown in Table 1, the Court of Justice and the Court of Auditors, also play important roles in this process.

All European law is currently treaty based, and the three primary procedures for enacting new European Union laws are called co-decision, consultation, and assent. Of these three procedures, the co-decision procedure is the most common procedure for passing European Union legislation, and it places the European parliament and the Council on an equal footing so that the laws they pass are in fact joint acts of the Council and Parliament. Under the consultation procedure Parliament merely gives its opinion. The European Commission chooses which procedure to follow when it proposes a new law, and this choice is dependent on which treaty-article the proposal is based. Table A.2 in the Appendix outlines the areas covered by each of these three procedures.

As revealed in the tables presented so far, Europe's institutions developed early in the integration process and their decision-making authority now covers a wide swath of European society, including labor and employment,[10] education, health, crime, taxes, economic policy, transportation, and others. In addition, the integration of Europe has been recently widened with the addition of 10 Eastern European countries, and it has been further institutionalized with the agreement among European leaders on a European constitution, which if approved will provide a single set of rules to replace the various treaties that have governed the union since the 1950s. Of course, the constitution was agreed after many compromises were made, and before it can take effect it must be ratified by all 25 countries, some of whose voters have displayed considerable apathy and disaffection with the union in recent elections.[11] Nevertheless, the fact that an agreement among the leaders of so many heterogeneous states could be reached at all is a momentous achievement and reflects the strong political will and importance of policy in Europe's integration process.[12]

East Asia's regional institutions[13]

East Asia's efforts to formalize regional cooperation into a workable arrangement for the promotion of trade, investment, and security in the region have been varied but not very successful. In spite of the fact that the first attempts at regional cooperation in East Asia date back to the 1950s, the same decade the European Union's institutions

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[9] European Communities (2004, p.1).

[10] Intra-European mobility remains very low (less than 0.2 percent of the European Union's total population) in spite of the Treaty of Rome's recognition of the principle of free movement for nationals of European Union countries and more recent measures taken to facilitate intra-European mobility. (World Bank, 2003c, p. 165).

[11] The constitution can be completely blocked by the rejection of a single country.

[12] For a detailed discussion of the contribution of Europe's regional institutions to integration see Gillingham (2003, Chapter 3, pp. 34-52).

[13] This section on East Asian institutions draws substantially from Sakakibara and Yamakawa (2003, Chapter III).

originated, regional institutions in East Asia have been slow to develop, and even after almost five decades they are not highly advanced or very influential. The region's early efforts at institutional development were complicated by (1) the heterogeneity of many political, economic, and social aspects of the region, (2) political tensions between certain countries historically, (3) the desire to protect national interests and specific industries (for example, agriculture and automobiles), and (4) Asia's historical openness in trade and FDI and its long-standing relationships with the United States and the European Union. Consequently, many of the regional cooperative arrangements that were formed at that time no longer exist.[14] Nevertheless, there are several regional groups that currently represent the region, including the Association of Southeast Asian Nations, Asia-Pacific Economic Cooperation (APEC), Asia-Europe Meeting (ASEM), and the Bangkok Agreement.[15]

Although the regional groups in East Asia are often referred to as "regional institutions," they are in fact dissimilar in a number of ways from the institutions of the European Union. East Asia's regional institutions include some member countries that are actually located outside of East Asia. Examples are APEC, which includes countries in North and South America, and the Asia-Europe Meeting, which is in reality an inter-regional group comprising countries in Europe and Asia. In addition, unlike the European Union's institutions, which exist within one regional group (the European Union) and serve separately defined functions within that regional group, East Asia's institutions are separate groups of countries with members often belonging to more than one group. In addition, some of these groups may have broadly similar goals and objectives, such as the reduction of tariffs for members, but they often have different agendas for achieving these goals, which can result in confusion and duplication of effort among members and also presents a non-unified face to the rest of the world.

ASEAN, which includes 10 nations, is probably the best known and most active regional institution in East Asia.[16] ASEAN's initial purpose as stated in its founding document, the Bangkok Declaration, is "to accelerate the economic growth, social progress and cultural development in the region." Nevertheless, it is widely acknowledged that the main impetus for ASEAN's formation was political.[17] However, in order to fulfill its stated objective of economic cooperation, ASEAN attempted to implement a number of economic initiatives, most of which were industrial cooperation initiatives. Through these initiatives ASEAN aspired to facilitate economic cooperation by developing regionwide industrial capacity as an alternative to national industrialization in order to harness the power of the region's huge population.[18]

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[14] See Sakakibara and Yamakawa (2003, p. 46) for a list of these early regional groups in East Asia.

[15] See Sakakibara and Yamakawa (2003, Chapter III and the General Appendix) for a description of these and other current regional groups in East Asia.

[16] ASEAN includes Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

[17] See Kartadjoemena (2001, p. 211) and references cited in Tan (2000, p. 21).

[18] While on a national scale individual ASEAN economies have small markets and limited skilled labor, on a regional scale the ASEAN market comprises around 500 million people.

However, the early economic plans initiated by ASEAN (in 1976 to 1988), such as the ASEAN Industrial Projects (AIP), the Preferential Trading Arrangement (PTA), and the ASEAN Industrial Complementation (AIC), were generally ineffective. The intent of these industrial-type cooperative efforts was to involve resource pooling and market sharing and thus allow the ASEAN economies to take advantage of economies of scale and a large combined market. These schemes were supposed to enable individual countries to specialize in manufacturing specific components as a means of developing large-scale industries (for example, automobiles). This would then increase complementarities among regional economies and eventually increase intraregional trade and investment. Finally, industrial cooperation was intended to shift the focus of industrialization from a national level to a regional level. As regional industrialization would grow, regional cooperation would increase and lead to further industrialization.[19]

Theoretically, this plan should have worked, but in reality it did not. The various industrial cooperative efforts were largely unsuccessful because of problems related to implementation, financing, and private sector involvement. ASEAN's early attempts at economic cooperation did not contribute to the remarkable economic performance of the ASEAN countries at the time. The good performance at that time was rather the result of their trade and investment links with each other and the rest of the world.

Europe's decision-making process, discussed above, is institutionalized. In other words, the process is set forth in its founding treaties and carried out by its three main institutions: the European Parliament, the Council of the European Union, and the European Commission. In East Asia, there is a similar process called consensus decision-making, but its usage is not stipulated by any particular authority or policy. It exists as a feature of Asian relationship culture. Consensus decision-making, along with the accommodation of the interests of others and non-interference in the internal affairs of neighboring nations, is the basis for the concept called the "ASEAN Way".[20] Although the "ASEAN Way" has been credited with enhancing political stability in the region, it has also been faulted for inhibiting rather than promoting economic cooperation within ASEAN.[21]

Regional agreements

In addition to the broad regional integration frameworks like the European Union and NAFTA, there are narrower regional arrangements formed between two or more countries that are another form of government-led cooperation. Regional agreements have existed for more than 50 years, and even though they are usually referred to as "regional *trade* agreements or arrangements" (RTAs) or "free *trade* areas" (FTAs), they often include articles or clauses dealing with areas such as foreign direct investment and services in addition to those dealing with trade.

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[19] Tongzon (1998, pp. 58-59).

[20] While referred to as the "ASEAN Way," this particular type of human interaction is not unique to ASEAN but is generally characteristic of the interaction among persons and groups nearly everywhere in Asia in general.

[21] Chia (1997) and others.

Between 1948 and 2003, a total of 160 primary regional instruments dealing with trade and FDI were adopted worldwide. Of these 160 regional instruments only 16 instruments (bilateral, regional, and interregional) involved East Asian countries, and they were formed (but not adopted in all cases) much more recently – between 1980 and 2003 (Table A.3 in the Appendix).[22] The relatively small number of such instruments involving East Asia indicates that the region is a newcomer to cooperative arrangements of this type. In comparison, Europe has in force 22 such instruments that are bilateral, regional, or interregional,[23] plus 71 bilateral association, cooperation, framework, and partnership agreements that include investment-related provisions (56 for the European Community and 15 for EFTA).[24]

In 1992, ASEAN responded to an environment of increasing regionalism in the world and an uncertain multilateral trading system by creating the ASEAN Free Trade Area (AFTA). AFTA is the earliest major regional trade arrangement in East Asia. It has been successful in reducing regional tariffs, for which it was initially conceived, and has also worked to remove nontariff barriers. While AFTA is best known for its trade measures, it also promotes FDI although this area is primarily dealt with through the ASEAN Investment Area (AIA), which was formed in 1998.[25]

In recent years, interest in forming regional arrangements has accelerated in East Asia. Since 2000, six trade-FDI instruments involving East Asia have been adopted with 14 more currently (as of 2003) under consultation or negotiation (Table A.3 in the Appendix).[26] Most of these are bilateral, and nearly half of them include Japan as one of the bilateral partners. However, ASEAN is also rapidly pursuing comprehensive arrangements with other Asian partners, the most prominent of which is the ASEAN-China Free Trade Agreement (ACFTA) adopted in 2002.[27]

We can see from the foregoing discussion that Europe's integration has been driven by governments and their policies through the creation of powerful regional institutions that have in their own right further deepened integration in the region. East Asia, however, has not been able or willing to establish such strong institutions despite a long history of trying to do so. Nor has East Asia participated to the extent that Europe has in the adoption of regional agreements, which have increased markedly on a global scale in recent years. In the next section, we will take a closer look the development of East Asia's integration and the forces that are driving it.

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[22] See UNCTAD (2003: Annex table A.I.13.) for a list of these instruments worldwide.

[23] The OECD, of which 21 out of 30 members are European countries, has an additional 15 such instruments.

[24] A total of 98 agreements have been signed by the two groups but 27 of these are not currently in force.

[25] APEC has also contributed to the reduction of tariffs in the region through its Bogor Declaration, but as mentioned earlier, APEC includes countries from other regions and is therefore not strictly an East Asian regional arrangement.

[26] The European Union and EFTA together have five such instruments under negotiation.

[27] Officially named "the ASEAN-China Framework Agreement on Comprehensive Economic Cooperation".

Market-driven regional integration in East Asia

Given the undeveloped condition of East Asia's institutions, the region's historical preference for maintaining national control and sovereignty, and the weak political will for making the tough decisions necessary to advance regional cooperation, one could ask whether regional integration is taking place at all in East Asia, and if it is taking place, what is driving it. The remainder of this paper will address these questions and in the process show that regional integration is indeed proceeding in East Asia and that it is driven by market forces. In fact, the main driving force for regional integration in East Asia has been and continues to be the trade and FDI carried out by multinational corporations (MNCs) and the consequent development of cross-border production networks. We will reveal how the growth of assembly trade (or trade in parts and components) in the region is evidence of the growth of production networks or production sharing. We will also show that East Asia's involvement in production sharing has promoted its regional integration but not at the expense of its participation in production networks on a global scale.

While U.S. multinational corporations were the initiators of international production networks, MNCs in Japan and Europe quickly followed their lead, and MNCs in the Asian NIEs also became involved later on. Furthermore, China is playing an increasingly significant role in these networks. Before proceeding to a discussion of East Asia's involvement in production networks, however, we will examine trends in the development of East Asia's integration as reflected in its trade and FDI patterns.

East Asian trade and foreign direct investment

Trade and foreign direct investment are closely linked as important elements in cross-border production networks, which are the foundation of market-led integration in East Asia.[28] An examination of trade and FDI trends provides valuable information about the development and geographic distribution of production networks and the progression of integration in the region. On a global basis, trade and FDI have grown rapidly over the past two decades. East Asia has not only shared in that growth, but its performance has been distinguished among that of developing countries worldwide.

Trading patterns

From 1978 to 2001, global exports of goods and services rose by 5.5 percent annually in real terms. Developing countries' exports of goods and services increased at nearly the same rate, slightly less than 6 percent annually in real terms, during the same period while their aggregate exports-to-GDP ratio rose by more than half.[29] During the second decade of this period (the 1990s), the merchandise exports (not including services) of developing countries rose 8.5 percent per year, considerably more than the trends of less than 2 percent in the 1980s.[30]

[28] For a discussion of the links between trade and FDI and their effect on growth and development see Sakakibara and Yamakawa (2004) and World Bank (2003b, Chapters 2 and 3).

[29] World Bank (2003b, p. 46).

[30] World Bank (2003c, p. 40).

All the developing countries of East Asia have experienced significant growth in exports since the East Asian crisis in 1997-98, except in 2001 when many of them suffered a decline in exports. Merchandise export growth in developing East Asia[31] was 12.1 percent in 2002 and 22.6 percent in 2003, and growth in Southeast Asia[32] was 4.7 percent in 2002 and 12.8 percent in 2003. China's export growth has been exceptional, 22.4 percent in 2002 and 34.6 percent in 2003, due to its growing production capacity and good competitive position.[33]

Developing East Asia and Southeast Asia's merchandise import growth followed the same general trend as their export growth – 10.4 percent (2002) and 24.3 percent (2003) for East Asia and 4.2 percent (2002) and 10.6 percent (2003) for Southeast Asia. Here again, China had the highest growth rate of all developing East Asian countries in those two years, with the rate in 2003 (41 percent) nearly double the rate in 2002 (21.3 percent). China's exceptional import growth was the result of its "strong domestic demand, higher oil prices, and lower tariffs," and this growth caused China's trade surplus to decline from US$44.2 billion in 2002 to US$41.4 billion in 2003.[34]

The rapid growth in developing country exports has been attributed in large part to the change in the composition of their exports from traditional agriculture and resource products to manufactured goods. Low and middle-income groups[35] have increased the share of manufactured products to 80 percent and 70 percent, respectively, of their exports. Reportedly, this increase is not just the result of price declines for agricultural and resource commodities relative to manufactured goods, neither is it attributable to the impact of large, high-growth exporters such as China and India. Even excluding China and India from the calculation, the share of manufactured goods in total exports of developing countries rose significantly – from 10 percent in 1980 to 60 percent in 2001. In East Asia and the Pacific (including China but not India) the share rose from just over 50 percent in 1981 to nearly 90 percent in 2001.[36]

The World Bank (2003c, p. 41) attributes this growth in manufactured product exports to "a combination of policy reforms, structural changes in global production processes, and general economic trends related to continuous increases in real per capita incomes."[37] For developing countries, not only labor-intensive goods but also (and even more so) high-technology goods, in particular electronics, contributed to the gain in manufactured exports. Table 2 shows the annual growth rates of exports of high-value products for low, middle, and high income countries in 1981-2001.

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[31] East Asia in this case includes China, Hong Kong (China), Korea, Mongolia, and Taiwan (China).

[32] Southeast Asia in this case includes Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

[33] ADB (2004, p. 43 and Table A10, p. 286).

[34] ADB (2004, p. 43 and Table A12, p. 288).

[35] Most developing East Asian countries are included in these two groups.

[36] World Bank (2003c, pp. 63-67).

[37] See World Bank (2003c, pp. 41-42) for further details.

Table 2: Exports of high-value products by developing countries, 1981-2001 annual growth rates
(percent)

	Low income less China & India	**Low income**	**China and India**	**Middle income**	**High income**	**World**
Primary products	1	2	5	1	4	2
Resource-based manufactures						
Agricultural	7	8	12	6	6	6
Other	4	7	10	5	5	5
Low-technology manufactures						
Textiles	14	15	15	7	5	8
Others	16	19	20	10	6	8
Medium-technology manufactures						
Automotive and components	22	20	19	19	7	8
Process industry products	14	13	12	11	6	7
Engineering products	21	23	24	12	7	8
High-technology manufactures						
Electronic	21	26	36	17	10	13
Other	10	16	20	12	9	9
Total	13	15	17	10	6	7

Source: Compiled from World Bank (2003c, Table 2.1, p. 68); data from COMTRADE, WITS, WTO.
Note: Table presents the annual growth rates by product group and by country groups assigned on the basis of 1981 income levels to avoid the selection bias that results when end-of-period attributes are used as the basis for selection. Product definitions are supplied by the WTO. Data analysis undertaken in World Integrated Trade Solutions (WITS) using "mirror" data from UN COMTRADE. Country groups defined by income status in 1981. While the results from this approach must be treated with some caution, because the level of technology of the process involved is frequently more important that the technology level of the product, examining the nature of the products being traded is clearly of interest.

For low-income countries the growth rate in all three levels of technology manufactures (low, medium, and high) was well above the world average in 1981 to 2001. This is true whether or not China and India, which together have very high growth rates, are included. Particularly noteworthy is the 26 percent growth rate in low-income countries' exports of electronic manufactures, such as computers, televisions, and components. This rate drops by 5 percentage points if China and India (with a combined growth rate of 36 percent) are excluded.

A major contributing factor to the change in the export patterns of developing countries, especially the increase in high-technology exports, is global production sharing.[38] Electronic products, in particular, can be readily broken down into parts and components that can be manufactured and then assembled in different locations. This

[38] World Bank (2003c, p. 69) and Deardorff (2001b), and Hummels, Ishii, and Yi (2001).

capability facilitates the formation of cross-border production networks for these and similar products. Later in our discussion we will reveal that there has been an increase worldwide in the trade of parts and components and that East Asia has a significant and rising share of that trade. This growth in parts-and-components trade is an indication of East Asia's increased participation in production networks.[39]

Intraregional trade[40]

For centuries, East Asia's trade has been characterized as both global and regional. Reflecting the global aspect, all ASEAN countries reported over 10 percent of their trade (imports, exports, or both) to be with the European Union and the United States in 2001. However, nearly all East Asian countries also have significant trade with one or more regional partners, with Japan being a major partner for most, followed by Singapore, China, and a few other larger regional countries.

Over the past two decades, East Asia's[41] intraregional merchandise exports have increased as a share of total world exports from 4.6 percent in 1980 to 11.8 percent in 2001 and as a share of total East Asian exports from 33.7 percent in 1980 to 47.7 percent in 2001. These increases are consistent generally with the increases in NAFTA's intraregional shares in world exports (from 5.4 percent in 1980 to 10.4 percent in 2001) and in total NAFTA exports (from 33.6 percent to 55.5 percent in those years, respectively). The trend for the European Union, however, is different in that its intraregional exports as a share of world exports declined from 29.5 percent to 22.9 percent between 1990 and 2001, and they declined as a share of total European Union exports from 65.9 percent to 61.3 percent in the same period. However, the European Union's shares since 1980 have been at a much higher level than those of either East Asia or NAFTA, and they have remained fairly stable for the past few years.[42] Nevertheless, this decline is noteworthy considering that Europe is the region that has become the most integrated during that time.

Figure 1 shows the trade intensity index for selected regional groups in East Asia, Europe, and North America. ASEAN has had a much higher index than any of the other groups for the years shown. Its index range of 3.9 to 5.7 was well above that of the European Union (1.6 to 1.9) and NAFTA (around 3.0) indicating that ASEAN has had a higher degree of intraregional trade than the European Union or NAFTA in 1980 and the 1990s. The ASEAN+3 and All East Asia groups have indices greater than that of the European Union, but less than that of NAFTA.

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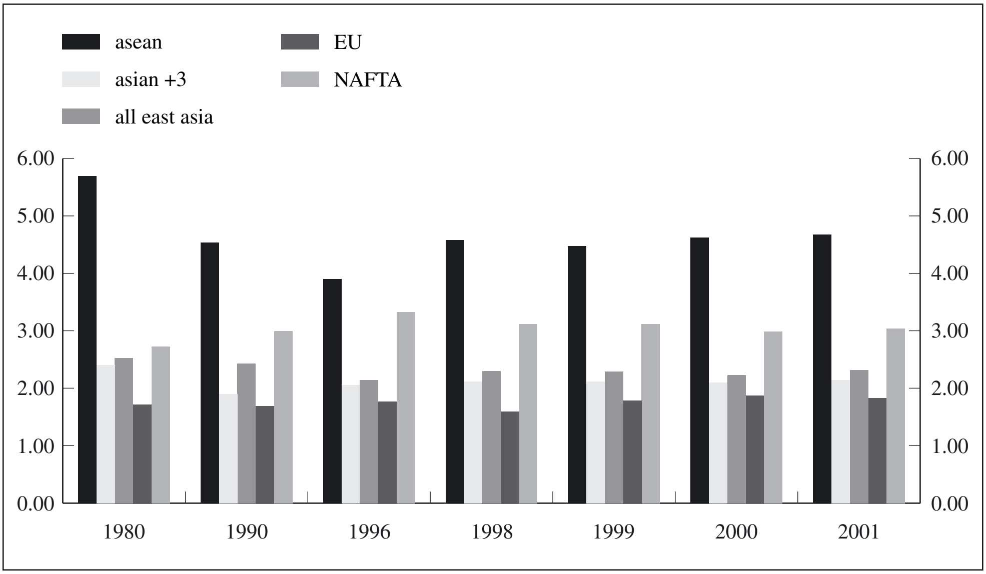
[39] World Bank (2003b, p. 46).

[40] The following discussion of East Asian intraregional trade draws from Sakakibara and Yamakawa (2004, pp. 72-84). Refer to that publication for details and further analysis on the topic of East Asian trade.

[41] East Asia (and "All East Asia" in Figure 1) includes the ASEAN countries plus Japan, Korea, China, Hong Kong (China), and Taiwan (China). Taiwan (China) is not included in 1980 and 1990 data.

[42] Sakakibara and Yamakawa (2004, Table 3.4, p. 76). Since data has been calculated back to 1980 on the basis of current group membership, these increases do not reflect the actual addition of new members.

Figure 1: Trade Intensity Index – intraregional, 1980-2001



Source: Sakakibara and Yamakawa (2004, Figure 3.1, p. 82); calculated using data from World Bank World Development Indicators (various years) and IMF Direction of Trade Statistics Yearbook (various years).

Overall, the data reveal that over the past 10 to 20 years East Asia's intraregional trade has increased significantly in importance in terms of world trade and its own trade, and that it is quite intense, particularly when compared with the intraregional trade of other regions.

Patterns of FDI flows[43]

Spurred by significant liberalization in East Asia during the 1980s and early 1990s, foreign direct investment inflows to the region increased about 2.6 times from an annual average of US$55 billion in 1991-96 to US$144 billion in 2000.[44] Although inflows then declined to US$93 billion by 2002, this figure still represents a 69 percent increase since the beginning of the 1990s.

[43] The discussion in this section is extracted directly from Sakakibara and Yamakawa (2004, pp. 84-94). Refer to that document for a complete review of FDI in East Asia. The source for data on FDI is UNCTAD (2003), unless otherwise indicated.

[44] East Asia in this context includes the ASEAN+3 countries, Hong Kong (China), and Taiwan (China).

In 2002, China attracted US$53 billion in FDI, the largest share of FDI inflows in the region as well as in the developing world.[45] This level of inflows represents a new high for China whose inflows were an annual average of only half that amount (US$25.5 billion) in 1991-96. China's advantage in attracting FDI lies in its huge domestic market, sustained rapid growth, improved export competitiveness, and recent accession to the WTO. Also contributing to its flows is the large overseas network of Chinese workers.[46]

The largest foreign direct investor in ASEAN from 1995 to 2001 (except in 1997) was the European Union, which accounted for 19-40 percent of investment (Figure 2).[47] The next largest investor is the United States, with a share of 20-30 percent in the past few years. Although the value of direct investment from the European Union and the United States in ASEAN was down significantly in 2001 from that in 1999 (by 41 percent and 37 percent, respectively), disinvestment (primarily in Indonesia and Malaysia) by Australia, Hong Kong (China), and Korea, and other unspecified countries in 2001 pushed up the share for the European Union and the United States.

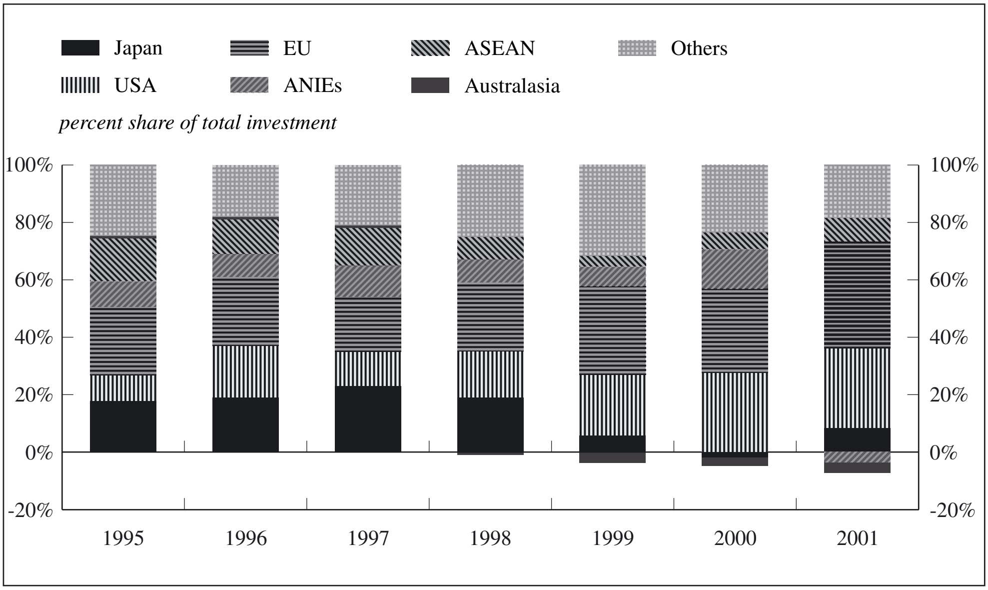
The share of ASEAN's FDI that comes from Japan dropped significantly from 23 percent in 1997 to only 9 percent in 2001. This was in part due to Japan's disinvestment in Indonesia of US$1.7 billion in 2000 and US$1.1 billion in 2001, and its disinvestment in Malaysia of US$1.2 billion in 2001.

[45] UNCTAD estimates that China's inflows would fall to about $40 billion in 2002 if round-tripping were taken into account. Round-tripping is the investment that comes from locations abroad but is made by investors from China, and it is believed to cause FDI flows to China to be overreported. It is estimated by the World Bank, however, that China's round-tripping will decrease in the future as it eliminates preferential treatment for foreign investors over domestic investors. UNCTAD (2003, pp. 43, 45).

[46] UNCTAD (2003, p. 42).

[47] Not including the category of "Others" which comprises fairly large investments from unspecified countries and unclassified sources, the latter covering the banking sector. Although not specified, this appears to relate to investment in the banking sector of Thailand in the postcrisis period.

Figure 2: FDI in ASEAN by source, 1995-2001
(in share)



Source: Compiled from ASEAN (2002, tables 3.1.2-3.1.9).
Note: Asian NIEs include Hong Kong (China), Korea, and Taiwan (China). Australasia is Australia and New Zealand. Others include Bermuda, Canada, the Cayman Islands, India, and Pakistan, as well as various Central and South American countries and a few others.

Japan's investment in China has been increasing since 1999. Before that, Japan invested far more in ASEAN-4 (Indonesia, Malaysia, the Philippines, and Thailand) than in China, but that investment began to decline sharply in 1997.[48] By 2002, the share of Japan's outward FDI to China was 8.1 percent, whereas that to ASEAN-4 was lower, at 6.8 percent. Although FDI outflows from Japan to East Asia rose by 2.8 percent in 2002, this finding reflects primarily increased flows to the Asian NIEs (by 20.3 percent) and to China (by 20.8 percent).[49] Outflows to ASEAN-4 declined by 25.3 percent in 2002.[50]

The specific industries targeted by Japanese investment in China have changed over time. In the mid-1980s, it was the food industry; in the early 1990s, it was the textiles industry; and since the end of the 1990s, it has been the chemical, electrical machinery, and transport machinery industries.[51]

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48 UNCTAD (2002, Box III.2., p. 44).
49 Asian NIEs in this case include Singapore in addition to Hong Kong (China), Korea, and Taiwan (China).
50 JETRO (2003, p. 16).
51 JETRO (2003, p. 17).

Intraregional FDI

Compared with those of the European Union, Asia's intraregional flows make up a smaller, but increasing, share of total flows. In 2001, 49 percent of the European Union's FDI outflows stayed within the European Union, and that share rose even higher to 66 percent in 2002.[52] By comparison, the developing East Asian group comprising ASEAN, China, and Hong Kong (China) as host economies and ASEAN, China, Hong Kong (China), Korea, and Taiwan (China) as source economies had a somewhat smaller intraregional share of 37 percent in 1999, increasing to 40 percent in 2001.[53] The Asian region has been at the forefront of a movement that began in the 1980s when MNCs located in developing countries began to increase their outward investment, mostly in other developing countries. South, East, and Southeast Asian firms have accounted for the major portion of these outflows – between 51 and 81 percent of developing-country outflows since 1997.[54] This position can be attributed to the export-oriented growth in these countries, which led to the growth of their MNCs; the MNCs then invested intraregionally as well as in industrial countries.[55]

There has been a noticeable shift intraregionally in flows away from the ASEAN countries to China. This shift was partly due to the Asian crisis, but recently, it has been caused more by the increase in China's attractiveness as a host country – an attractiveness generated largely by its lower wage costs and its highly skilled labor, as well as its increasingly liberalized trade and FDI environment. Not only Japan, but also other major regional investors, including Hong Kong (China), Korea, and Taiwan (China), are focusing on China. Between 1999 and 2001, Taiwan (China) reduced its investment in ASEAN by 67 percent while increasing its investment in China by 15 percent. Korea disinvested in ASEAN in 2001 and raised its investment in China by a remarkable 69 percent. And China raised its investment in ASEAN by 94 percent.[56]

Trade and FDI in East Asia: some conclusions

We can draw some general conclusions about East Asia's trade and FDI patterns:

- East Asia still does a great deal of trade with, and receives a large amount of direct investment from, the United States and the European Union, albeit from some European Union countries more than others.
- Although the United States and certain European countries are still Japan's primary trade and investment partners, there are signs of a shift in both Japan's trade and its FDI from outside to inside the region, and there are shifts within the region as well, such that Japan's shares of trade with and investment in China are beginning to surpass those with ASEAN.

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[52] UNCTAD (2003, p. 70).
[53] See Table 3.8, p. 92, in Sakakibara and Yamakawa (2004).
[54] UNCTAD (2003, pp. 253-56).
[55] UNCTAD (1999, p. 14).
[56] See Table 3.8, p. 92, in Sakakibara and Yamakawa (2004).

- ASEAN's trade with Japan is declining, while its trade with China and Korea is rising, and ASEAN is receiving less investment from Japan as well.
- The rise of China is having a major effect on the region's trade and FDI patterns as MNCs both inside and outside the region shift operations to that country, often from other countries within the region.

From these observations, we can discern the continuation of the highly liberalized nature of East Asia's trade and direct investment and the importance of maintaining its extraregional relationships. At the same time, intraregional relationships are strengthening as individual countries struggle to find a way to prosper and grow in the shadow of a rising China.

Trade and FDI are closely linked as major elements in the broader phenomenon of cross-border production networks. These networks and their role in the integration of East Asia are the focus of the discussion in the remainder of this paper.

Cross-border production networks facilitate regional integration in East Asia

Cross-border production networks are the focus of much analysis and discussion in economic literature today.[57] Although this phenomenon is identified in the literature by various names with sometimes different definitions,[58] Borrus, Ernst, and Haggard (2000, p. 2) describe it in its broadest sense as follows:

By a lead firm's "cross-border production network" (CPN) we mean the inter- and intra-firm relationships through which the firm organizes the entire range of its business activities: from research and development, product definition and design, to supply of inputs, manufacturing (or production of a service), distribution, and support services. We thus include the entire network of cross-border relationships between a lead firm and its own affiliates and subsidiaries, but also its subcontractors, suppliers, service providers, or other firms participating in cooperative relationships, such as standard setting or R&D [research and development] analysis.

Multinational corporations (MNCs) are attributed with initiating the phenomenon of cross-border production networks through their establishment of subsidiaries in other countries to handle certain stages of production. While MNCs are still at the center of most production networks, local firms in host countries are becoming increasingly involved in networks as subcontractors that are not directly part of an MNC.[59] Also emerging from the production network phenomenon are global contract suppliers who

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[57] For example, Athukorala (2003), Baldwin (2001), Borrus, Ernst, and Haggard (2000), Deardorff (2001a), Ernst (2002), Feenstra (1998), Jones and Kierzkowski (2001), Venables (1999), Navaretti, Haaland, and Venables (2002), and Yusuf, Altaf, and Nabeshima (2004).

[58] These names include production sharing, production outsourcing, cross-border or international production fragmentation, distributed manufacturing, and dispersed manufacturing. The concept may include only production-related activities in the network or all stages of the value chain. (See Yusuf 2003, pp. 273-74 for a discussion of the differences in these terms.).

[59] Athukorala (2003, p. 6).

serve a large and diverse set of purchasers.[60] In East Asia the concept of "third-party logistics" is emerging. This concept involves the outsourcing of logistics by international manufacturers to specialized service providers who can handle the efficient transport of components through "multimodal transport systems packaged with simplified trade documentation and clearances valid across modes" (Yusuf 2003, p. 278).[61]

In recent years, production networks have expanded to include many countries in the production of a single product. In the early stages of development a network might consist simply of the production of one small part or component of a good in a low-cost country and then its reimportation to the home country for assembly into the final good. This process has changed over the years so that it now involves many countries, and thus border crossings, in the production and assembly of a final product.[62] Thus, the development of cross-border production networks has led to the integration of the countries involved in the network.

As we mentioned earlier, a country's increased trade in parts and components is one indication of its increased participation in production sharing. Furthermore, as the trade (both imports and exports) in parts and components increases and more countries become involved in the production sharing system, their participation becomes more tightly woven into the network. This is true for East Asian countries on a global as well as intraregional basis.

Trade in parts and components

Due to fairly recent (mid-1980s) revisions in the publication of trade data, it is now possible to separate the trade data for parts and components from that of final products in the machinery and transport sector (SITC 7)[63] and in the miscellaneous goods sector (SITC 8) of total manufacturing trade. This parts-and-components trade (also called "assembly trade" or "fragmentation trade") currently occurs largely in the machinery

[60] These global suppliers have formed their own international networks that are used by MNCs or "lead firms" of international production networks. See Yusuf (2003) for a discussion of the concept of "lead firms" and the functions and performance demanded of global suppliers by today's international production networks.

[61] For a thorough analysis of logistics in East Asia see Heaver (2004).

[62] The final stage of assembly is still generally located in other industrialized countries or in NIEs because it requires labor with a high level of technical and managerial skills, good domestic supply and service networks, and excellent infrastructure, among other things. However, China is emerging as a location for final assembly because of its large domestic market for the products concerned; the existence of this market reduces the risks associated with establishing facilities there. (Athukorala 2003, p. 7).

[63] SITC is the acronym for Standard International Trade Classification.

and transport equipment sector (SITC 7).[64] Electronics and electrical equipment is a subsector of SITC 7 and that subsector is broken down further into 3-digit, 4-digit, and 5-digit groups that consist solely of components of manufactured equipment to be assembled.[65]

The assembly trade (exports and imports) of East Asia is heavily concentrated in electronics and electrical products. Over 80 percent of the region's total trade in 2000 was in parts and accessories of office machinery, telecommunications equipment, electrical circuit apparatus, and household electrical equipment.[66]

Between 1992 and 2000, world trade in parts and components rose from US$336.8 billion to US$1,086.4 billion, or average growth of 18 percent per year.[67] The share of these products in world manufacturing trade rose from 20.7 percent to 25.4 percent for exports and from 21.7 percent to 24.5 percent for imports between those two years (Table 3).

[64] Athukorala (2003, p. 10-11) cautions that even with the latest SITC revision, the data does not include all sectors where parts and components are used in product assembly. He goes on to say that assembly activities are spreading to other sectors, such as pharmaceutical and chemical products, but SITC 7 and 8 sectors include such a large proportion of total manufacturing trade (around 70 percent in 1992, 1996, and 2000) that the data should fairly represent this type of assembly trade.

[65] Two recent studies that have used this data to explore production networks in East Asia are Athukorala (2003) and Ng and Yeats (2003). The analysis in this section of the paper draws heavily from information and data presented in these two studies.

[66] These are 3-digit SITC sectors under electronics and electrical equipment, which is a subsector under machinery and transport equipment (SITC 7).

[67] Athukorala (2003, p. 12 and 25).

Table 3: Share of world trade in parts and components, 1992-2000
(percent)

Region/Country	**Exports**			**Imports**			**Trade balance**		
	1992	**1996**	**2000**	**1992**	**1996**	**2000**	**1992**	**1996**	**2000**
East Asia[a]	34.5	38.3	39.5	33.5	32.8	33.1	24.1	11.0	13.4
Developing East Asia	16.6	22.8	26.8	14.7	28.0	28.4	-34.8	-28.1	-9.4
ASEAN	7.7	11.8	13.6	12.6	14.5	12.0	-37.4	-27.8	8.5
Japan	17.9	15.5	12.6	4.5	4.7	4.7	78.7	68.4	61.9
Indonesia	0.2	0.3	0.5	1.2	0.9	0.3	-525.2	-259.3	26.1
Malaysia	2.6	3.4	3.7	3.5	3.8	3.6	-13.0	-16.0	0.4
Philippines	0.4	1.2	2.1	0.7	1.5	1.2	-38.4	-24.0	39.0
Singapore	3.4	5.6	5.5	5.0	6.0	5.1	-25.2	-10.3	3.8
Thailand	1.1	1.2	1.7	2.2	2.3	1.6	-60.3	-89.5	4.4
Vietnam	0.0	0.0	0.1	0.0	0.1	0.1	-1275.0	-371.7	-155.6
China	1.1	1.7	3.0	3.5	2.9	4.9	-168.5	-78.5	-71.4
Hong Kong (China)	2.2	0.9	0.5	3.3	4.6	4.9	-29.8	-408.9	-837.0
Korea	3.0	3.8	4.3	3.8	3.3	3.3	-9.5	10.5	20.3
Taiwan (China)	2.7	4.5	5.4	3.3	2.8	3.2	-4.4	36.0	38.7
NAFTA	28.2	24.0	23.9	33.5	25.8	27.5	-0.1	-11.8	-18.9
United States	22.1	18.7	17.0	23.2	17.7	17.7	11.8	1.7	-1.9
European Union	32.8	38.0	30.9	35.1	33.8	21.5	10.0	7.6	28.3
World[b]	100.0	100.0	100.0	100.0	100.0	100.0			
World ($ billion)	336.8	756.9	1,086.4	336.8	756.9	1,086.4			
Share of parts and components in world manufacturing trade	20.7	21.7	25.4	21.7	21.4	24.5			

Source: Compiled from Athukorala (2003, Table 1, pp. 25); data from UN COMTRADE database.
[a] East Asia includes Japan and the developing countries. The developing countries include China, Korea, Taiwan (China), Hong Kong (China), and ASEAN (excluding Brunei Darussalam, Cambodia, Lao PDR, and Myanmar because of the lack of data).
[b] Does not sum to 100 percent because some countries and regions are not included in the table.

Table 3 shows that East Asia's share of world exports of parts and components increased from 34.5 percent in 1992 to 39.5 percent in 2000. This gain in share reflects the increase of 10 percentage points in developing East Asia's share, which more than offset the decline of 5 percentage points in Japan's share. All the developing countries included in Table 3, except Hong Kong (China), reported at least some gain in share of world parts-and-components exports.

East Asia's share of world imports of parts and components remained about the same in 2000 (33.1 percent) as it was in 1992 (33.5 percent). However, if Japan, whose share remained relatively unchanged during that period, is excluded from the calculation, then (developing) East Asia's share increases substantially, by nearly 14 percentage points. In addition, developing East Asia's share of world imports is nearly the same as its share of world exports in parts and components, particularly in 2000. Athukorala (2003, p. 12-14) argues that this finding reflects Japan's prominent role in assembly activities in East Asia and that Japan's large trade surplus (Table 3) can be attributed to the heavy involvement of Japanese companies in such activities. He also attributes the trade positions of Malaysia, the Philippines, and Singapore, all of which shifted from deficits to surpluses between 1992 and 2000, to growing intraregional cross border trade in assembly products. This shift can be seen in the column under "Trade balance" in Table 3 and in the columns under "Exports" and "Imports", where it is shown that in 1992 import shares for these three countries exceeded export shares. While these shares increased slightly between 1992 and 2000, their export shares increased even more, so that by 2000 their export shares exceeded their import shares, leading them from a position of trade deficit to trade surplus.

Tables 4A and 4B reveal that East Asia has a greater dependency on assembly trade than do NAFTA, the European Union, and the world. The share of parts and components in East Asia's total manufacturing exports was 32 percent in 2000 compared with 28.1 percent for NAFTA, 18.9 percent for the European Union, and 25.4 percent for the world. In 1992-2000, the contribution of parts and components to East Asia's export growth (43.5 percent) was also greater than the contribution to NAFTA's growth (30 percent), to the European Union's growth (22.2 percent), and to world growth (29.5 percent).

These regions' import shares of parts and components were in line with their export shares. Import shares in 2000 were 35.4 percent for East Asia, 22.8 percent for NAFTA, and 20.3 percent for the European Union. Although most countries within East Asia have fairly large assembly-trade shares, Malaysia, the Philippines, and Singapore are particularly notable for their shares that are 50 percent or higher for both exports and imports. In addition, assembly trade has contributed over 50 percent to export and import growth in these three countries, in Japan (exports only), and in Indonesia, Korea, and Thailand (imports only). The share of this type of trade in China's total manufacturing trade is also worthy of note because it has risen from 6.7 percent in 1992 to 14.5 percent in 2000 for exports and from 19.5 percent to 33.5 percent for imports. Parts and components contributed 42 percent to China's import growth between 1992 and 2000.

Table 4A: Share of parts and components in manufacturing trade
(percent)

Exports

Region/Country	**Share of parts and components**			**Export growth**	**Contribution of parts & components to export growth**
	1992	**1996**	**2000**	**1992-2000**	**1992-2000**
East Asia	21.3	28.0	32.0	3.8	43.5
Developing East Asia	19.7	26.7	32.8	5.1	41.9
ASEAN	26.4	35.0	44.4	5.6	55.0
Japan	22.9	30.2	30.6	1.8	50.4
Indonesia	4.0	7.4	14.2	4.4	22.7
Malaysia	40.4	42.6	49.7	6.2	54.3
Philippines	23.9	52.5	64.0	9.0	74.3
Singapore	28.2	39.7	49.6	4.9	64.5
Thailand	21.2	23.4	35.9	4.8	46.7
Vietnam	2.0	5.2	8.7	21.0	8.9
China	6.7	9.8	14.5	6.7	17.9
Hong Kong (China)	21.5	26.7	25.8	-3.2	16.3
Korea	17.8	25.2	30.6	4.5	41.0
Taiwan (China)	20.1	28.8	37.8	5.8	47.4
NAFTA	26.2	27.2	28.1	4.1	30.0
United States	26.9	30.5	31.6	3.3	37.5
European Union	15.5	17.7	18.9	3.9	22.2
World	20.7	21.7	25.4	4.2	29.5

Table 4B: Share of parts and components in manufacturing trade
(percent)

Imports

Region/Country	**Share of parts and components**			**Import growth**	**Contribution of parts & components to import growth**
	1992	**1996**	**2000**	**1992-2000**	**1992-2000**
East Asia	22.8	27.9	35.4	4.4	45.9
Developing East Asia	24.8	30.2	38.4	4.5	49.3
ASEAN	30.4	39.3	48.6	3.6	68.2
Japan	15.4	19.3	24.2	4.1	32.1
Indonesia	20.5	23.8	19.4	-0.1	63.6
Malaysia	37.9	47.5	58.8	4.2	77.5
Philippines	32.6	43.6	55.1	6.9	64.4
Singapore	32.0	42.8	51.7	3.9	70.7
Thailand	26.6	32.9	39.8	2.6	62.0
Vietnam	4.2	11.1	19.1	10.1	22.1
China	19.5	21.1	33.5	5.4	42.0
Hong Kong (China)	15.1	20.4	28.2	5.2	36.7
Korea	26.7	27.4	38.9	3.6	52.1
Taiwan (China)	29.6	35.0	37.3	5.1	42.5
NAFTA	20.4	23.6	22.8	4.8	24.6
United States	18.2	21.7	19.4	4.7	20.3
European Union	16.0	18.9	20.3	2.4	28.0
World	21.7	21.4	24.5	5.9	26.0

Source: Compiled from Athukorala (2003, Table 1, pp. 30-31); data from UN COMTRADE database.
Note: East Asia includes Japan and the developing countries. The developing countries include China, Korea, Taiwan (China), Hong Kong (China), and ASEAN (excluding Brunei Darussalam, Cambodia, Lao PDR, and Myanmar because of the lack of data).

Intraregional trade in parts and components

Parts and components comprise a major proportion not only of East Asia's total trade (as previously discussed) but also of its intraregional trade. This finding goes to the heart of the discussion in this paper. In other words, significant intraregional production sharing is taking place in East Asia and, in fact, has increased since the mid-1980s.

Between 1985 and 2001, the share of machinery and transport equipment (SITC 7) in developing East Asia's total intraregional exports increased from 18.1 percent to 47.9 percent, indicating a significant rise in the relative importance of this sector in East Asia's intraregional trade.[68] Although this increase occurred for all developing East Asian countries, especially notable were the gains in share between 1985 and 2001 for China (32 percentage points), Malaysia (49 percentage points), the Philippines (44 percentage points), Singapore (34 percentage points), and Thailand (38 percentage points).[69] Ng and Yeats (2003, p. 33) attribute these gains to the participation of these countries in international production networks and point out that China in particular specializes in the assembly of imported parts and components.

The Asian Development Bank (ADB) reported recently that between 1995 and 2003, exports to China from all of Asia grew at an average annual rate of 16.9 percent (measured in US dollars), which was more than three times the 5.3 percent growth in world trade, due to China's "strong economic growth, stable yuan exchange rate, and the international segmentation of production processes."[70] The ADB also reported that during the same period, exports of precision instruments and electrical machinery to China from its nine major regional trading partners increased sixfold, and exports of machinery, chemical products, and transportation equipment from the same countries increased threefold.[71] In 2003, the main categories of exports from these nine economies to China were electrical machinery (34 percent share), machinery (17 percent share), chemical products (15 percent share), and textiles and apparel (6 percent share).

In fact, over the past decade, nearly all major East Asian economies have experienced a change in the products they export to China from those in low value-added sectors to those in high value-added sectors. The ADB attributes this shift in product composition to an increase in production sharing as described below:

The PRC [China] has established a strong comparative advantage in downstream stages of production, especially for electronics products, largely a result of its massive foreign direct investment inflows and large supply of low cost labor. The final stages of production of some items have been moved to the PRC from other Asian economies. As a result, the PRC's demand for intermediate components from its nine major regional trading partners has grown sharply, while its exports of final goods to non-Asian industrial economies also increased significantly. The structural trade balances between the PRC and its major trading partners clearly show its role as an assembly center for many exports from Asia to the United States and European Union.[72]

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[68] Data in this section is sourced from Ng and Yeats (2003) who define East Asia to include Brunei Darussalam, Cambodia, China, Hong Kong (China), Indonesia, Korea, Lao PDR, Malaysia, Mongolia, the Philippines, Singapore, Taiwan (China), Thailand, and Vietnam. Some references include Japan, and these will be noted as such.

[69] Ng and Yeats (2003, Tables 11.1 and 11.2, pp. 34-36).

[70] ADB (2004, p. 5).

[71] The ADB identifies Hong Kong (China), Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, Taiwan (China), and Thailand as China's nine major Asian trade partners.

[72] ADB (2004, p. 5).

Between 1995 and 2003, China's trade balances in machinery, electrical machinery, chemical products, and transportation equipment have become increasingly negative in the case of its nine Asian partners but increasingly positive in the case of the United States and the European Union.[73] These findings indicate that China's participation in production sharing is both regional and global. Participation in production sharing on these two levels is also the case for East Asia as a whole.

Table 5: The composition of East Asian exports to regional and non-regional markets in 1985, 1995 and 2001

	East Asia			**Japan**			**All other counries**		
East Asian Exports (SITC No.)	**1985**	**1995**	**2001**	**1985**	**1995**	**2001**	**1985**	**1995**	**2001**
	East Asian exports (US$ million)								
All goods	48,965	306,767	398,516	35,007	118,841	145,003	99,339	382,846	574,780
	Share of East Asian exports *(percent)*								
All goods (0 to 9)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Food and live animals (0)	8.6	3.4	2.7	12.1	13.1	8.8	6.3	3.3	2.6
Beverages and tobacco (1)	0.5	0.5	0.3	0.1	0.1	0.1	0.3	0.1	0.1
Crude materials, inedible (2)	8.1	3.7	2.4	11.4	6.6	3.6	4.5	2.5	1.4
Mineral fuels and lubricants (3)	23.0	6.2	7.1	50.9	12.9	12.6	7.4	1.2	1.6
Animal and vegetable oils (4)	1.9	0.8	0.4	0.5	0.4	0.2	2.3	1.3	0.5
Chemicals and related products (5)	5.0	7.8	8.3	2.4	3.1	3.6	2.0	3.1	3.2
Manufactured goods (6)	18.2	20.8	15.1	8.7	13.4	10.1	14.9	11.4	11.0
Machinery and transport equipment (7)	18.1	38.6	47.9	3.5	24.9	35.4	24.4	45.5	48.5
Miscellaneous manufactured articles (8)	10.6	16.7	15.2	8.6	23.8	23.4	36.6	30.4	29.8
Commodities and transactions, nes (9)	5.8	1.6	0.6	1.9	1.8	2.1	1.1	1.0	1.4

Source: Compiled from Ng and Yeats (2003, Table 11, p. 36).
Note: East Asia includes Brunei Darussalam, Cambodia, China, Hong Kong (China), Indonesia, Korea, Lao PDR, Malaysia, Mongolia, the Philippines, Singapore, Taiwan (China), Thailand, and Vietnam.

[73] ADB (2004, Box Figure 2, p. 6).

East Asia's exports of machinery and transport equipment (SITC 7) increased as a share of its intraregional exports between 1985 and 2001. However, they also increased as a share of its exports to Japan (from 3.5 percent to 35.4 percent) and to countries outside of East Asia (from 24.4 percent to 48.5 percent). Thus, this category of exports accounts for the largest share of both East Asia's intraregional exports and its extraregional exports.

As we previously mentioned, the machinery and transport sector (SITC 7) includes trade in parts and components as well as in final goods, and it is the trade in parts and components that is relevant in assessing the degree of production sharing in the region. Ng and Yeats (2003, p. 53) found that "East Asian intra-trade in goods normally used in production sharing grew at an annual rate of 21 percent from the mid-1980s to mid-1990s. This was approximately 7 percentage points higher than East Asia's intra-trade in all goods." By 2001, East Asia's regional trade in parts and components had increased to 26.2 percent of its total regional manufacturing trade (excluding chemicals). Furthermore, this regional trade in parts and components is fairly concentrated with nearly 85 percent of it accounted for by only four products: parts of office machinery (37.5 percent), parts of telecommunications equipment (27.7 percent), switchgear (12.9 percent), and electronic components (6.7 percent).[74]

The importance of parts and components in both the regional and non-regional trade of East Asia is further evident at the four-digit SITC level. For example, in 2001 several major products at the four-digit level, including "parts of office machinery" (SITC 759.9) and "parts of telecommunications equipment" (SITC 764.9), were among East Asia's top 30 four-digit SITC exports both on a regional and non-regional basis.[75]

The high degree of production sharing in East Asia is evident in the results of a survey of "high-performing" East Asian firms in seven East Asian countries presented in Yusuf (2003). These results (Table 6) indicate that internationally networked firms are prevalent in East Asia.[76]

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[74] Ng and Yeats (2003, Table 17.1, pp. 54-55).

[75] See Ng and Yeats (2003, Tables 12.1 and 12.2, pp. 39-40) for specific data.

[76] The survey covered 1,500 Chinese firms in five cities and 326 firms in six other East Asian countries (Indonesia, Korea, Malaysia, the Philippines, Singapore, and Thailand). A firm was classified as a member of an international production network if its general manager reported that since January 1999, it had (1) used parts specifically supplied by a foreign firm and (2) produced parts for a foreign firm or produced final goods to the specifications of a foreign firm. (See Yusuf 2003, p. 295-305 for further information on this survey).

Table 6: Prevalence of networking among firms in East Asia

Indicator	Chinese firms	Non-Chinese firms[a]
Number of firms in survey	1,500	326
Number of internationally networked firms	219	76
Percentage of internationally networked firms that:		
Import parts and produce parts or final goods for foreign buyers	100.0	100.0
Import parts and produce final goods for foreign buyers	71.2	72.5
Import parts and produce parts for foreign buyers	61.6	72.5
Import parts and produce parts and final goods for foreign buyers	32.2	43.3
Number of firms not internationally networked	1,281	250

Source: Yusuf (2003, Table 7.4 p. 296) compiled from survey of firms in China and several other East Asian nations conducted by the World Bank during the spring of 2001.
[a] Firms in Indonesia, Korea, Malaysia, the Philippines, Singapore, and Thailand.

Of the non-Chinese firms surveyed, nearly one-quarter are internationally networked with 43.3 percent of those (or 10 percent of the total 326 firms) both importing parts and producing parts and final goods for foreign buyers. The results for Chinese firms in the survey are not quite as strong. Only 14.6 percent of these firms are internationally networked with just 32.2 percent both importing parts and producing parts and final goods for foreign buyers. Yusuf (2003) attributes the weaker result for the Chinese firms to China's "relatively recent and ongoing integration into the world trading system."[77]

The central roles of Japan and China in East Asian production networks

The roles of both Japan and China in production networks are worthy of special note. Japan's role has been pivotal historically in the establishment and expansion of production networks in East Asia, and China is already showing signs of becoming a key player in these networks.

In any discussion of Japan's role in the formation of production networks in East Asia, the flying-geese model always comes to mind.[78] Japan established regional production networks in East Asia through its extensive foreign direct investment and the cross-border activities of its MNCs.[79] These activities included trade, investment, licensing, and sub-contracting. These original networks were extended as other countries in the region followed Japan's strategy of industrial development. Japanese MNCs have come under some criticism for allegedly continuing to utilize their own subsidiaries and

[77] Yusuf (2003, p. 295).

[78] In the "flying geese" model Japan's lead was followed by the Asian NIEs [Singapore, Hong Kong (China), Taiwan (China), and Korea], then by the ASEAN-4 (Malaysia, the Philippines, Indonesia and Thailand), by China, and most recently by Vietnam. See Ozawa (1999) for a detailed description of the flying-geese model.

[79] For a comprehensive discussion of the historical development of production networks in East Asia, see Yusuf (2004, pp. 8-11) and Sturgeon and Lester (2004, pp. 44-56 and 74-78).

keiretsu-related firms for their large-scale sourcing throughout the region and thus limiting the opportunities for local firms to upgrade their capabilities.[80] Yet, Japanese firms are recognized for their substantial impact on industrial upgrading through their substantial flows of technology, investment, and training resources to East Asian economies.[81]

Today, Japan continues to play a major role in regional production networks as seen in Table 7, which provides a matrix of intraregional trade in parts and components among East Asian countries in 2001. Japan was by far the largest exporter of parts and components to the region in that year with a value of US$38.7 billion, or 31 percent of the total parts-and-components exports of all 10 countries included in the table. China followed Japan with a value of US$26.8 billion, or 22 percent of total regional parts-and-components exports. China's export value represents an increase of nearly US$16 billion since 1995. Half of China's parts exports go to Hong Kong (China), and 21 percent go to Japan, whereas 37 percent of Japan's parts exports go to China and Hong Kong (China).

Evidence of Japan's role as the major exporter in intraregional parts trade can be found also in the share of each exporter in the total imports of its trading partners (bottom half of Table 7). For many countries, including Indonesia, Korea, the Philippines, Taiwan (China), and Thailand, Japan's share in their total parts imports is close to or over 50 percent. And China obtains over 43 percent of its parts imports from Japan. Among the countries included in Table 7, China is the largest supplier of parts only to Hong Kong (China) (45.5 percent) and to Japan (36.7 percent).

80 See Yusuf (2003, pp. 284-86) and Sturgeon and Lester (2004, pp. 77-78).
81 Sturgeon and Lester (2004, pp. 74-75).

Table 7: Matrix of intra-trade and trade balances in parts and components among East Asian countries, 2001

	Exporter										
Partner (Importer)	**China**	**Hong Kong (China)**	**Indo-nesia**	**Korea**	**Malay-sia**	**Philip-pines**	**Singa-pore**	**Taiwan (China)**	**Thai-land**	**Japan**	**EA10***
Value of exports of parts and components (US$ million)											
China	0	1,542	313	2,442	1,267	342	759	3,279	952	8,292	19,188
Hong Kong (China)	13,556	0	97	2,038	2,070	494	1,980	2,928	513	6,119	29,795
Indonesia	109	13	0	114	40	10	219	64	82	1,558	2,209
Korea	1,695	230	64	0	330	183	287	754	162	4,317	8,022
Malaysia	1,394	745	500	748	0	416	1,697	1,102	687	3,610	10,899
Philippines	170	502	26	788	259	0	804	523	256	3,683	7,011
Singapore	1,989	808	1,426	838	4,611	390	0	1,118	1,623	3,890	16,693
Taiwan (China)	1,308	237	42	719	303	202	529	0	97	3,502	6,939
Thailand	1,030	153	139	486	729	625	490	363	0	3,714	7,729
Japan	5,587	238	500	1,728	1,086	1,229	766	2,866	1,230	0	15,230
All of the above	26,838	4,468	3,107	9,901	10,695	3,891	7,531	12,997	5,602	38,685	123,715
Share of exporter in total imports of the trading (*percent*)											
China	0.0	8.0	1.6	12.7	6.6	1.8	4.0	17.1	5.0	43.2	100.0
Hong Kong (China)	45.5	0.0	0.3	6.8	6.9	1.7	6.6	9.8	1.7	20.5	100.0
Indonesia	4.9	0.6	0.0	5.2	1.8	0.5	9.9	2.9	3.7	70.5	100.0
Korea	21.1	2.9	0.8	0.0	4.1	2.3	3.6	9.4	2.0	53.8	100.0
Malaysia	12.8	6.8	4.6	6.9	0.0	3.8	15.6	10.1	6.3	33.1	100.0
Philippines	2.4	7.2	0.4	11.2	3.7	0.0	11.5	7.5	3.7	52.5	100.0
Singapore	11.9	4.8	8.5	5.0	27.6	2.3	0.0	6.7	9.8	23.4	100.0
Taiwan (China)	18.9	3.4	0.6	10.4	4.4	2.9	7.6	0.0	1.4	50.5	100.0
Thailand	13.3	2.0	1.8	6.3	9.4	8.1	6.3	4.7	0.0	48.0	100.0
Japan	36.7	1.6	3.3	11.3	7.1	8.1	5.0	18.8	8.1	0.0	100.0
Trade balance of exporter											
Value (US$ million)	7.650	–25,327	898	1,879	–204	–3,120	–7,736	6.058	–2,127	23,455	–
Share of exports (%)	28.5	–566.8	28.9	19.0	–1.9	–80.2	–102.7	46.6	–38.0	60.6	–

Source: Compiled from Ng and Yeats (2003, Table 18.1, p. 58).
* East Asia includes only 10 countries due to the lack of COMTRADE data for Brunei, Cambodia, Lao PDR, Mongolia and Vietnam in 2001.

Japan's heavy involvement in production sharing in East Asia can be seen from a different perspective in Table 8, which shows the sales of Japanese overseas subsidiaries in the United States and in selected East Asian and European countries for FY2001 and FY2002. Local sales of Japanese overseas subsidiaries in the East Asian countries were between 18 percent and 58 percent of the subsidiaries' respective country sales, while local sales of Japanese subsidiaries in the United States and in the European countries were between 65 percent and 92 percent. Exports going directly to Japan from the United States and the European countries were only 1-2 percent, but exports to Japan from the East Asian countries were between 20 percent and 41 percent. Thus, the proportion of Japanese affiliates' exports that went to third countries (countries other than Japan or the country of operation) from the East Asian countries was around 30-50 percent, but the proportion from the European countries was smaller at 22-34 percent and that from the United States was only 6.4 percent. Although the composition of these exports is not known, these three sets of statistics indicate that Japanese overseas affiliates tend to export to Japan and to third countries from East Asia much more than they do from North America and Europe. This tendency is consistent with Japan's heavy involvement in the assembly trade of production networks in the region.

Table 8: Business activities of Japanese overseas subsidiaries in selected countries, FY2001-2002

		US$ millions		Percent of subsidiaries' country sales	
Location of subsidiary	**Subsidary sales[a]**	**FY2001**	**FY2002**	**FY2001**	**FY2002**
China	Total sales	24,905	29,107	100.0	100.0
(incl. HK)	Local sales	8,823	10,553	35.4	36.3
	Exports to Japan	8,375	9,991	33,6	34.3
Indonesia	Total sales	8,001	9,498	100.0	100.0
	Local sales	3,167	4,253	39.6	44.8
	Exports to Japan	1,785	1,882	22.3	19.8
Malaysia	Total sales	13,001	12,817	100.0	100.0
	Local sales	3,458	3,437	26.6	26.8
	Exports to Japan	3,097	2,938	23.8	22.9
Philippines	Total sales	7,713	8,990	100.0	100.0
	Local sales	1,407	1,636	18.2	18.2
	Exports to Japan	3,169	3,388	41.1	37.7
Singapore	Total sales	12,109	10,963	100.0	100.0
	Local sales	5,994	4,833	49.5	44.1
	Exports to Japan	1,941	1,778	16.0	16.2
Thailand	Total sales	15,935	21,225	100.0	100.0
	Local sales	8,211	12,234	51.5	57.6
	Exports to Japan	3,834	4,350	24.1	20.5
United States	Total sales	158,673	160,677	100.0	100.0
	Local sales	145,358	148,012	91.6	92.1
	Exports to Japan	2,689	2,380	1.7	1.5

Table 8: Continued

Location of subsidiary	Subsidary sales[a]	US$ millions FY2001	FY2002	Percent of subsidiaries' country sales FY2001	FY2002
United Kingdom	Total sales	21,023	23,151	100.0	100.0
	Local sales	15,818	17,779	75.2	76.8
	Exports to Japan	361	300	1.7	1.3
France	Total sales	6,343	7,202	100.0	100.0
	Local sales	4,200	4,671	66.2	64.9
	Exports to Japan	119	98	1.9	1.4
Germany	Total sales	8,536	9,385	100.0	100.0
	Local sales	5,892	6,670	70.1	71.1
	Exports to Japan	120	121	1.4	1.3
World Total	Total sales	347,401	372,167	100.0	100.0
	Local sales	256,477	274,832	73.8	73.8
	Exports to Japan	28,932	30,945	8.3	8.3

Source: FY2001, compiled from Japan METI, "The Bahovior of Overseas Subsidiaries", June 2002, p. 39 of "Report" and p. 2 of "Statistics". FY 2002 compiled from Japan METI, "Trends in Overseas Subsidiaries", September 30, 2003, p. 42 of "Report" and p. 1 "Statistics". Available online at http://www.meti.go.jp/statistics/index.html.
Note A: The data in this are estimates of Japanese overseas subisdiaries' activities because (1) the data are based on a series of quarterly surveays, (2) the survey questions and companies included were sometimes changed quarter to quarter, and the response rate varied from quarter to quarter with non-reporting componies' performance figures being estamated. For further information, see course.
Note B: Survey covers all industries except finance, insurance and real estate and includes parent companies with more than 100 million yen capital, more than 50 employees, and with overseas subsidiaries that are manufacturing companies with more than 50 employees, and more than 50% investment by the parent company.
[a] Total sales are sales of Japanese subsidiaries located in designated country. Local sales are sales in the countries where overseas subsidiaries are located. Exports to Japan are products exported directly to Japan.

In 2001, China ranked second [after Hong Kong (China)] as an importer of parts and components from East Asian countries (top half of Table 7). The reason for China's high volume of parts imports (US$19.2 billion) was in fact policy related (as opposed to market driven). The Chinese authorities encouraged component trade through their policies, such as tariff exemptions, because they viewed the local assembly of foreign components as a means to enter high technology product markets. They also believed that importing components would lower production costs and thus improve the foreign competitiveness of other industries.[82]

[82] These reasons were indicated by the Chinese authorities in consultations with the World Bank in the early 1990s. See World Bank (1994) for further details (Ng and Yeats 2003, p. 57).

Hong Kong (China) and Singapore's high volume of parts-and-components imports (US$29.8 billion and US$16.7 billion, respectively, in 2001) was also in part policy related. Partly in reaction to the East Asian crisis, both economies sought to upgrade the final composition of their exports by encouraging the production of high technology products, for which they needed to import parts and components for assembly.[83]

Ng and Yeats (2003) attribute China's trade surplus of US$7.7 billion in intraregional parts trade in 2001 (Table 7) mainly to its special trading relationship with Hong Kong (China).[84] Because of this relationship, Ng and Yeats (2003) decided to net out the intra-trade between China and Hong Kong (China) in order to present a clearer picture of the intra-trade among the three entities: (1) China and Hong Kong (China) combined, (2) Japan, and (3) the rest of East Asia.

[83] Ng and Yeats (2003, pp. 57, 59).

[84] Hong Kong (China) imports from China an unusually high volume of parts and components (particularly parts of telecom equipment), well above the average volume of imports of these goods in other East Asian countries. For more details, see Ng and Yeats (2003, p. 59).

Table 9: Trade in parts and components between China and Hong Kong (China) combined and other East Asian producers in 2001

	Exporter			
Partner (importer)	**China and Hong Kong (China)**	**East Asia (7)[a]**	**Japan**	**All East Asia**
Value of exports of parts and components (US$ million)				
China and Hong Kong (China)	–	19,474	14,411	33,885
East Asia (7)[a]	10,383	24,845	24,274	59,502
Japan	5,825	9,405	–	15,230
All East Asia	16,208	53,724	38,685	108,617
Share of exporter in total imports of trading partner (*percent*)				
China and Hong Kong (China)	–	57.4	42.6	100.0
East Asia (7)[a]	17.4	41.8	40.8	100.0
Japan	38.2	61.8	–	100.0
All East Asia	14.9	49.5	35.6	100.0
Trade balance of exporter (US$ million)				
China and Hong Kong (China)	–	9,091	8,586	17,677
East Asia (7)[a]	–9,091	–	14,867	5,778
Japan	–8,586	–14,869	–	–23,455
All East Asia	–17,677	–5,778	29,280	–
Trade balance as a percent of exports (*percent*)				
China and Hong Kong (China)	–	46.6	59.6	52.2
East Asia (7)[a]	–87.5	–	61.2	9.7
Japan	–147.4	–158.1	–	–154.0
All East Asia	–109.1	–10.8	60.6	–

Source: Compiled from Ng and Yeats (2003, Table 18.3, p. 60).
[a] Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand.

Through this adjustment it is revealed that the combination of China and Hong Kong (China) is a major intraregional importer of parts and components for assembly. In 2001, 57.4 percent of China and Hong Kong's (China) total parts-and-components imports came from East Asia (7 countries) and 42.6 percent from Japan. However, as an exporter of parts and components in the region, it supplies only 17.4 percent of East Asia's parts-and-components imports and 38.2 percent of Japan's.[85] Therefore, China and Hong Kong (China) together have a trade deficit for these goods that is around US$9 billion with Japan and East Asia, each. This data emphasize the importance of China and Hong Kong (China) in the region's assembly trade and production sharing system.

Reasons for East Asia's major role in assembly trade

There are a number of reasons for East Asia's major role in assembly activities and the growth of production networks in the region.

The reduction of trade barriers and the elimination of restrictions on FDI in East Asia have made the region attractive to MNCs, which were responsible for initiating and expanding production networks in the region.

East Asia has lower wages in manufacturing than do countries in Europe and North America. Furthermore, significant differences in wages among the countries of East Asia have led to increased cross-border production sharing in parts and components, which has led to increased "intraregional" production networks.[86]

MNCs tend to locate their assembly activities in countries where there are already other key participants so that countries such as Singapore, Korea, Taiwan (China), and Malaysia, which became part of international production networks early on, can attract even more assembly activities as networks grow.[87]

Over time, MNC affiliates in a particular country invest in the local production facilities and establish information links and become accustomed to the investment climate so that they are reluctant to withdraw even for cost reasons.[88]

Concluding remarks

The integration processes in Europe and East Asia developed along different paths. In Europe, the process was driven by governments and their policies, including the early creation of regional institutions, which strengthened over time to become a driving force for integration in their own right.

In East Asia, where regional institutions are not well developed, integration has nevertheless progressed to a fairly high level, and the driving force behind it has been the market, or more specifically, multinational corporations and their production networks. This assessment is supported by the data for East Asia's parts-and-components trade as

[85] Further evidence of China as a major importer of parts and components from East Asia is presented in Ng and Yeats (2003, Table 4.1, p. 11), which shows "parts of office machines" and "parts of telecom equipment" as the first and third largest products, respectively, in China's imports from East Asia in 2001. However, on the export side, their Table 4.2, p. 12 reveals that these two products have risen from less than 1 percent share of China's total exports to East Asia in 1987 to around 4 percent in 2001, thus ranking second and fourth in the list of 30 largest products in China's exports to East Asia.

[86] Athukorala (2003, p. 13).

[87] Athukorala (2003, p. 13), Barry and Bradley (1997), and Ruane and Görg (2001).

[88] Athukorala (2003, p. 13).

presented in this paper. In recent years, parts and components have made up an increasingly large share of East Asia's total manufacturing trade, indicating the region's increasing involvement in production networks. As these production networks evolve and grow, they bind the countries involved in them into closer and closer cooperation. And when the countries in the network are located within the same region, the process leads to deeper regional integration.

Three points that have important implications for the future of regional integration in East Asia can be drawn from this paper. First, China's role in regional production sharing has grown markedly in recent years. China has been described as a specialist in assembly trade and the increase in its imports of parts and components from its major East Asian partners is an indication of its integration into regional production networks. Although China's role in these networks is not as prominent as Japan's role, there is little doubt that it will continue to expand and could approach that level during the next decade.

Second, although we have emphasized the market-driven nature of East Asia's regional integration and the weakness of its institutions, it should not be assumed that regional governments and their policies played no role at all in the integration process. In fact, as mentioned in our discussion, the increase in production sharing for some countries (for example, China and Singapore) was in part attributable to policy directives of their governments. It could even be argued that the stage was set for market-driven integration in East Asia by the policy actions of East Asian governments and regional institutions. For example, the reduction of restrictions on trade and FDI was one of the reasons that production networks have developed so well in East Asia. While much of this reduction has been on a unilateral basis, the effect of regional initiatives, such as AFTA, on trade barriers should not be overlooked. In addition, MNCs are attracted not only to countries with low labor and other costs but also to countries that are stable politically and economically, have good physical infrastructure and a skilled labor force, and that operate under the rule of law. These characteristics are essential not only to attract FDI but also to ensure the continued growth of production networks.

There is still much work to be done in these areas. While tariffs have been significantly reduced, there are still non-tariff barriers in some East Asian countries that can seriously inhibit trade flows. There is also considerable need for further reforms that could improve the commercial environment for both foreign and domestic enterprises.[89] These reforms include "more effective R&D and other support schemes, better physical infrastructure, legal reform, improved education, and administrative reform."[90]

Third, the participation of East Asian countries in production networks is growing not only on a regional basis but also on a global basis. While the ultimate and preferred goal for East Asian countries might be full-fledged participation in international production networks, the current direction in the region is toward increased involvement in regional

[89] The Asian Development Bank states, "It needs to be emphasized that domestic investors are invariably the key players in any economy and that domestic investor sentiment weighs heavily in MNEs' [multinational enterprises] international location decisions" (ADB 2004, p. 246).

[90] ADB (2004, p. 244).

arrangements, such as free trade areas. Although these arrangements tend to be bilateral or regional in scope and policy-driven in nature, they have the potential to lead to market-driven global production networks.[91] There is little doubt that market-driven regional, as well as global, integration will continue for East Asia.

[91] See Sakakibara and Yamakawa (2004) for a discussion of how this process could take place.

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Appendix

Table A.1: Europe's integration treaties

Treaty	**Date signed\ in force**	**Expiry date**	**Objectives/ Accomplishments**
Founding treaties:			
Treaty of the European Coal and Steel Community (ECSC), or Treaty of Paris	1951/1952	2002	Intended as first stage towards a European "Federation". Set up a "High Authority", a Parliamentary Assembly, a Council of Ministers, a Court of Justice and a Consultative Committee.
Treaty of the European Economic Community (EEC)*	1957/1958	Unlimited Period	Establish a common market based on the four freedoms of movement of goods, persons, capital and services and the gradual convergence of economic policies.
European Atomic Energy Community (EAEC of EUROTOM)*	1957/1958	Unlimited Period	Coordinate the research programs on the peaceful use of nuclear energy, already under way or being prepared in the Member States.
Subsequent treaties:			
Treaty on European Union (Maastricht Treaty)	1992/1993	Unlimited Period	Three pillars: • The European Community: provides framework for member states to jointly exercise their sovereignty in areas covered by the Treaties. • The Common Foreign and Security Policy (CFSP): Defines and implements, by intergovernmental methods, a common foreign and security policy. • Cooperation in the Fields of Justice and Home Affairs: Develop common action in these areas by intergovernmental methods to provide citizens with a high level of safety within an area of freedom, security and justice.
Treaty of Amsterdam	1997/1999	Unlimited Period	Amends the Maastricht Treaty in areas of: • Freedom, security and justice • Citizenship of the Union • External policy • EU Institutions • Closer cooperation Also amends the Treaties establishing the European Communities and certain related acts.

Source: European Communities (2000).
* These two treaties (EEC and EURATOM) constitute the Treaties of Rome.

Table A.2: Decision-making in the European Union

Procedure	**Description**	**Areas covered**
Co-decision	Parliament and the Council share legislative power	• Non-discrimination on the basis of nationality • The right to move and reside • The free movement of workers • Social security for migrant workers • The right of establishment • Transport • The internal market • Employment • Customs co-operation • Implementing decisions regarding the European Social fund • Education • Health • Consumer protection • Trans-European networks • The environment • Transparency • Preventing and combating fraud • Statistics • Others
Consultation	The Commission sends a proposal to both the Council and Parliament. The Council official consults Parliament and other bodies before taking a decision	• Police and judicial co-operation in criminal matters • Revision of the treaties • EU citizenship • Agriculture • Visas, asylum, immigration, etc. • Transport having significant impact on certain regions • Competition rules • Tax arrangements • Economic policy • Others
Asset	The Council must obtain the Parliament's assent before certain very important decisions are taken	• Specific tasks of the European Central Bank • Amending the statutes of the European system of Central Banks/European Central Bank • The Structural Funds and Cohesion Funds • The uniform electoral procedure for the European Parliament • Certain international agreements • The accession of new member states

Source: Compiled from European Communities (2003, pp. 6-11).

Table A.3: Main instruments involving East Asian countries and dealing with foreign direct investment, 1948-2003

Year	**Title**	**Setting**	**Level**
1980	Cooperation agreement between the EC and Indonesia, Malaysia, the Philippines, Singapore and Thailand	ASEAN-EC	Interregional
1987	Revised basic agreement on ASEAN industrial joint ventures	ASEAN	Regional
1987	An agreement among the governments of Brunei Darussalam, the Republic of Indonesia, Malaysia, the Republic of the Philippines, the Republic of Singapore and the Kingdom of Thailand for the promotion and protection of investments	ASEAN	Regional
1994	APEC non-binding investment principles	APEC	Regional
1995	ASEAN framework agreement on services	ASEAN	Regional
1995	Osaka action agenda on implementation of the Bogor declaration	APEC	Regional
1996	Protocol to amend the 1987 agreement among ASEAN member countries for the promotion and protection of investments	ASEAN	Regional
1998	Framework agreement on the ASEAN investment area declaration	ASEAN	Regional
1999	Agreement between the government of the United States of America and the government of Japan concerning cooperation on anticompetitive activities	Japan-US	Regional
1999	Short-term measures to enhance ASEAN investment climate	ASEAN	Regional
2000	Agreement between New Zealand and Singapore on closer economic partnership	New Zealand-Singapore	Bilateral
2001	Protocol to amend the framework agreement on the a ASEAN investment area	ASEAN	Bilateral
2002	Agreement between Japan and the Republic of Singapore for a new-age economic partnership (JSEPA)	Japan-Singapore	Bilateral

Table A.3: Continued

Year	Title	Setting	Level
2002	ASEAN-China framework agreement on comprehensive economic cooperation	ASEAN-China	Bilateral
2003	Free trade agreement between the government of the Republic of Chile and the government of the Republic of Korea	ASEAN-Chili-Korea	Bilateral
2003	Singapore-Australia free trade agreement (SAFTA)	Singapore-Australia	Bilateral
Instruments currently under consultation or negotiation (all bilateral except as noted)			
ASEAN – India ASEAN – Japan Canada – Singapore FTA Chile – Japan FTA China – Japan India – Singapore FTA Japan – Republic of Korea FTA	Japan – Malaysia Japan – Mexico FTA Japan – Thailand Japan – Philippines Jordan – Singapore FTA Mexico – Singapore FTA Singapore – ASEAN – China FTA (plurilateral)		

Source: Sakakibara and Yamakawa (2004, table 3.9, p. 96), compiled from UNCTAD (2003, annex table A.I.13) and other sources.Note: All agreements are adopted and binding, except those of APEC, which are nonbinding.

Regional economic integration and institution building*

C. Randall Henning

Introduction

A large number of diverse regional economic arrangements have evolved over the past half century with an especially creative burst of regionalism over the past fifteen years. This trend toward regionalism occurs as markets become more integrated on a regional and global basis. Does the integration of markets for goods, services and capital drive the creation of regional institutions? Or, does the creation of regional institutions drive the integration of markets? The short answer is that the relationship is reciprocal but not deterministic; it varies across regions and is conditioned by several contextual factors.

This paper examines the reciprocal relationship between economic integration and institutional integration. It begins by briefly surveying the regional orientation of international trade and its importance to national economies. It then addresses the role and function of regional institutions, defining more precisely what we mean by "institutions" and presenting some of the theories about how the integration of markets generates institutions. This section draws from the insights of a branch of political science that attributes independent causal significance to international institutions. The paper then addresses key factors that affect the political dynamic between markets and institutions – such as political regionalism, multilateralism and private networks – and derives some lessons from the European experience for institutions in other regions.

The paper concludes that aspirations for political union are not a necessary precondition for building regional institutions that foster economic integration. Strengths and weaknesses of multilateral economic institutions provide critical explanations for regionalism; and regions should pay due regard to the multilateral regime when designing their institutions and collective practices. Successful international institutions are not necessarily those that enforce hard rules, but instead those that provide information, monitor agreements and facilitate bargaining among governments in the context of a web of agreements that span a number of issues. Domestic political support is crucial to the success of regional institutions, which should be designed with roots in societal constituencies. These and other lessons are summarized in the concluding section.

* The author gratefully acknowledge discussants Marc-Olivier Strauss-Kahn and Ricardo E. Ochoa Rodriguez, the other participants in the conference in Beijing, and Ellen Frost for valuable comments, as Youliana Ivanova for excellent research assistance.

Market integration

A basic comparison of market integration in Europe, Asia, North America and other regions is presented in Tables 1-5. Table 1 displays the global pattern of regional trade in 2002. As the second panel illustrates, the percentage of each region's total trade that occurred intra-regionally was greatest for Western Europe (67.3), second for Asia (48.9) and third for North America (40.3). The third panel shows that these figures represent 28.5 percent, 12.6 percent, and 6.1 percent of world trade respectively. For each of the other regions, intra-regional trade is small compared to extra-regional trade, particularly with North America in the case of Latin America, with Western Europe in the case of the transition economies and Africa, and with Asia in the case of the Middle East. Regrouping Latin America with North America under the proposed FTAA, and/or North America with Asia under APEC, would alter the picture, but progress in these broader regions has disappointed proponents.

In 2003, the intra-regional exports of the EU15 were 63.5 percent of total EU15 exports, while the intra-regional imports of the group were 67.1 percent of its total imports (Calculated from European Commission, Statistical Annex of European Economy, Spring 2004). Intra-regional trade of the euro area was about 65.5 percent of the area's total trade (Pedersen 2004, 5). Among the countries of East Asia, intra-regional exports reached 52.7 percent in 2003, surpassing substantially the peak of 47.4 reached prior to the Asian financial crisis of 1997-98 (Table 2). Exports to the region reached 48.3 percent of Japan's total exports and substantially higher percentages of many other countries total exports in 2003, reflecting in part strong imports on the part of China. China's exports to the region, by contrast, have been declining as a percentage of China's total exports, but nonetheless remain at 46.9 percent (Table 3).

Next, compare the present levels of market integration in Asia to those that obtained in Europe at the advent of regional monetary cooperation there. Interestingly, intra-regional exports of the six members of the European Community were 48.6 percent of their total exports in 1970, while intra-regional imports were 48 percent of the EC6 total imports – slightly below recent Asian ratios (Calculated from United Nations, Direction of Trade Statistics Yearbook, various years). In 1970, notably, the EC6 committed themselves to forming Economic and Monetary Union by 1980. Although that plan proved to be wildly ambitious, the European states floated their currencies jointly against the dollar after the dissolution of the Bretton Woods regime and in 1979 created the European Monetary System.

As a percentage of regional GDP, intra-Asian trade flows are comparable to intra-European trade when monetary cooperation was initiated but, again, less significant than present European trade. For the region as a whole, intra-Asian exports represent about 13.5 percent of regional GDP. Although exports to East Asia are only about 5.3 percent of GDP for Japan, they represent almost 8.2 percent of GDP for Australia and between 14 and 17 percent of GDP for China, South Korea, and Myanmar, between 21 and 32 percent for Indonesia, Thailand, Vietnam and Taiwan, and very large percentages for Malaysia, Singapore and Hong Kong (See Table 4). In Europe, intra-regional exports comprised 8.7 percent of the combined GDP of the six members in 1970 and 16.7 percent of EU15 GDP in 2003.

In North America, trade among the three partners has grown quickly since the introduction of NAFTA more than a decade ago. Intra-regional trade, again, amounts to somewhat more than 40 percent of the total trade of the region. However, large asymmetries exist among the three member states (as in East Asia and the European Union). US trade with Canada and Mexico was roughly one-third of its total trade in 2003, whereas Mexico and Canada's trade within NAFTA was more than three-quarters of their total trade. Imports plus exports within the region represented 45.7 percent of Canadian GDP and 38.1 percent of Mexican GDP, but only 5.8 percent of US GDP (Table 5. See also Pastor 2001, Tables 1.1 and 1.3).

The comparison across regions and over time suggests several observations. First, the overall association between institutionalization and the regional orientation of trade appears tenuous, as underscored by the fact that Asia ranks above North America despite lacking the regional equivalent of NAFTA. Second, while regional institutions can strongly facilitate regional trade and investment, which they appear to have done in Europe and North America, they are not strictly necessary for robust regional markets, as evidenced by East Asia. Third, market integration is an ambiguous predictor of regional cooperation in related areas, such as monetary and financial matters. If the integration of goods markets were the leading factor, East Asia could be expected to seriously pursue exchange-rate stabilization and monetary cooperation, as did Europe in the 1970s. So, the relationship between market integration and institutionalization of regional cooperation is likely to hinge substantially on factors residing in the broader context.

Institutions: concepts and approaches

While the integration of markets is reasonably well defined – as the interpenetration of national markets, measured by flows of goods and capital and convergence of prices and interest rates – the concept of "institutions" is worth brief elaboration. After defining the term, we then review the explanations developed in the international political economy literature for the origins of institutions and the role that market integration plays in that process.

Some analysts employ the term "institution" narrowly to refer exclusively to formal bureaucratic organizations with a legal charter. Other analysts refer to formal rules and procedures for collective governance, while still other writers include informal norms, expectations and patterns of behavior under the definition of the term. Colloquial usage can be broader still and refer to things as varied as the currency, income tax, democracy and marriage as "institutions."

This paper examines the relationship between market integration, on the one hand, and institution-building and institutional design, on the other. We are interested in institutions that either eliminate or facilitate the elimination of barriers to trade and investment, including the harmonization of national regulations, regulatory frameworks and other legal, tax and policy changes that facilitate markets. We are also interested in the mechanisms through which common policies – such as the CAP, monetary union and "economic governance" in the EU context – are created and administered. This paper thus requires a broader concept than that employed by economists' "new institutionalism" (Williamson 1985; North 1990).

The political economy of international regimes struck a broad and widely used definition of their focus of research that has sometimes been used synonymously with the term "institution". Regimes are "sets of implicit or explicit principles, norms, rules and decisionmaking procedures around which actors' expectations converge in a given area of international relations" (Krasner 1983, 1). Goldstein, Kahler, Keohane, and Slaughter (2000, 387) define international institutions as "enduring sets of rules, norms, and decision-making procedures that shape the expectations, interests, and behavior of actors".

The project on the Rational Design of International Institutions defines them somewhat more narrowly as "explicit arrangements, negotiated among international actors, that prescribe, proscribe, and /or authorize behavior" (Koremenos, Lipson and Snidal 2001, 762). As such they have five key dimensions: membership rules, scope of issues covered, centralization of tasks, rules for controlling the institution, and flexibility of arrangements.

Another meaning, advanced by Milner (1998, 761), is "the means by which the diverse preferences of individuals are aggregated into choices or outcomes for the collective. Institutions here both shape and reflect the strategic interaction among agents". They are mechanisms to aggregate preferences (of individuals or states) and to exercise collective choice (See also Eichengreen 1998, 996).

This paper thus employs the term "institution" to include both (a) explicit, formal commitments and organizations and (b) informal norms, rules, common understandings and expectations. The term encompasses formal bureaucracies, decisionmaking procedures, informal consultative forums, patterns of cooperation, and informal agreements among states that facilitate, monitor and implement international agreements. With respect to East Asia, for example, the term "institution" can thus refer to ASEAN+3, the Chiang Mai Initiative, and Japan-Singapore Economic Partnership Agreement, as well as trilateral summit meetings, policy dialogue and the "ASEAN way" (principle of noninterference). The term does not include economic policies and regulations themselves (these are the focus of collective decisionmaking within institutions); nor does it include private-sector networks, elite networks and transnational political and technocratic alliances.

Institutionalization is distinct from, but related to, "legalization". Legalization in its hard form refers to a particular variation of institutionalization. Hard legalization entails (a) binding rules of obligation, (b) precision in those rules, and (c) delegation to a third party of the interpretation, monitoring and implementation of those rules, dispute settlement, as well as perhaps the promulgation of further rules (Goldstein et al. 2000, 387; Abbott and Snidal 2000). The European Union is often cited as a case of relatively hard legalization (Alter 2000), NAFTA as a case of hardening legalization (F. Abbott 2000), while cooperation in the Asia-Pacific is described as nonlegal (Kahler 2000).

Hard law holds a number of benefits over softer forms of institutionalization. As argued by F. Abbott (2000), it "(1) reduces intergovernmental transaction costs associated with trade and investment, (2) reduces private risk premiums associated with trade and investment, (3) promotes transparency and provides corollary participation benefits, (4) tends to restrain strategic political behaviors, and (5) may increase the range of integration effects by encouraging private actions to enforce intergovernmental obligations". But it also carries a number of disadvantages (discussed below).

As the reciprocal relationship between market and institutional integration suggests, "[I]nstitutions are simultaneously causes and effects; that is, institutions are both the object of state choice and consequential," as Simmons and Martin (1998, 743) put it. "[S]tates choose and design institutions . . . because . . . of their intended effects. Once constructed, institutions will constrain and shape behavior, even as they are constantly challenged and reformed by their member states".

Economic integration and institutions

The implicit model of many analysts and policymakers through which economic integration leads to regional institution-building contains several channels. As trade and investment increase across borders, private actors demand elimination of costly barriers and provision of greater certainty in the security of contracts and investments. They petition governments to create regional agreements and institutions that underpin liberalization of tariffs and non-tariff barriers and harmonization of regulations. National politicians may accommodate those pressures as a matter of electoral necessity. Governments can have their own motives for building regional institutions, such as managing the negative consequences of economic integration – policy externalities, regulatory arbitrage, races to the bottom, and dislocation of uncompetitive firms and their workers. States with autonomous policy preferences that are at odds with some private groups might also wish to move decisionmaking to the regional level, where particularistic interests hold less influence over policy and legislation.

The importance of economic integration for institutional integration is best appreciated by neofunctionalism, a school of integration politics championed by Ernst Haas in the early years of the European Community. Haas (1964) posited three specific mechanisms by which modest levels of integration produced an upward ratcheting of regional cooperation: functional spillover, political spillover, and cross-issue bargains mediated by autonomous institutions. Functional spillover captures the notion that cooperation in some areas (such as coal and steel) leads to cooperation in others (such as the Common Market) owing to interdependence among the sectors of advanced economies. Functional spillover is complemented by political spillover, through which societal groups interests' coalesce supranationally around expanding cooperation and institutions created to implement cooperative agreements become active (See, Kahler 1995, Moravcsik 1998 and Mattli 1999).

The dense network of regional institutions – the formal governing institutions of the EC as well as the more technical and less formal ones – facilitated bargaining and side-payments to overcome deadlock on key issues. Some of the institutions of the European Union, the European Commission and European Parliament in particular, act in their own right to advance integration (For discussion of "supranationalism," see, for example, Sandholtz and Zysman 1989, Anderson 1995 and Moravcsik 1991). Martin (1993), for example, argues that these institutions were critical for smoothing the way to the Maastricht treaty agreement. Structural and cohesion funds served as side-payments to countries that were reticent to commit to the monetary union. Cohen (1993) argues that the presence of robust institutions distinguishes successful from unsuccessful monetary unions in the past.

A neofunctionalist thread can be woven through the history of European integration. The formation of the European Coal and Steel Community led to the Common Market and Common Agricultural Policy, which in turn led to the search for currency stability in the form of the "snake" and then the European Monetary System (McNamara 1993). The Common Market and the expansion of the membership of the European Community led to the formation of the Single Market, an important feature of which was the elimination of capital controls and liberalization of trade in financial services. The free movement of capital within (and beyond) the European Union then forced member states to choose between accepting more flexible exchange rates, which would undermine the single market, or to press onward toward monetary union. (Padoa-Schioppa 1990 and 2004, Delors Report 1989, European Commission 1990).

In theory and as interpretation of European integration history, neofunctionalism conceives of the relationship between economic and institutional integration as a virtuous circle. The simple forms of this approach bordered on the idealistic and naïve, however, as demonstrated by backsliding and long lapses in European integration. The approach also suffered from significant gaps in theory. Those gaps included insufficient attention to the role of national governments, precisely how institutions facilitate international cooperation, political backlash against regionalism on the part of private actors and coalitions, and, more generally, to the conditions that could generate the virtuous circle as opposed to backsliding. Simple neofunctionalism would also have difficulty accounting for what might be called the "diseconomies" of dense institutionalization – inter-institutional conflict, policy incoherence, and gridlock in institutional reform – as well as for discontent over the "democratic deficit" and accountability in the European Union. These gaps have been addressed, though not necessarily filled, by subsequent approaches developed by political scientists.

Subsequent approaches

Neoliberal institutionalists argue that states create international institutions in order to overcome dilemmas of collective action. In the classic formulation, Keohane argued that under conditions of high transaction costs and uncertainty, institutions could help states overcome market failure in reaching international agreements, such as that modeled by the prisoners' dilemma game. "Chiefly by providing information to actors (not by enforcing rules in a centralized manner), institutions could enable states to achieve their own objectives more efficiently. Institutions would alter state strategies by changing the costs of alternatives; institutionalization could thus promote cooperation." Institutions affected outcomes by (a) providing information, (b) monitoring compliance, (c) increasing iterations, (d) facilitating issue linkages, (e) defining cheating, and (f) offering salient solutions (Katzenstein, Keohane and Krasner 1998, 662; Keohane

1984). When the coordination problem among states has multiple equilibria, institutions can provide mechanisms for solving distributional conflict (such as side payments in the form of EU cohesion funds for accession to the Maastricht treaty), signaling salient solutions and reducing bargaining costs. Once a particular equilibrium solution is chosen, institutions tend to lock it in (Katzenstein, Keohane and Krasner 1998). The logic applies equally to the regional and multilateral levels.

A key argument advanced by this approach is that international institutions should not be understood as coercive enforcers of hard rules against the will of member states. Instead, international and regional institutions are the instruments of states in their pursuit of mutually advantageous cooperation and integration. To conceive of institutions as hard constraints on national governments rather than their tools is to begin the analysis on the wrong foot.

Institutionalists juxtaposed their explanation to that of realism, dominated by the notion that powerful states create international institutions to serve their international interests. Hegemons create strong international institutions to support and defend a liberal international economic order from which they benefit, in the realist interpretation. The distribution of power in the international system is thus critical to creating and sustaining both international institutions and market liberalism. Again, the logic can be applied to both the global system and regions.

Domestic politics determine the preferences of states, whether operating within a realist or institutionalist framework, and complement both institutionalism and realism. National politicians respond to the demands of societal groups and their balance of influence in distributional conflicts when deciding to establish or change international institutions. Separately, international institutions may evolve depending on *knowledge and information*. As technical understanding becomes more broadly shared among expert communities, decisionmakers can converge on a specific set of institutional solutions to international problems (For reviews of explanations, see, for example, Kahler 1995, 6-11; Katzenstein, Keohane and Krasner 1998; among others).

Constructivism challenges the preceding causal arguments as far too rationalistic and adopts a sociological approach. For Katzenstein (1997), the key to understanding European integration lies not in the material interests of traded and nontraded goods sectors or their investors, but in the “Europeanization” of state identities, especially that of Germany, and shared norms. Norms about the conduct of regional relations shape regional institutions. In analyzing the Asian case, Katzenstein (1998) and Katzenstein and Shirashi (1998) argue that common norms arise from “the distinctive character of Asian state institutions,” where the state is embedded in society and constituted by elaborate networks, to which reciprocity is critical to political consensus and legitimacy. With such state systems, state sovereignty cannot be pooled in international organizations constituted by public international law – which presupposes European historical experience and concepts of sovereignty – and gives rise to the distinctively informal character of Asian institutions. Networks of public and private officials, corporations and organizations are thus critical to the formation of regionalism, though different network models (Japanese and Chinese) compete for dominance.

Comparison of regions

The European Union clearly has the most highly elaborated set of regional institutions, based on treaties, with supranational organizations (the Commission, Parliament and Court of Justice), an intergovernmental body (Council), a capacity to establish secondary legislation, a body of law and regulations, as well as a broad set of common policies and instruments. Despite the pauses and lapses in the integration process, Europe is a paradigmatic case of the reciprocal interaction of economic and institutional integration.

NAFTA has a well-defined set of rules regarding trade and investment that, while incorporating agreement on labor and the environment, is considerably narrower in scope. A free trade agreement rather than a customs union, its penetration of national regulatory matters is relatively weak. Weakness of the few organizations created by NAFTA leaves the region without robust supranational or intergovernmental bodies or a regional capacity for secondary legislation. Some of the functional spillover from trade and financial integration has been handled on a bilateral or multilateral basis, such as the 1994-95 peso crisis. Despite proposals to develop NAFTA along the lines of the EU model (Pastor 2001), with regular summit meetings and institutions and a capacity for fiscal transfers similar to the EU structural funds, there is so far little political impetus in the United States for doing so. Rising economic integration of the region has not yet produced self-reinforcing iterations of liberalization and institution building, but could eventually do so.

East Asia now appears to be coalescing around the ASEAN+3 group, although other configurations remain relevant to regional cooperation. The Chiang Mai Initiative represents the most advanced cooperative agreement as a region thus defined. A number of subregional trade agreements have been struck, the most important of which could be the China-ASEAN agreement, or are under negotiation. A region-wide trade agreement, distinct from APEC, is discussed but does not appear imminent. Formal institutions within East Asia and the Asia Pacific are numerous but their degree of legalization, as defined above, has always been quite low. Policy dialogue among members of the region has recently intensified and is now quite robust, the ASEAN+3 meetings are institutionalized and broad in scope, and further initiatives are being considered. The considerable degree of economic integration could thus lead to further institution building, but this is not by any means clear.

Generalizability of the EU model

The EU model is a demanding one in terms of institutional depth and political commitment and thus probably out of reach of other regions aspiring to integration. The EU experience nonetheless offers important lessons that can be applied in other regions. Doing so, however, requires a clear understanding of (a) the nature of the EU model and (b) the lessons to be derived.

Rules and institutions

Kahler (1995, 85) urges careful interpretation of the role of European institutions. The importance of the supranational bodies of the EU stems not from their formal roles but from other, more subtle processes that revolve around them:

> The nomenclature of the EU institutions (Parliament, Court) may obscure as much as it clarifies... The three institutional dimensions that set the EU apart from other regional groups lie instead in the degree of institutional delegation..., the scope of European bargains, and perhaps most important, the domestic political linkages constructed between European and national institutions. If there is a 'European model' for the future of other regional arrangements, it lies in these characteristics.

First, EU member states delegated more important and extensive functions to the EU institutions than have regions elsewhere. Second, bargains across functionally linked issues cumulated into an increasingly dense network of interdependent agreements. Crucially, argues Kahler, Community enforcement of rules and law has been less important than "national reputational considerations that serve as a central binding device". Reneging in one issue area would have negative consequences for the government concerned in others.

The Stability and Growth Pact offers an object lesson in the role of hard rules in the European Union. These rules were designed to constrain governments' fiscal deficits and were given teeth in the form of painful sanctions. When they conflicted with the preferences of the large member states, however, the rules were effectively suspended and a broad discussion was launched on how to reform them. It is notable that reforms discussed as of this writing would place less emphasis on the hardness of the rule (and sanctions) and more emphasis on early sharing of information, analysis, consultation, debate and publicity – prior to, rather than subsequent to, governments' committing themselves to a fiscal path. Breaching the limits under the SGP has had substantial political consequences within the EU for relations between large and small states, providing the large with an incentive to conclude an agreement on SGP reform. The hard rule has been important not because it was enforced – to the contrary, it was violated – but because it altered the context in which member states bargained over economic policies and institutional reform.

Third, European institutions have developed deep connections to domestic political institutions and interest groups. "Those links, far more than the capabilities of European Institutions alone for monitoring and enforcement, provide a basis for ensuring that European bargains are implemented" (Kahler 1995, 86). Tacit collaboration between the Court of Justice, on the one hand, and lower national courts and private groups and firms, on the other, generated forward movement in cases such as Cassis de Dijon, which established the principle of mutual recognition underpinning the single market (See Burley and Mattli 1993, Alter and Meunier 1994, Slaughter and Mattli 1998). This general analysis is widely, though not universally shared, among analysts of European integration in political science.

The implications of this literature for proponents of regionalism elsewhere are not that they could bypass the creation of institutions, because they remain at the heart of each of the three processes, but that they must ultimately focus on delegation, institutions' roots in domestic politics, and the negotiation of pareto-improving cross-issue bargains. Members of ASEAN+3 have been grappling with the issue of creating a secretariat but have reached no agreement, for example. If the context were somewhat more broad, with more issues and institutional questions in play, a bargain could conceivably be negotiated across trade and finance, say, that parceled out institutional prerogatives (See, de Brouwer 2004 on the design of a possible Asian Monetary Fund).

Political integration

The argument that aspirations for political union underpin the evolution of the European Union is widely asserted in public commentary and some parts of the literature on the European economic integration. EMU, for example, is frequently cited as the product of widely shared political ambition for something akin to a United States of Europe (See, for example, Eichengreen 1992). The absence of such ambitions in East Asia and North America are cited as reasons for pessimism with respect to economic and institutional integration in those regions. While commitment to political integration plays a role, however, it has been substantially over-rated by some analysts.

Over the course of postwar history, first of all, economic projects for European integration have consistently received greater support than projects for political and security cooperation. Proposals for European Defense Community and European Political Community failed in the 1950s, for example, while the European Economic Community succeeded (See, for example, Dinan 2004). The Constitution for Europe would go some distance toward political integration, to choose a contemporary example, but its ratification will be decidedly difficult.

Second, while it is true that war in Western Europe has become "unthinkable", it has been "unthinkable" for quite some time, at least the 1960s and 1970s if not before. European integration has continued far beyond the point where interstate violence was a conceivable threat. Finally, ambitions for political union do not easily explain the successive enlargements of the membership. Britain, Ireland and Denmark did not join the European Community because they wanted to participate in an ever closer political union. Many in successive enlargements are reticent, including the ten new members from Central and Eastern Europe. Indeed, the greater number and diversity of member states spawned by enlargements have created substantial barriers to political deepening. For these reasons among others, many political scientists conclude that the political-unity motive is a contributing but distinctly secondary motivation for European integration (See for example Moravcsik 1998).

Analysis of political motivation should carefully distinguish between (a) ambitions for political union, (b) desire to avoid security conflict and war, and (c) political agreement on economic measures and the institutions necessary to implement them. Regional integration obviously cannot take place in the face of sharp security conflict, threats or interstate violence. Ambitions for political integration and a peace community can certainly reinforce regional integration, on the other hand, but they are not necessary.

Political agreements on the economic measures, common policies and regulations are indeed necessary, as is agreement on the institutions that would implement and monitor them. But the latter is a substantially lesser hurdle that the former. While the former is out of reach in East Asia, and probably in North America as well, the latter is achievable in both.

"Diseconomies" of institutional deepening

The European case illustrates not only the benefits but also the costs of institutional elaboration and complexity. Inter-institutional competition is rife within the European Union. The supranational institutions vie for prerogatives and influence among themselves as well as with national governments and institutions, such as national legislatures. While some of these inter-institutional conflicts can be ameliorated under the proposed Constitution for Europe, other inter-institutional conflicts will be created. The proliferation of institutions thus weakens the coherence of policy within the Union, a focus of the Sapir Group Report (Sapir et al 2003).

Reform of these institutions, moreover, has become exceedingly difficult as member states are unwilling to surrender their prerogatives under one institutional framework for the sake of efficiency of decision making under another. Those institutional reforms that have been ratified (Amsterdam and Nice) have been modest, widely regarded as insufficient for a Union of twenty-five countries. The Constitution for Europe was negotiated to streamline the institutional structure and settle, hopefully once and for all, distributional conflict over voting schemes and limit institutional conflict. But the Constitution, which has fallen short of the hopes of many analysts (Devuyst 2004), might well not be ratified. This experience raises the question as to whether institutional deepening within the EU has reached a point of diminishing, or even negative, returns and suggests that other regions should institutionalize selectively.

Multilateral context

The historical evolution of the three regions considered here illustrates the importance of the multilateral system in providing motives for regional cooperation and setting its agenda. In short, much of the impetus for regionalism springs from inadequacies of or discontent with multilateral institutions. If the multilateral regime fully satisfied the preferences of member countries for international cooperation, national governments would have little incentive to embark on regional projects. The Common Market was launched after the rejection of the International Trade Organization and after early rounds of GATT negotiations yielded only meager results. The multilateral trade regime would not soon provide much liberalization beyond border measures and would not provide for competition policy that could prevent gains from trade liberalization being captured by collusive agreements among firms. Because the international monetary regime was reasonably stable and expected to endure, by contrast, monetary integration was not prominent on the early agenda of European integration. As the Bretton Woods regime broke down, however, Europeans experimented with the Snake and launched the EMS, the precursor to the monetary union (Henning 1998). Had the Bretton Woods regime survived, European monetary integration might have taken a very different course. Similarly, NAFTA was conceived and negotiated as a "GATT plus" agreement at a moment when the members of the GATT were having substantial difficulty concluding the Uruguay Round. Aspirations for regional cooperation in East Asia received powerful impetus from the 1997-98 financial crisis and resentment within the region of the International Monetary Fund and the United States for their handling of that episode (Henning 2002).

Conclusions and recommendations

Our review of the interaction between economic and institutional integration in Europe, East Asia and North America generates a number of lessons and insights for regionalism.

Desire for political integration is not a necessary precondition for regional institution building and integration. Political agreement on such institutions and the substance of cooperation is essential. But political support for economic cooperation is very different from aspirations for political integration or unification, and also very different from an elite consensus on using regional institutions to limit security conflict; it is also easier to achieve. This is good news for proponents of regionalism in East Asia and other parts of the world where there is little interest in pooling sovereignty in ways that Western European countries have done.

The state of the multilateral system and the role of key states have strong bearing on the substantive focus and timing of regional integration programs. When aspirations of a region are not satisfied by liberalization and cooperation provided at the multilateral level, they are more likely to explore or launch regional cooperative arrangements. When states are satisfied with multilateral regimes and content with the behavior of systemically important countries, such as the United States, they are less likely to embark on regional programs or to strengthen existing regional institutions.

Regional arrangements should nonetheless be designed with due regard for the multilateral regime and its objectives. If constructed carefully, regionalism can complement rather than undermine aspects of the multilateral regime that function effectively. International financial cooperation, for example, would benefit from a set of principles that distinguish regional financial arrangements that are compatible with members' obligations in the IMF from those that are not (Henning 2002, 77-86). When appropriate, moreover, institutional arrangements should provide for external representation of the region as an entity in negotiations at the multilateral level.

Harder rules are not necessarily better rules. Rules are useful not because they are necessarily enforced – they are often violated – but rather because they alter the context in which bargaining takes place (The commonly made distinction between rules and discretion is a false dichotomy). Information, monitoring and bargaining among governments with stakes in cooperation across a number of issue areas, and therefore an interest in maintaining the confidence of their partners, is more important than enforcement of hard law to advancing integration. There is a danger that enforcement of hard legalization can produce domestic political backlash when rules conflict too strongly with domestic political imperatives (Goldstein and Martin 2000).

Domestic political support is critical and substantially determines whether the relationship between economic and institutional integration becomes a virtuous circle. Regional institutions should nurture this support and find alliances in the domestic political arena. "Sink deep roots into domestic politics". Such roots are hard to construct or even identify ex ante: the tacit alliance between the ECJ and domestic courts was not anticipated at the outset of European integration and evolved only gradually. Regional institutions should not be designed, as they often are, in isolation from or without regard to domestic politics and the need to secure domestic constituencies.

The European case underscores the importance of making side-payments and concluding cross-issue bargains to assist governments in solving domestic political problems confronted in the process of integration. Political deadlock among member states was overcome on many occasions by exchanging concessions across policy areas and institutions. Such bargaining is facilitated by multi-sector economic integration and regional institutions (For an illustrative case within the G-7 context, see Putnam and Henning 1989).

Regional institution building can also reach a point of diminishing returns. Inter-institutional competition, insufficient coherence of policy, and deadlock on institutional reform might suggest "diseconomies" of institutional scale within the European Union. For this reason, institution building in other regions should be selective, designed with a view toward supplying the specific functions needed to negotiate, conclude and monitor agreements on trade, money, finance and regulations.

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Table 1: Intra- and inter-regional merchandise trade, 2002
(billion dollars and percentage)

Destination / Origin	North America	Latin America	Western Europe	C/E Europe/ Baltic States/ CIS	Africa	Middle East	Asia	World
Value								
North America	382	152	170	7	12	20	204	946
Latin America	215	54	44	3	4	5	23	350
Western Europe	270	55	1787	168	66	68	208	2657
C./E. Europe/ Baltic States/CIS	14	6	176	80	4	7	24	314
Africa	24	5	71	1	11	3	24	140
Middle East	38	3	40	2	9	17	116	244
Asia	394	39	260	21	26	48	792	1620
World	1336	315	2549	282	133	169	1391	6272
Share of inter-regional trade flows in each region's total merchandise exports								
North America	40.3	16.1	17.9	0.7	1.2	2.1	21.5	100.0
Latin America	61.3	15.4	12.6	1.0	1.2	1.3	6.7	100.0
Western Europe	10.2	2.1	67.3	6.3	2.5	2.6	7.8	100.0
C./E. Europe/ Baltic States/CIS	4.5	1.9	56.2	25.5	1.2	2.4	7.7	100.0
Africa	17.0	3.3	50.9	0.7	8.1	2.3	16.8	100.0
Middle East	15.5	1.4	16.4	0.8	3.8	7.1	47.4	100.0
Asia	24.3	2.4	16.0	1.3	1.6	3.0	48.9	100.0
World	21.3	5.0	40.6	4.5	2.1	2.7	22.2	100.0
Share of regional trade flows in world merchandise exports								
North America	6.1	2.4	2.7	0.1	0.2	0.3	3.2	15.1
Latin America	3.4	0.9	0.7	0.1	0.1	0.1	0.4	5.6
Western Europe	4.3	0.9	28.5	2.7	1.1	1.1	3.3	42.4
C./E. Europe/ Baltic States/CIS	0.2	0.1	2.8	1.3	0.1	0.1	0.4	5.0
Africa	0.4	0.1	1.1	0.0	0.2	0.1	0.4	2.2
Middle East	0.6	0.1	0.6	0.0	0.1	0.3	1.8	3.9
Asia	6.3	0.6	4.1	0.3	0.4	0.8	12.6	25.8
World	21.3	5.0	40.6	4.5	2.1	2.7	22.2	100.0

Source: World Trade Organization.

Table 2: Direction of East Asian exports, 1980-2003

	1980-84	1985-89	1990-94	1995-99	2000	2001	2002	2003
Intra-regional exports as % of total EA-17 exports	38.2	38.4	45.9	49.4	49.9	50.0	51.5	52.7
Regional exports to Japan as % of total regional exports (minus Japan)	20.5	16.8	14.2	12.5	12.6	12.8	11.6	10.9
Regional exports to China as % of total regional exports (minus China)	3.0	5.2	6.5	8.8	9.6	11.0	13.0	16.3
Regional exports to US as % of total regional exports	24.1	29.9	23.7	22.2	23.4	22.3	21.8	19.7

Sources: Direction of Trade Statistics, IMF, 2004; National Statistics of Taiwan, Directorate General of Budget, Accounting and Statistics, Executive Yuan.
Note: EA = East Asia includes ASEAN-10 (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam), plus China (Mainland and Macao), Hong Kong, Japan, Korea, Taiwan, Australia and New Zealand.

Table 3: Exports to East Asia as percentage of total exports, 1980-2003

	1980-84	**1985-89**	**1990-94**	**1995-99**	**2000**	**2001**	**2002**	**2003**
China	54.2	59.5	62.4	54.4	49.8	49.8	49.0	46.9
Hong Kong	33.2	44.0	47.4	51.3	51.2	53.3	55.7	58.8
Korea	28.4	31.0	40.8	46.1	47.5	46.6	48.2	50.8
Japan	27.8	29.0	36.9	41.9	42.9	41.8	44.9	48.3
Brunei	87.1	94.2	97.5	88.9	83.8	86.3	89.2	86.7
Cambodia	52.6	40.1	75.8	57.3	11.3	9.6	14.1	12.6
Indonesia	68.5	66.6	65.3	60.7	62.1	60.9	61.1	61.3
Laos	63.9	76.1	66.3	56.6	48.0	43.3	43.4	42.9
Malaysia	59.9	59.9	58.8	56.1	58.7	58.2	59.0	58.1
Myanmar	44.6	44.2	52.0	43.2	35.4	46.9	51.1	51.4
Philippines	41.2	39.9	37.6	43.1	50.4	52.7	56.6	60.9
Singapore	49.9	46.3	50.0	54.8	56.5	57.5	59.0	59.3
Thailand	41.7	41.8	44.0	50.4	51.7	51.7	52.6	55.2
Vietnam	55.7	21.0	65.4	61.8	63.3	57.9	49.2	45.4
Taiwan	20.9	28.9	41.2	46.7	48.0	49.1	53.7	56.2
Australia	51.4	54.7	62.6	62.9	61.5	59.8	59.7	58.9
New Zealand	39.7	46.1	52.8	55.8	55.5	54.2	53.2	53.5
EA region	38.2	38.4	45.9	49.4	49.9	50.0	51.5	52.7

Sources: Direction of Trade Statistics, IMF, 2004; National Statistics of Taiwan, Directorate General of Budget, Accounting and Statistics, Executive Yuan.
Note: EA = East Asia includes ASEAN-10 (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam), plus China (Mainland and Macao), Hong Kong, Japan, Korea, Taiwan, Australia and New Zealand.

Table 4: Exports to East Asia as percentage of GDP, 1980-2003

	1980-84	**1985-89**	**1990-94**	**1995-99**	**2000**	**2001**	**2002**	**2003**
China	4.1	6.7	11.3	10.9	12.6	11.3	12.6	14.6
Hong Kong	25.1	43.2	53.8	57.4	62.5	62.1	69.0	83.0
Korea	8.0	9.4	9.7	13.6	16.0	14.5	14.2	16.4
Japan	3.5	3.0	3.2	3.9	4.3	4.0	4.7	5.3
Brunei	15.4	66.5	75.5	58.2	61.4	69.2	71.6	72.8
Cambodia		1.5	5.5	10.6	3.6	3.3	6.1	6.3
Indonesia	16.3	13.7	15.1	18.7	25.7	23.9	20.1	21.3
Laos	2.0	3.9	6.7	12.2	10.8	9.2	9.5	9.7
Malaysia	28.8	33.9	41.7	49.8	64.0	58.3	58.1	68.0
Myanmar	2.7	1.0	11.7	9.0	6.6	14.9	14.7	14.8
Philippines	6.5	6.8	7.4	14.5	25.8	23.9	25.9	33.2
Singapore	69.7	64.3	67.1	74.6	84.2	81.4	83.6	93.6
Thailand	7.8	9.7	13.1	19.9	29.0	29.1	28.6	31.1
Vietnam	0.5	1.8	17.3	20.6	30.2	28.1	22.6	25.8
Taiwan	13.2	14.3	16.3	19.6	23.0	21.5	24.9	28.3
Australia	6.5	7.1	8.6	9.4	10.3	10.6	9.7	8.2
New Zealand	9.6	9.9	12.2	12.1	13.7	14.4	12.8	11.2
EA region	6.3	6.0	7.5	9.6	11.3	11.0	12.1	13.5

Sources: Direction of Trade Statistics, IMF, 2004; National Statistics of Taiwan, Directorate General of Budget, Accounting and Statistics, Executive Yuan; World Economic Outlook database, IMF.
Note: EA = East Asia includes ASEAN-10 (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam), plus China (Mainland and Macao), Hong Kong, Japan, Korea, Taiwan, Australia and New Zealand.

Table 5: NAFTA: intraregional trade, 2003

	Exports			Imports			Total trade		
	In percent of			In percent of			In percent of		
	In billions US dollars	**total exports**	**GDP**	**In billions US dollars**	**total imports**	**GDP**	**In billions US dollars**	**total trade**	**GDP**
Canadian trade with									
Mexico	1.5	0.6	0.2	8.8	3.7	1.0	10.4	2.0	1.2
United States	232.9	86.4	27.3	147.4	61.2	17.3	380.3	74.5	44.5
NAFTA	234.5	86.9	27.5	156.2	64.8	18.3	390.6	76.5	45.7
World	269.7	100.0	31.6	240.9	100.0	28.2	510.6	100.0	59.8
Mexican trade with									
Canada	8.3	5.3	1.3	1.8	1.2	0.3	10.1	3.3	1.6
United States	127.0	81.7	20.6	97.5	63.1	15.8	224.5	72.4	36.5
NAFTA	135.3	87.9	22.0	99.3	64.3	16.1	234.6	75.7	38.1
World	155.4	100.0	25.3	154.4	100.0	25.1	309.9	100.0	50.4
United States trade with									
Canada	169.5	23.4	1.6	227.7	17.4	2.1	397.1	19.6	3.7
Mexico	97.5	13.5	0.9	139.7	10.7	1.3	237.2	11.7	2.2
NAFTA	266.9	36.9	2.5	367.4	28.1	3.4	634.3	31.3	5.8
World	723.0	100.0	6.7	1,305.0	100.0	12.0	2,028.0	100.0	18.7
Memorandum items									
Nominal GDP (in billions U.S. dollars)									
Canada	853.8								
Mexico	615.1								
United States	10,857.2								

Source: *Direction of Trade Statistics Quarterly,* International Monetary Fund; and UN National Accounts Main Aggregates Database, **http://unstats.un.org/unsd/snaama/Introduction.asp**

Not only trade: Regional monetary and financial integration

Yu Yongding

Introduction: Rationale and preconditions for monetary and financial integration

It is argued in literature that eliminating national currencies and moving to a common currency can be expected to lead to gains in economic efficiency. These gains in efficiency have two different origins. One is the elimination of transaction costs associated with the exchanging of national moneys. The other is the elimination of risk coming from the uncertain future movements of exchange rates.

The elimination of transaction cost also has an indirect gain: consumers who now can see prices in the same currency unit are able to make better price comparisons, and to shop around. This in turn should increase competition and benefit all consumers. More importantly, the introduction of a common currency will stimulate financial integration. This in turn may set in motion a dynamics of integration in other areas. For example, financial market integration is likely to push for further legislative harmonization.

A decline to real exchange rate uncertainty, due to the introduction of a common currency can reduce adjustment costs. As a result, the price system becomes a better guide to making the right economic decisions. The reduction of exchange rate uncertainty will lead to the reduction of the real interest rate. Risk aversion investors will demand a lower interest premium, which in turn will promote economic growth.[1]

All in all, a common currency, a monetary union, or a move towards monetary integration will promote trade (at least among members) and economic growth. The conclusion seems to be borne out by empirical evidences.

On the other hand, there are costs for monetary integration in the form of common currency. The main costs of a common currency area are the loss of the independence of monetary policy, giving up the possibility of changing exchange rate when the change is necessary for achieving fundamental balances of the economy. According to Mundell (1961), the costs of adopting a single currency depend crucially on how easily an economic shock in one country is transmitted to other country in the same region. If a supply shock strikes one member of the union, and if correlations of shocks are high among the members, all members will be affected in the same way. A symmetrical set of policy mix can then be used to offset the shocks for all members, thereby eliminating the need for policy autonomy.

[1] P Grauwe: Economics of Monetary Union, Oxford University Press, 2003. p 60.

What are the pre-conditions to ensure a successful monetary and financial integration process? Are better developed financial markets, deeper trade and factor market integration, liberalized capital markets among the pre-conditions?

Traditional literature suggests a set of criteria for optimum currency area. Among the criteria are factor mobility (Mundell, 1961) trade integration (McKinnon, 1963), regional production patterns (Kenen, 1969), policy preference, high correlation of shocks among members, and so on. Generally speaking, countries with strong trade and financial ties are identified as candidates for optimum currency area. It is assumed that asymmetrical shocks in a optimum currency area can be transmitted rapidly from one member country to anther, and make the shocks "common" for all members. As a result, idiosyncratic national policy, for example, changing exchange rate vis-à-vis other member countries, become unnecessary. According to Mundell (1961), if a negative asymmetric demand shock hits one of the members of an optimum currency area, the labour will move from this country to other members. With high labour mobility, the labour migration between members will equalize wages as well as labour demand and supply in all members. As a result, a common monetary or fiscal policy can be used to stimulate the economies of all members. Hence migration is a channel through which adjustment to asymmetric shocks can take place, and flexible exchange rates between the members are no longer necessary for restoring fundamental balances.

When applying the above-mentioned criteria, some studies found that Euroland is not an Optimum currency area. One reason is that at present there is neither a high degree of factor mobility within Euroland nor factor immobility outside Euoland.[2] In contrast, some other studies found that East Asian countries can form a monetary union without incurring so much opportunity costs of losing monetary independence and policy autonomy. The conclusion was based on the analysis of correlations of shocks.[3] The seemly-unexpected conclusions are actually not surprising at all. As Frankel and Rose pointed out "Trade patterns and income correlations are endogenous… A country could fail the OCA criterion for membership today, and yet, if it goes ahead and joins anyway, as the result of joining, pass the OCA criterion in the future."[4] When we look at the process of the financial and monetary cooperation in the East Asia, the relevance of the endogenous theory of optimum currency area is becoming even more obvious.

In some aspects, East Asian countries fit the criteria for an optimum currency area quite well. Firstly, in terms of trade integration, East Asian countries have comfortably met the criteria for a Optimum currency area in comparison with European countries when they initiated the efforts for the European Monetary Union. Table 1 shows the intensity of intra-regional trade among East Asian countries is high and rising steadily. Intra-trade among these countries has already surpassed their trade with all trading blocks outside the region. It is especially true for the three key north east Asian countries: China, Japan and Korea. They have become the most important or second most important trading partners with each other.

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[2] Elinda Fishman Kiss: Optimum Currency Area: Euro as a Practical Paradigm? Rutgers, the State University of New Jersey.

[3] Tanawat Trivisvavet: Do East Asian Countries Constitute An Optimum Currency Area? Durham University.

[4] Elinda Fishman Kiss: Optimum Currency Area: Euro as a Practical Paradigm? Rutgers, the State University of New Jersey. P3.

Table 1: Dynamics of the Korea-China-Japan-ASEAN intra-trade intensity index

	Year	**Korea**	**China**	**Japan**	**ASEAN**
Korea	1980	–	0.08	2.39	1.97
	1985	–	0.06	2.23	1.56
	1991	–	0.78	2.61	2.02
	1996	–	2.84	1.88	2.03
	2001	–	3.22	1.98	1.92
China	1980	0.12	–	2.90	2.00
	1985	1.01	–	3.30	3.20
	1991	0.32	–	2.17	1.16
	1996	0.79	–	3.17	0.88
	2001	2.02	–	3.21	1.19
Japan	1980	3.59	3.71	–	3.05
	1985	2.47	3.18	–	1.98
	1991	2.79	1.52	–	2.41
	1996	2.57	1.88	–	2.63
	2001	2.86	1.98	–	2.59
ASEAN	1980	1.42	1.02	3.64	–
	1985	1.90	1.63	3.61	–
	1991	1.54	1.12	2.71	–
	1996	1.28	1.12	2.18	–
	2001	1.71	1.40	2.45	–

Sources: Kiep.
Note: 1. The trade intensity index of country i is defined as

$$\mathrm{TIIij} = \frac{Xij / Xi}{\mathrm{Mj / Mw}}$$

where Xij is export from country i to j, Xi is total export of country i, Mj is total import of country j, Mw is world total import. TIIij compares export from country i to j divided by total export of country i to the ratio of import of country j divided by total world import. If TIIij is greater than 1 then country i and j are related more closely than others. The index was computed using IMF, *Direction of Trade Statistics Yearbook* (various issues).
2. ASEAN data represent Indonesia, Malaysia, Philippines and Thailand.

Secondly, in terms of production pattern in the region, the creation of international production network in the region in the past decade enormously deepened East Asian countries' economic integration. Before the 1990s, the regional division of labour in the East Asian countries can be roughly characterized by the so-called flying geese formation. It was Akamatsu (1962) who first used the term *flock formation of flying wild geese pattern* of industrial development in 1943. In 1970s, Kojima renamed the pattern the catching-up product cycle (CPC) after its association with the product cycle model of Vernom. The development gaps of economies in the region, which are reflected in the fact that they are in different stages of the product cycle in their respective industries at a given period of time, rather than the similarity in stage of development, give rise to the possibilities for forming a close regional network of trade and investment based on vertical division of labor in the region. Following the collapse of the flying geese formation in the last decade, a new pattern of regional division of labour seems to have taken shape, which is characterized by the establishment a regional production network as a result of the global strategy of multinationals. Owing the trade liberalization and technological progress, especially the IT revolution, corporation organization has changed greatly, with many activities outsourced to enterprises in other countries. Parts and components are produced and traded across borders before final products are completed. Processing trade is flourishing. With old pattern of flying geese, division of labour was made along the line of industries. The new pattern of division of labour is characterized by outsourcing non-core functions by leading firms[5] in response to the fast changes in technology and market conditions. In other words, in contrast to the traditional pattern of vertical inter-industrial division of labour, the new pattern of division of labour is not only an intra-industrial but also an intra-product one.

Thirdly, as a result of closer trade and investment linkage based on a newly emerged international production network, the correlation of cyclical economic changes and rapid transmission of external shocks has increased significantly. The contagious effect during the Asian financial crisis is a case in point. It seems that East Asian countries have already laid a solid foundation for embarking on the process of monetary and financial integration.

However, measured by the key criterion proposed by Mundell, namely, labour mobility, East Asian countries are far from an optimum currency area. Japan's conservative attitude towards labour immigration is notorious. The records of other East Asian countries are not much better either. The mechanisms for achieving the sort of equilibrium via free movement of factors of production, as envisaged by Mundell are basically nonexistent. As a result, country-specific macroeconomic policy is indispensable, and common demand management policy is out of question. Last but not least, flexible exchange rates between East Asian countries are still necessary for restoring internal and external balances.

It seems that whether East Asian countries, ASEAN 10 plus 3 more specifically, fit the criteria for OCA is not really an important issue. The real issue is whether countries in the region have the political desire to strengthen their economic integration and financial integration. If the countries concerned have the political will and are able to come up with specific plans for achieving monetary and financial integration in the region, physical, institutional and other elements of an optimum currency area can be established or perfected, and eventually achieve the objective of regional monetary integration. Better-developed financial markets, deeper trade and factor market integration, liberalized capital markets are not only preconditions for monetary integration but also results of the efforts in promoting the integration in the region.

[5] A forthcoming report by a group international researchers.

I. The creation of a regional financial architecture

The issue of East Asian financial cooperation can be roughly divided into two parts: the creation of a regional financial architecture, and the management of regional exchange rate arrangements. The main functions of an East Asian financial architecture should include exchange of information, promoting transparency and providing rescue packages. Asian countries' desire for establishing a regional financial architecture is a natural response to the disappointing performance of the IMF before, during and after the Asian financial crisis.

The dissatisfaction felt by Asian countries to IMF's insensitivity towards Asian countries' suffering found its initial expression in Japan's proposal of establishing an Asian Monetary Fund (AMF). The most essential function of the proposed AMF is to provide emergency financial support to would-be crisis-affected countries. Ideally, the emergency financial support provided by the AMF will be more speedy and the condition for providing such support will be less harsh and more in line with "Asian way".

The stillborn of the AMF is attributable not only to the objection by the US and the IMF, but also to the lack of communication or miscommunication among some East Asian economies including China. In this regard, my friend, Prof. Sakakibara, the Architect of the AMF should take the main blame. The process of establishing an East Asian financial architecture is a process of trust building, which should start from some less grandiose endeavours and then forge ahead gradually. Only when progress in easier but nonetheless serious cooperation has been made, can trust be created and consolidated. Before institutionalised the regional monetary and financial integration, there many less controversial and less irretrievable steps can be taken.

Firstly, each East Asian economy should make its domestic economic policy transparent to other economies. Asian governments should regularly study and exchange views on their partner's macroeconomic situation and coordinate each other's macroeconomic policies. The existing forums of policy dialogue among East Asian countries should be strengthened and expanded.

Secondly, Asian countries should strengthen their cooperation in supervision and regulation of capital flows. The host country and guest country should corporate to ensure the smooth flows of capital across borders. The host country and guest country should provide with each other full information relevant to the flows of capital. The host country should help the guest country to stop the flow of hot money. Asian governments can assist each other by not allowing its own territory to be used by speculators to launch an attack on a neighbouring country.

Thirdly, Asian governments can join in force to establish physical and institutional infrastructure such a clearing system to reduce settlement risk. More experienced government should provide technical assistance on risk management and on how the central banks should deal with speculative attack with a combination of financial instruments.

Fourthly, Asian governments might be willing to provide funds for countries in trouble to pre-empt a looming speculative attack (to deter speculators from launching an attack). Guidelines should be formulated beforehand, so that when speculative attack happens, central banks could intervene on foreign exchange markets in a coordinate fashion. After the attack, emergency funds could be provided bilaterally or multilaterally so as to reduce the pain of adjustment.

The "Chiang Mai Initiative"(CMI) is the most important milestone of Asian financial crisis. According to The Joint Ministerial Statement of the ASEAN + 3 Financial Ministers Meeting, published on 6 May 2000, Chiang Mai, Thailand, the ASEAN + 3 agreed to strengthen policy dialogues and regional cooperation activities in the areas of capital flows monitoring, self-help and support mechanism and international financial reforms. They recognized a need to establish a regional financing arrangement to supplement the existing international facilities. They agree to establish a network of research and training institutions to conduct research and training on issues of mutual interests. Besides these general statements, the statement declared that the "Chiang Mai Initiative" involves an expanded ASEAN Swap Arrangement that would include ASEAN counties, and a network of bilateral swap and repurchase agreement facilities among ASEAN countries, China, Japan and the Republic of Korea. The swap arrangement marked an important turning point in the road for Asian financial cooperation in history. In recent years, the swap arrangement based on bilateral agreements has developed into one based on multilateral agreements. Works have also been done on the development of an Asian bond market. Recently, there is an increasing concern about the direction of future evolution of the CMI. This concern arises mainly due to the problems in the structure and operation of the CMI. The key problem is the CMI's symbolic feature, which "reflects the stance of 'constructive ambiguity' adopted by Asian officials to deflect the objections directed at their earlier proposal for Asian monetary fund. But this stance has costs; in particular, governments are unlikely to invest significant resources in a new regional arrangement unless its objectives are made explicit and hence the returns on their investment are clear"(Eichengreen 2002). In this regard, some bolder policy initiatives are needed.

In a paper written in 2000, the author argued that: "To implement the cooperation, Asian governments can first try to put the relevant communication and consultation on a regular basis, such as holding quarterly or annual meetings. As the second step, to establish a research institute may be necessary. The institute should consist of representatives from major Asian economies who are highly qualified scholars with official position and officials from financial authorities. The institute should have its publications, such as newsletters, reports and so on. In the Age of IT, the institute should fully use the new technology available to speed up the exchanging of information and ideas and the networking region wide. The institute should keep a close eye on major Asian countries' economic situation and issue its evaluations on the situation. The institute should formulate all sorts of emergency plans in case that a crisis erupts. The institute can also help to coordinate different rescue packages, which are based on bilateral agreements. The nature of the institute can change following the passage of time. When the conditions are matured, the institute could evolve into a sort of AMF. In the new century, faced with the challenge of other continents, Asian economists should provide their clear visions for the cooperation of the Asian economies. We might need a grand plan for Asian integration, which covers political cooperation as well as economic integration. It should pay great attention not only to short-term financial rescue package but also to implementation of a concerted long-term economic adjustment to allow a parallel development of all-Asian economies."[6] It seems that the time is more mature now than in 2000 for the establishment the above-mentioned institution.

II. Regional exchange rate arrangements

For more than a decade before the Asian financial crisis, East Asian currencies were pegged to the US dollar. In effect, their mutual link to the dollar was the collective nominal anchor for their domestic price levels. McKinnon [2000] called it as East Asian dollar standard (EADS).

After the crisis, the pre-crisis peg to the US dollar was judged as a failure. During and after the Asian financial crisis, some economists argued that a country must choose a "corner solution". That is, the country either should adopt the floating exchange rate regime or the extreme form of the fixed exchange rate regime, namely, the currency board system. According to them, there was no middle ground. However, in the years after the Asian crisis, the middle ground seems to have asserted itself. There are mainly two schools of thought on the currently status of exchange rate arrangements in the East Asian region. McKinnon [2000] argued that in the year 2000, both the crisis and non-crisis countries of East Asia have retuned to formal or informal dollar pegging. According to McKinnon, East Asian countries, like other developing countries, are being "fear of floating" [Reinhart 2000]. They fear appreciation, because it is unfavourable to capital inflow and exports. They fear depreciation, because it will increase their dollar liabilities. Another explanation is "original sin" hypothesis [Eichengreen and Hausmann 1999], which attributes the reluctance to float to incomplete domestic financial markets. A country whose external liabilities are necessarily denominated in foreign exchanges is by definition unable to hedge. The cost of hedging would be extremely high. This means that some inflexibility in exchange rates is a cheaper price they prefer to pay.

In the opposition campus, Kwan [2001] argued that the post-crisis Asian countries mostly have converted to pegging to a basket of currencies with substantially higher weight of the Japanese Yen. In contrast, McKinnon [2000] argued that although not as good as common currency that provides an independent anchor and full long-run exchange rate certainty, a common monetary standard among close trading partners is still preferable to unrestricted exchange rate flexibility. It is better than floating exchange rates for mitigating asymmetric shocks. The common monetary standard recommended by McKinnon is US dollar.

Kwan [2001] disagreed with McKinnon. In his opinion, pegging to the dollar has some intrinsic weakness. With the yen fluctuating widely against the dollar, the traditional policy of pegging to the dollar has led to macroeconomic instability in Asian's developing countries. According to Kwan [2001], since the Plaza Accord in 1985, there has been a clear tendency for economic growth in Asia to accelerate when the yen

[6] Yu Yongding :China and Asian Monetary Cooperation, KIEP/NEAEF Hawaii Conference, August 10-11, 2000.

appreciates and to decelerate when the yen depreciates. The weakening yen led to a marked deterioration in Asia's export performance and current account balances in 1996, paving the way for the currency crisis.

During and after the Asian financial crisis, the Chinese monetary authorities have maintained the stability of the RMB, which contributed greatly to the recovery of East Asian economies. As pointed out by McKinnon [2000], if China were to let the yuan begin depreciating, no sustainable equilibrium for the East Asian economy would exist. In other words, competitive devaluation in East Asia would be unavoidable and the crisis would have been much worse.

Asian counties' experience shows that fixed exchange rate regime tends to invite speculative attacks, which would lead to a bigger instability in currency than under free floating exchange rate regime. However, due to lack of flexibility in the economic structure, a less developed country needs a stable currency. Therefore, to choose a middle way – to peg national currency to a basket of reserve currencies seems a favourable solution.

As pointed out by Kwan [2001], switching from pegging to the dollar to pegging to a basket of currencies means moving towards de-dollarization. However, what will be the net result of the de-dollarization for an individual country and for the region as a whole is still a question unanswered. Another important question is that, given different exchange rate arrangements (or the same exchange rate arrangement), what will be the equilibrium, if any, of the exchange rate game. In other words, the question of whether current exchange rate arrangements in the region are sustainable is still unanswered. If each country just takes into consideration its short-term national interests in deciding its exchange rate regime and exchange rate policy, the final result may be detrimental for the country as well as the region. For example, according to [McKinnon 2000], due to the temptation to target the real exchange rate, contagious devaluations would actually built into the rules of the currency basket game. Even if just for self-interests, each EA economies should take a regional view of exchange rate stability. East Asian governments need to cooperate in the management of exchange rates in the region. Otherwise, when a new shock wave strikes, EA countries' exchange rate alignment may be in disarray again. EA countries may not be able to avoid beggar-thy-neighbour devaluation one more time.

The most important characteristic of the current international monetary system is the domination of the dollar. Milton Friedman predicted that under flexible exchange rates countries would not need reserves. He is wrong. Countries need more reserves today under flexible exchange rates than they ever needed under fixed exchange rates. The main reserve they use is dollar. As a result, the United States is able to extract seiniorage from other countries. According to Mundell [1997], the total amount of United States' currency outside banks is nearly $400 billion. Most of the currency is outside the United States, being used as the international currency of the world. It was estimated that only 10% to 15% of the $400billion in circulation would be held in the United States. The rest of it would be used outside—not just by central banks but also by travellers, the drug cartel, tax evaders and foreign banks. With US dollar as the single most important international reserve money, the US is able to pay its huge current account deficits and to accumulate more than US $1.5 trillion foreign debts. On the other hand, the rest of the world has to rely on the mercy of Fed's self-discipline. As a result of the Asian financial crisis, EA economies as a whole now hold more than US $1.5 trillion with very low returns. East Asians are footing the bills for spendthrift American households.

Mundell [1997] pointed out that the United States would be the last country to ever agree to an international monetary reform that would eliminate this free lunch. The United States would not talk about international monetary reform, because a superpower never pushes international monetary reform unless it sees reform as a change to break up a threat to its own hegemony. The dollar liabilities of the United States have been rising by bushels and bushels. From a national standpoint, the United States is never going to suggest an alternative to its present system because it is already a system where the United States maximizes its seigniorage. East Asia should and would not tolerate this situation forever. East Asian economies have to work together to achieve the goal of establishing a more equitable international monetary system. The forming of an Asian currency, side by side of Euro, will help to end the hegemony of the US dollar.

What is the most feasible way to coordinate exchange policy? Is it a common basket peg scheme, or Asia Exchange Rate Mechanism, or Yen Bloc or Dollar Zone? Due to various economic structures and preferences in East Asia economies, different scheme means different costs and benefits for the economy. Some economies maybe ready for a close exchange rate coordination arrangement in East Asia, such as a common basket peg, while some economies need more time to prepare for it. Up to now, we can hardly find any exchange rate coordination scheme that can be fully accepted by all the economies.

In a research paper commissioned by the Ministry of Finance of the PRC,[7] we argued that, due to the endogenous nature of monetary integration, the focus of the efforts in promotion of exchange rate coordination in East Asia should shift to the construction of fundamentals, while studies on coordination schemes are continued.

Firstly, formal and regular dialogues on exchange rate policy and information exchanges among East Asia economies should be introduced as soon as possible. The increase in mutual understanding, in turn, will pave the way for more consensuses.

Secondly, the regional exchange stability should be jointly announced as an important consideration in East Asia economies' national exchange rate policy by relevant monetary authorities. Since a formal common basket peg or East Asia Exchange Rate Mechanism can hardly be adopted by East Asia economies in the near future, a compromise should be found. On the one hand, more stable exchange rate between the US dollar and the Japanese Yen should be achieved through the bilateral efforts of the US and Japan. On the other hand, the rest of East Asia currencies should opt out of Dollar Standard and find a finer balance between the exchange rate stability vis-à-vis the US dollar and the Japanese Yen. Hopefully, this approach can help to increase the intra-regional exchange rate stability.

[7] Sequencing of East Asia Exchange Rate Coordination, Prepared by the research team led by Yu Yongding, Institute of World Economics and Politics (IWEP), Chinese Academy of Social Sciences (CASS), 2004.

Thirdly, a set of financial integration arrangements and domestic financial reform plans can be introduced to promote further financial integration in the region. The development of Asian Bond Market is a case in point. These arrangements and plans are fundamentals for further monetary integration in East Asia. By pushing forward these arrangements and plans, the costs of switching from the old exchange rate regime to a more cooperative exchange regime could be reduced. A East Asia exchange rate scheme with ECU feature will be more acceptable.

Fourthly, a regional investment bank can be introduced to promote regional economic integration and facilitate fundamental constructions by less development economies in the region. In the process of pushing forward financial integration in East Asia, private sector should play a more important role. The establishment of a regional investment bank could provide financial support for private sectors' economic activities within the region and encourage more private sectors join in the fundamentals constructions. Difference from ADB, a regional investment bank should be aimed at promoting regional economic integration.

To establish an Asian currency unit should be the ultimate goal of East Asian countries' efforts in strengthening regional monetary and financial integration. If all parties concerned accept this objective, then the establishment of an Asian exchange rate mechanism (AERM) is inevitable. All these in turn imply that East Asian countries are aiming at establishing an Asian Economic Union. However, this is already an objective beyond the scope of economic studies.

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Stepping stones or building blocs? Regional and multilateral integration

Richard E. Baldwin

1. Introduction

Do regional trade arrangements help or hinder multilateral liberalisation?

The debate surrounding this question can be colourfully illustrated by recounting the famous exchange between two eminent economists, Larry Summers and Jadish Bhagwati, at a World Bank conference in 1992. Summers, the head of the Bank's research department at the time, was supposed to welcome Bhagwati as the keynote speaker with the customary 'few kind words'. Instead, Summers launched into a half hour discourse on what a good thing regional integration was. His most famous line was "I like all the 'isms', unilateralism, regionalism and multilateralism". Feeling quite upstaged, Bhagwati quietly fumed until it was his turn. Taking the floor, Bhagwati launched into an energetic attack on the Panglossian embrace of regionalism. Among his many dire predictions, he argued that regionalism would undermine the GATT-based world trading system, place small nations under the thrall of hegemonic powers, and even foster wars among trade blocs.

This debate – which has raged for more than a decade – brings to mind the Buddhist parable, 'The Blind men and the Elephant'.

Once upon a time a wise Raja summoned all the men in his realm who were born blind and proceeded to present an elephant to them. To one he showed its ears, to another its tusk, to another its trunk, and so on. He then said, "Tell me blind men, what sort of thing is an elephant?" Each gave his view, and since each had felt the elephant with his own hands, each was stubbornly sure that he knew the true nature of an elephant. They began to quarrel and eventually came to blows over the matter.

The morale of this story applies directly to the regionalism debate.

Liberalising on a regional basis means liberalising on a discriminatory basis. Therein lays the two-sided nature of regionalism. The "liberalisation" part in "discriminatory liberalisation" is generally good since it removes artificial barriers between domestic and some foreign producers. The "discrimination" part, by contrast, is generally bad since it creates new barriers between various foreign producers. Plainly then, one cannot know whether regionalism helps or hinders multilateralism based on pure logic. This brings us to the state of the debate.

1.1. State of the debate

The Larry-Summers school-of-thought looks at discriminatory liberalisation and sees liberalisation. An outcome it welcomes since it views regionalism as having a largely benign effect on the multilateral system. The Jagdish-Bhagwati school looks at discriminatory liberalisation and sees discrimination. An outcome it views as a serious threat to the WTO-centred world trading system. We first consider the logic behind the Bhagwati school's thinking.

1.1.1. Stumbling blocs: logic and fears

The Bhagwati-school posits two key risks of regionalism (see for example his tract entitled *"The dangerous drift to preferential trade agreements"*):

- 1. Regional liberalisation is a substitute for multilateral liberalisation, and this for two reasons:

it dampens nations' enthusiasm for further multilateral liberalisation, and

it diverts policy makers' attention from WTO rounds

- 2. Regionalism shifts power in worrying directions, specifically

it fosters greater dominance of small nations by hegemonic powers, and

it increases the chances of inter-bloc trade war.

Regionalism's dark history – regionalism and fascism in Europe and Asia

The Bhagwati fears are based first and foremost on historical analysis. As Doug Irwin wrote "In the interwar period discriminatory trade blocs and protectionist bilateral arrangements contributed to the severe contraction of world trade that accompanied the Great Depression". The latter wave of regionalism is often associated with the pursuit of beggar-thy-neighbour policies and substantial trade diversion. Worse yet, regionalism was associated with some of the most horrific episodes that humankind has ever witnessed – the WWII fascist regimes.

This may seem like an unnecessary diversion in a paper on regionalism and multilateralism in the 21st century, but it is not. When Jagdish Bhagwati and Anne Kruger write about the "dangerous drift" of regionalism, they have the interwar period in mind.

Fascism, autarky and regionalism

Fascism is organised around the primacy of the nation and when it comes to economic policy this means promoting national industry by, among other things, avoiding 'destructive competition.' High tariff barriers were an important part of this in the 1920s and 1930s. Of course, protectionism was embraced by all major states in those times, but with an important difference. Most nations viewed protection as a stop-gap measure to address the crisis of unemployment and/or as a reaction to foreign protectionism. In Fascist Italy, Germany and Japan, by contrast, international trade per se was viewed with suspicion. Indeed, national self-reliance, i.e. autarky, was an explicit goal of policy. The connections can be made most clearly by tracing out the logic linking fascism, autarky and regionalism in its most destructive expression – Hilter's territorial ambitions known as Lebensraumpolitik in German.

Hitler, whose formative years were deeply marked by the economic disruptions in the 1920s and 1930s, was thoroughly suspicious of trade. He believed that the Great Depression was caused by an over production of manufactured goods and explicitly rejected the notion that a nation could prosper as an exporter of manufactured goods and an importer of food. Moreover, while the Atlantic Europeans had prospered and industrialised with the help of captured overseas markets (colonialism), Germany's colonial ventures were economic disasters. The development of Germany's industry relied much more on the formation of a regional trade bloc among the hundreds of small states of the German Confederation – Bismarck's famous customs union (Zollverein). Hitler's suspicions of relying on foreigners via trade were confirmed when the League of Nations placed trade sanctions on the Italian fascist state in reaction to Italy's invasion of Northeast Africa.

Hitler's mistrust of trade interacted with his dual doctrines of 'race' and 'space' to produce a radical and particularly destructive trade policy. There was nothing new about his belief that his race was superior; many people believe this of their own race even today. The dangerous innovation was his view of history as a struggle among races, with a winner-take-all outcome being inevitable. Each race, he thought, had to balance its population and its living space. If a people choose to adjust its population to its living space, Hitler thought, decline and eventual enslavement by another race was inevitable. "Hitler had no confidence in the possibility of increasing food production from available land. The struggle for existence in which the races of the world engaged, the basic element of life on earth, was fundamentally a struggle for space. In this struggle the stronger won, took the space, proliferated on that space, and then fought for additional space. Racial vitality and spatial expansion were directly related" (Weinberg 1996 p. 34).

In short, Hitler, viewed trade with suspicion and autarky as a merit, but he realised that Germany could not prosper in isolation. The solution, he decided, was to rearrange international boundaries so that international trade became domestic trade. Signing bilateral trade agreements with fellow fascists and future victim nations were stepping stones to military invasion.

Italian fascism pursued a similar logic towards a similar goal, but in Mussolini's case the end point was a new Roman Empire. Fortunately, Italian fascists failed to implement the territorial expansion phase as effectively as the Nazis. Japanese fascism followed a similar logic taking steps towards what eventually became the "Greater East Asia Co-Prosperity Sphere". In the Japanese case, apologists for imperialism sought to justify the regional trade bloc in terms of anti-Western imperialism.

In all cases, fascism aimed to set up more or less autarky trade blocs designed primarily to further the economic and political power of the hegemonic power.

Non-fascist trade blocs[1]

The regional arrangements formed between World Wars I and II by non-fascist nations were highly discriminatory, relying on high external tariffs to provide preferential market access. For example, France and Great Britain sought to consolidate their empires. France formed a customs union with members of its empire in 1928 and the Commonwealth system of preferences established by Great Britain in 1932.

Smaller European nations reacted defensively. Hungary, Romania, Yugoslavia, and Bulgaria each negotiated preferential access for their agricultural goods with various European countries. Belgium, Denmark, Finland, Luxembourg, the Netherlands, Norway, and Sweden signed economic agreements throughout the 1930s. Outside of Europe, the United States forged almost two dozen bilateral commercial agreements during the mid-1930s, many of which involved Latin American countries.

1.1.2. Building blocs: logic and hopes

Summers' argument is basically a reaction to Bhagwati's fears. Bhagwati recalls that regionalism lead to terrible outcomes in the past and makes the general point that regionalism might be a substitute for multilateralism. Summer's argument is to implicitly reject this historical analysis, adopting a what-me-worry attitude, instead. According to Summers' worldview, post-WWII regionalism has resulted in a great deal of tariff removal and there is no clear evidence that regionalism has sidetracked multilateralism in the capitals that matter.

Prima facie rejection of fears

The Summers point of view has been strengthened by the world's experience over the past 15 years. There are three salient points in the prima facie argument that "all the 'isms' are good".

1980s and 1990s regionalism did not thwart the Uruguay round

Bhagwati's warnings fell on attentive ears in the early 1990s. The Uruguay Round, which was scheduled to finish in 1991, dragged on and on. In contrast, preferential trade arrangements in European and the Western Hemisphere spread like wildfire. By the mid-1990s, however, this journalistic reading of history seemed passé. The Round finished, the WTO was set up and the nations that were responsible for the final push for the WTO were exactly the ones who lead the wave of regionalism that Bhagwati asserted would undermine the Round. This leads to the second point.

[1] This section draws heavily on Mansfield and Milner (1999).

The key multilateralist nations are also regionalists, and have been since WWII.

Multilateral liberalisation since WWII has been wildly successful at cutting developed nations' industrial tariffs. Yet the nations that steered this multilateral liberalisation – the US, the UK, the EEC6, the Nordics and Canada – are the same ones that drove regional liberalisation since the 1958 Treaty of Rome, the 1960 Stockholm Convention, and the 1965 Canada-US Auto Pact. Japan is the exception that confirms the rule. Although Japan has always been a good citizen when it comes to the multilateral trade system, it was never a leader in the GATT Rounds and it was also never involved in regional trade arrangements until recently.

Moreover where GATT Rounds failed, the regional route also failed. Historically, developed nations resisted agricultural trade liberalisation both multilaterally and regionally, and developing nations resisted tariff-cuts on manufactures both multilaterally and regionally.

Multilateralism as a response to regionalism

Finally, a number of observers believe that regional integration efforts promoted multilateral liberalisation via 'competitive liberalisation' (to use Fred Bergsten's term). For example, most scholars believe that formation of the EEC induced the US to push for multilateral tariff-cutting via the Kennedy Round. Kenen (1989) provides the textbook treatment, which entails two steps. First, the phase-in of EEC preferences harmed US exporters. Second, redressing the discrimination required multilateral liberalisation (the direct way to offset it, joining the EEC, was unthinkable). In this roundabout way, European regionalism created a burst of free-trade multilateralism among US exporters, and the US government followed suite. Similar arguments have been made that the EU's Single Market Programme (announced in 1985 and ratified in 1986) fostered the launch of the Uruguay. See Schiff and Winters (2003) for more examples.

1.1.3. A dynamic view of regionalism and multilateralism

For ten years, I've been pushing a more focused rejection of the Bhagwati fears. Building political economy models of trade liberalisation known as 'the domino theory of regionalism', and the 'Juggernaut theory of reciprocal liberalisation'.

2. Dominos and Juggernauts

To think about regionalism's role as a stumbling or building bloc, it is useful to answer two questions independently and then to hook them up in the next section. The questions are:

"Why are countries eager to open markets regionally?" and;

"Why has GATT/WTO multilateral talks been so successful at liberalising the industrial tariffs of industrialised nations?"

We take these questions in turn.

2.1. Why does regionalism spread in waves?

One oft-heard explanation for why regionalism is so popular rests on two assertions.[2]

- Regional integration has prospered as an alternative to multilateralism since multilateral trade negotiations have become too cumbersome to deal with today's complex trade issues. (This argument, first introduced when the Uruguay Round proved difficult to conclude, as re-emerged as the Doha Round is proving difficult to conclude.)

- Regionalism is fostered by the United States' conversion from devoted multilateralist avid regionalist.

Both of these assertions are just plain wrong, as I have argued (Baldwin 1997). In Baldwin (1993, 1995), I proposed a very different answer – the domino theory of regionalism.

2.1.1. The domino theory of regionalism

This theory is simple. It starts with an idiosyncratic shock, such as deeper integration of an existing regional bloc or formation of a new FTA for political reasons. This triggers membership requests from countries that were previously happy to be non-members. Why? The stance of a country's government concerning membership in a regional bloc is the result of a political equilibrium that balances anti-membership and pro-membership forces. Among the pro-integration forces are firms that export to the regional bloc. Since closer integration within a bloc is detrimental to the profits of non-member firms (trade diversion), closer integration will stimulate the exporters to engage in greater pro-integration political activity. If the government was previously close to indifferent (politically) to membership, the extra activity may tilt the balance and cause the country to join the bloc. If the bloc enlarges, the cost to the non-members increases since they now face a cost disadvantage in an even greater number of markets. This second round effect will bring forth more pro-integration political activity in non-members and thus may lead to further enlargement of the bloc. The new political equilibrium will involve an enlarged regional trading bloc. Meanwhile it would appear that regionalism was spreading like wildfire.

If the trade bloc is open to expansion, virtually all nations who depend heavily on the bloc will end up signing preferential trade agreements (this is what has happened in Europe and most of the Mediterranean Basin). If the bloc's natural enlargement 'burn-path' is barred, the new political economy flames may find vent in preferential arrangements among excluded nations (this is what happened when Mercosol was formed). Notice that such regionalism could occur despite any progress being made in ongoing multilateral talks, unless these also promised to fully offset the discrimination.

[2] A succinct exposition of this explanation can be found in the Bhagwati (1993) and Krugman (1993) papers that appear in the World Bank/CEPR volume on regionalism (De Melo and Panagariya 1993).

An old idea. The basic idea is not new. With hindsight, one can discern a version of it in Jacob Viner's account of how dozens of German principalities and city-states were cajoled and coerced into joining Prussia's Zollverein between 1819 and 1867 (Viner 1950 Chapter V.3). But the notion is probably much older. Bismarck himself probably understood the political-economy dynamics of trade diversion. Be that as it may, it is important to minutely examine the internal logic of even the oldest ideas and this requires maths. To my knowledge, Baldwin (1993), which deals with EU enlargement, was the first formal framework to explore the dynamic political-economy implications of trade diversion. Several subsequent studies – most notably Yi (1996), Ethier (1996) and Siedmann and Winter (1997) – have elaborated the basic framework.

Historical examples. A domino effect has occurred repeatedly in Europe (e.g. in 1961, 1973, 1986, and 1994), and in the Western Hemisphere with NAFTA, the Enterprise for the Americas Initiative, Mercosol, and it is just starting in East Asia. (See Baldwin and Wyplosz 2003 Chapter 1 on the European cases, Baldwin 1997 on the Western Hemisphere, and Baldwin 2003 on East Asia.)

The arrangement of preferential trade arrangements in the world is not completely random. In the Western Hemisphere and Europe, the system resembles an old fashioned wagon wheel, where the hub is a large economy (the US, the EU, Brazil-Argentina, etc.) and the spokes are the FTAs linking smaller, nearby nations to the hub.

2.2. Why hub & spoke bilateralism? Some theory

The world is full of hub and spoke trade arrangements. What are the political economy forces that so systematically yield hub-and-spoke bilateralism?

2.2.1. The mercantilist view of trade negotiations[3]

From a political perspective, exports are good and imports are bad. While this idea is economic nonsense from the medium- or long-run perspective, the important fact is that this mistaken reasoning points governments in the right direction. It leads them to conduct trade negotiations based on an exchange of market access. Specifically, since exports are good and imports bad, if country A wants better access to country’s B’s markets, then country A is expected to ‘pay’ for this market access by opening its own market to B’s exports.

Law of the jungle, MFN rules and FTAS

Usually, the market opening that result from this mistaken reasoning is good for all nations involved. A drawback of this mechanism, however, is that may create a sort of law of the jungle. That is, with market access as the currency of exchange, big countries are rich and small countries are poor. The rules of the GATT correct this imbalance with the principle of Most Favoured Nations (MFN) treatment. However, when it comes to negotiating regional trade arrangements, MFN does not apply, so the law of the jungle may prevail. Nations with big markets are strong and those with small markets are weak.

[3] This section draws on Baldwin (1994).

Political economy of hub and spoke bilateralism

The political economy forces created by this law of the jungle foster hub-and-spoke bilateralism. Take a country like the Czech Republic in the mid-1990s, before it joined the EU. On the pro-liberalization side, Czech exporters have a large interest in the EU market, but only a minor interest in the market of, say, Estonia. On the anti-liberalization side, Czech import-competing industries dislike imports whether they come for the EU, Estonia or elsewhere. Now consider the line-up of political forces inside the Czech Republic. Czech exporters are willing to fight quite hard for market opening with the big EU market. They are willing to fight much less hard for market opening with Estonia. In other words, there are strong political forces backing market opening with the "hub" but very little support for market opening with other “spokes”. Since Czech protectionists simply want to reduce import competition from any source, the protectionists are likely to win when it comes to blocking spoke-spoke liberalization, though they lose when it comes to hub-spoke liberalization.

An interesting add-on effect may occur if foreign investment from the hub is important in the spoke economies. To attract foreign investors, the spoke governments may promise protection from imports. Moreover, given a credible trade agreement with the hub, it is much easier for the spoke government to promise long-term protection against import from other spoke economies. If this sort of pandering-for-investment protectionism becomes quite common, the spoke economies may end up ‘Balkanized’. That is, foreign multinationals may be enticed into locating inefficiently small production facilities in each spoke economy. Having done this, the multinationals may become a new anti-liberalization force. Companies from the hub that have invested in inefficiently small facilities in several spoke economies may resist efforts to liberalize spoke-spoke trade. This may make the hub governments more reluctant to take any initiative in redressing hub-and-spoke bilateralism.

Why FTAS between developing nations usually fail

If some idiosyncratic event stirs a great wave of enthusiasm for brotherhood among the spoke economies, politicians in these countries may sign agreements promising to open spoke-spoke trade. Yet once the headlines fade and the enthusiasm wanes, the drab politics of protectionism usually reasserts itself. Promises are broken, or never fulfilled and the expected liberalization never appears. Moreover, since protectionist forces reappear in both spoke economies, the broken promises are generally accepted without protest. Note how different the situation is for spoke-hub trade arrangements. Exporters in both the hub and the spoke (but especially those in the spoke economies) care a good deal about access to each other’s market. Accordingly, exporters would raise their voices if promises were not kept. That is to say, the same sort of backsliding that is common in spoke-spoke agreements will not be tolerated in hub-spoke trade deals.

2.2.2. Domino effect applied to hub and spoke bilateralism[4]

The domino theory asserts that the signing of one preferential trade arrangement triggers a chain reaction in that it tends to induce other such arrangements, with the force of this effect feeding on itself. The theory was originally conceived to account for NAFTA and the create pro-EU-enlargement pressures that emerged in the 1990s. But the theory can be extended to the specific case of hub-and-spoke bilateralism.

The above political economy reasoning suggests that exports to the hub are the key to the domino effect in this case, even though the full problem is radically more complex. To illustrate the basic logic as simply as possible, we make the extreme assumption that exports to the hub are the only thing that matter. To be concrete, suppose we have three nation that are potentially spoke, spokes 1, 2 and 3, and one potential hub. For simplicity's sake, assume that all of the spokes are symmetric to each other.

Presuming the hub initially imposes an MFN tariff of T on all three of its partners, the signing of the first hub-to-spoke FTA raise the price facing exporters based in the spoke nation that negotiated the FTA. However, the extra competition in the hub market means implies a price and sales drop for exporters in the excluded spokes.

When the second hub-spoke FTA is signed, three things happen to spoke exports. The second FTA signer sees its exports rise as the price it faces rises. The first FTA signer sees an erosion of its preference, so its export volume and price fall in the hub market. The remaining spoke sees its exports fall as the price it faces for exports to the hub also falls. When the third and final hub-spoke FTA is signed, two things happen. The first and second FTA signer see their exports fall as the price they face falls to the free trade price. The third FTA signer sees its export volume to the hub expand significantly, as all the discrimination is removed, and the price it earns on exports to the hub rises.

Race to be first

To summarise, when we focus only on spoke exports, we can say that the gain is greatest for the first signer, next biggest for the second signer and smallest for the last. This ordering has important implications.

Let us suppose that for some reason or the other, the hub cannot, or at least might be able, to simultaneously negotiate all three FTAs simultaneously. To keep things simple, let us make the artificial but useful assumption that the hub can do one FTA per year. It is obvious from the discussion above that any spoke that believes it will eventually sign an FTA with the hub would like to be the first one to do so. Or, to put it more colloquially, there will be scramble for the head of the queue, once the spokes knows that the hub is open to FTAs. Moreover, the same scramble would occur even if the hub can negotiate many FTAs at once but there is a possibility that some of these might be put off, or that at some point the hub would stop signing FTAs.

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4 This section draws on Baldwin (2004).

This is what happened when the US and Mexico announced their FTA in 1990. Within months, Chile, Brazil, Argentina, Uruguay and Paraguay all formally or informally approached the US with requests for FTAs.[5] The Bush administration, fearing five separate battles with protectionists in Congress, discouraged these efforts and offered the Enterprise for the Americas Initiative (EAI) instead; this was launched in June 1990. According to CEA (1991 p.255), the EAI created a process leading to free trade agreements, the first step of which required nations to sign so-called Framework Agreements. These committed countries to reducing their investment restrictions, inter alia, in exchange for promises of closer US ties in the future. Although the Framework Agreements might be viewed as unilateral 'concessions' by mercantilists, 26 Latin American countries signed them in 1991.

The model discussed above leaves out two very important elements. First, it ignores the impact of FTAs on the spoke's economies. A full analysis would account for the political economy forces opposing an FTA with the hub. While these are surely important to the whole picture, post-war history shows that very few spoke economies can resist the appeal of an FTA with the hub, once the hub starts signing such agreements. The second aspect has greater relevance to recent regionalism, namely, the attitude of the hub to further FTAs. In Europe, where the EU is clearly the hub, this is not an issue since the EU has committed itself to what might be called open FTA-ism. The EU will sign an FTA with almost any nation that is democratic and is willing to accept the EU's insistence that agricultural trade be excluded. In the Americas, where the US is the dominant hub, things are quite different. The US has been extremely reluctant to accede to the many FTA offers it has received. Plainly, it would be nice to have a convincing analysis of why the EU and US approaches are so different, but I suspect that the real answer is non-economic.

2.3. Explaining the GATT/WTO's success

The standard account of multilateral liberalisation starts from the Prisoner's dilemma created by so-called optimal tariffs. That is, nations, just like firms, can use their market power to force down the price of the goods they buy. According to the textbook presentation, all nations can improve their terms of trade by imposing a tariff (although the potential improvement is very small for very small nations). Terms-of-trade changes, however, are worse than a zero-sum game. If all nations strive of better terms of trade, the 'size of the pie' shrinks and all may end up worse off. Or, to put it differently, every nation may gain by removing its tariff in concert with other nations.

This standard account is a nice story, but it fails to explain most of the big facts of multilateralism. Stylising the facts for rhetoric's sake, only rich nations liberalised and then only industrial goods. Moreover, the process took 40 years.

The Juggernaut theory proposes a very different approach. The theory was first posited informally by Baldwin (1994) and Baldwin and Baldwin (1996) and formalised by Baldwin and Robert-Nicoud (2004),

[5] At the time, I was working for the Bush administration's Council of Economic Advisors following trade policy matters.

2.3.1. The Juggernaut theory of multilateral liberalisation

The Juggernaut theory asserts that liberalisation begets liberalisation, so once the liberalisation ball starts rolling, it is difficult or impossible to stop.[6] Here is the logic.

Wind back the clock to 1947 when the GATT became active. At that moment, tariffs started at levels that were politically optimal. That is, tariff levels – like prices in a competitive market – balance the supply and demand for protection in the political market. The main demanders of import protection are import-competing firms and workers they employed. The government was the supplier of protection, but was reluctant to raise tariffs to autarkic levels since this would harm the general economic health of the nation.

How to get the Juggernaut rolling

Starting from this situation, announcement of multilateral tariff-cutting talks based on the principle of reciprocity alters the array of political forces inside each and every nation participating in the talks on the basis of reciprocity. And reciprocity is the key. Reciprocity turns each nation's exporters from bystanders in the tariff debate to fervent opponents of protection within their own nation. Why? The principle of reciprocity means exporters win the prize of better access to foreign markets only if home tariffs are lowered. Thus lobbying against domestic tariffs becomes a way of lowering foreign tariffs.

Since this rearrangement of political forces goes on inside every nation involved in the talks, a new political equilibrium emerges. Tariffs are cut because now the supply of protection shifts in (exporters increase the marginal political cost to their government of maintaining any given level of tariffs), but the demand for protection is unchanged. Note that tariffs do not go to zero, but they are cut in all participating nations and these tariff cuts are phased in over a 5 to 10 year period.

The phase in of tariff cuts at home and abroad alters the economic landscape and this generates a sort of political economy momentum.

The economic source of the political economy momentum

In all participating nations, export sectors expand output and employment as foreign tariffs come down, and import-competing sectors reduce production and employment as home tariffs are lowered. In economic terms, the long-run supply responses in the export and import-competing sector are greater than the short-run responses. Why does this matter?

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[6] 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 diety 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.

Although many factors affect a sector's political influence in tariff-setting, size always matters. That is, other things equal, a sector with lots of workers, lots of capital and lots of profit will have more influence. Since the export sectors in all nations have expanded while all of the import-competing sectors have shrunk, the next GATT/WTO Round leads to a different outcome.

A few years down the road, when another multilateral Round 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 in every nation. The result is that all participating governments find it politically optimal to cut tariffs, but again not to zero. As these fresh tariff cuts are phased in the cycle is repeated.

This process means that any sector in any nation that is included in the reciprocal trade talks will eventually get liberalised.

Exceptions that prove the rule

Oversimplifying to make a point, tariffs in the world can be summarised in three points: they are zero on industrial goods imported into rich nations, they are high on food imported into rich nations and they are high on industrial goods imported into poor nations. How does the Juggernaut theory account for these 'facts'?

Until the 1990s, GATT Rounds focused on manufactured goods, so it is no surprise that food was not liberalised. More specifically, the import competitors in the EU, US and Japan were so strong that they managed to take food tariffs off the bargaining table, so no one inside the EU, US and Japan gained from lobbying against food tariffs. In this way, food tariffs were shielded from the relentless crushing force of the Juggernaut effect.

Developing nations have participated in GATT/WTO Rounds, but not on the basis of reciprocity. Until the 1970s, the GATT was a rich-man's club. Most poor nations were colonies or newly independent states, few of which wanted to join. When the merit of membership did become to be appreciated by some developing nations in the 1970s, the GATT adopted its "Enabling Clause" – which should have been called the 'disabling clause' since it disables most of the GATT's discipline for poor nations. The Enabling Clause meant that developing nations did not have to make tariff concessions in order to gain better market access. Or, more to the point, GATT Rounds did not turn developing country exporters from bystanders to free traders. Under these rules, the multilateral talks had no impact on the array of pro-trade and anti-trade political forces within developing nations. Little wonder, then, that they decided to stay with the initial level of their tariffs, which were after all politically optimal to begin with.

2.3.2. Multilateralism and regionalism as complements

Does recent regionalism threaten the future of the world trading system? My best guess is that because trade is already quite free in the major trading nations, few regional liberalisations are capable of creating important anti-liberalisation forces. For this reason, most regional deals will weaken the key opponents of free trade (import competitors) while simultaneously strengthening its key proponents (exporters). Regional integration will, therefore, foster multilateral liberalisation and vice versa, just as it has done for the past 40 years.

If this is right, regional deals are not building blocks or stumbling blocks. Regionalism is half of the trade liberalisation ‘wheel’ that has been rolling towards global free trade since 1958.

The discussion, hereto, has been relatively abstract. I turn now to the most important “news item” when it comes to regionalism: East Asian regionalism.

3. Likely evolution of East Asian regionalism

At the end of 2004, the first hints of the ‘wildfire regionalism’ can clearly be seen in East Asia. No one, however, is in charge. There is no overarching plan for managing it. Judging from the history of unplanned regionalism in other areas of the world, the most likely outcome will be hub-and-spoke regionalism for a very simple reason. Bilateral trade flows in Asia form a hub-and-spoke pattern. As argued above, the mercantilist forces that drive nations’ trade policies tend to free up major trade routes, leaving minor trade routes un-liberalised. Because bilateral trade flows in Asia form a hub-and-spoke pattern, the future pattern of FTAs is likely to follow the same pattern.

But who will be the hub in East Asia? The results of the calculations in Baldwin (2003) suggest that both Japan and China will naturally emerge as hubs.

3.1. East Asian bicycle: two hubs, many spokes

Tying the Baldwin (2003) hub-ness findings to political economy reasoning, it seems likely that the pattern of FTAs that will be signed in the next ten years will have two hubs, Japan and China – something like a bicycle (Figure 1). Of course, our numerical results are not essential to this prediction; it would also be suggested by a careful examination of the regional trade patter. The merit of the rough quantification of “bilateral attractiveness” is that it provides some discipline on what is usually an unruly analysis. One just cannot think of, say, Singapore or Vietnam, as a hubs even if they signed an FTA with every East Asian nation.

Figure 1: A possible FTA pattern: East Asian bicycle

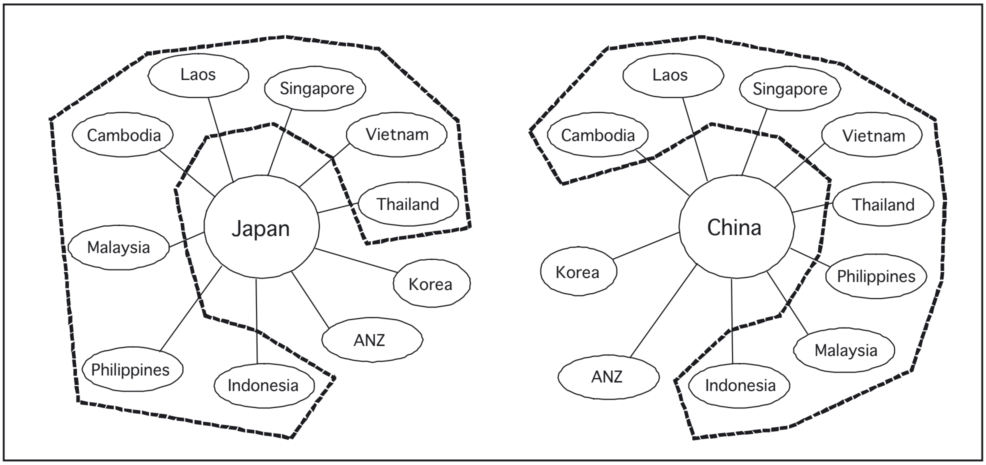

Figure 1 is a schematic drawing of this prediction for East Asian FTAs. While it does not show all the FTAs (e.g. Singapore has signed many bilateral FTAs), it stylised the implications of rampant bilateralism. Since ASEAN is not an effective free trade area, it is shown as a dashed and irregular shaped line.

3.1.1. Problems with the bicycle

Some readers may interpret Figure 1 very differently. Indeed, I could have drawn it in a way that makes Japan and China the spokes with every other nation as a hub. This misses an important point. Hub status is all about market access. For most industries, domestic market access is quite important, so it is worth noting the so-called 'border effect' (McCallum 1995). As it turns out, domestic firms have much, much better access to the domestic market than foreign firms do, even when those foreign firms have duty-free access. Consequently, the market access provided to a firm in Korea may be much less than one in Japan or China, even if there are Korean FTAs with both China and Japan, but no Japan-China FTA.

Another problem arises when considering the 'law of the jungle' bilateral FTAs between big and small nations naturally tend to reflect the concerns of the big nation much more than those of small nations – after all, market access is the currency in an FTA negotiation, so negotiators from big-market nations can 'buy' more than those from small-market nations. Given this hard fact of bilateralism, a spoke's FTA with China and its separate FTA with Japan is likely to impose conditions that diminish the attractiveness of the spoke market.

While there many, many other possibilities, it seems to me that the two-hub scenario is the most likely for East Asia – unless something is done to prevent it. (See Baldwin 2002, 2003 for a discussion of various solutions.)

4. Concluding remarks

I started my remarks with the question: "Do regional trade arrangements help or hinder multilateral liberalisation?" I end with the economist's ever-reliable credo: "It depends".

Because regional trade liberalisation is both discrimination (i.e. not MFN) and liberalisation, its implications are profoundly ambiguous. The regionalism-is-a-stumbling-bloc school focuses on the discrimination. The regionalism-is-a-building-bloc school focuses on the liberalisation. In this paper, I have argued that for the most part, reciprocal liberalisation of most kinds tends to strengthen pro-trade political economy forces while at the same time weakening the anti-trade political economy forces, and this within each of the participating nations. I believe that North-North regionalism is not a threat to the multilateral system since it has been accompanied by multilateral liberalisation for so long. North-South regionalism is also not a problem since the Southern partner ends up facing something close to world prices via the previous MFN liberalisation of the Northern partner. South-South regionalism, however, poses the possible that it will create new, politically power interest groups that will oppose multilateral liberalisation. In my view, the only South-South regional trade agreements that have the potential of becoming real stumbling blocs are to be found in the southern cone of South America and in East Asia. The dangers of this would be mitigated if these developing nations fully participated in the exchange of market access taking place in the Doha Round.

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