European Integration: What Lessons for Asia?

Barry Eichengreen
University of California, Berkeley
May 2007

There is now a small but rapidly growing industry concerned with lessons from Europe for regionalism in Asia. European experience is ritually invoked if only because the European Union, starting at a relatively early date, has gone far in the direction of regional integration. Close study of Europe can thus shed light on facilitating conditions for regional integration and identify strategies for pursuing it. Insofar as the European story has not been one of uninterrupted progress, it can also point to barriers to overcome.

Asia is not Europe. Both politics and economics differ across regions, whether one compares Asia now with Europe now or Asia now with Europe when the Treaty of Rome was signed. In Europe at mid-century, nationalism was delegitimized by two devastating wars, and political integration was seen by important elites as an instrument for avoiding the recurrence of those same cataclysmic events. In Asia, in contrast, World War II triggered decolonization, which legitimized rather than discrediting nationalism. Nationalism being alive and well, willingness to contemplate political integration and build transnational institutions of economic governance remains more limited in Asia. Similarly, by 1957 only a few tentative steps had been taken in the direction of reconstructing the network of intra-European trade. By 2007, in contrast, Asia had already developed an extensive and rapidly expanding regional trade network.

The global context also differs. Fifty years ago the process of rebuilding the world economy following the disruptions of two world wars and a Great Depression had only just begun; now, in contrast, the world economy is more extensively globalized than in a century.[1] Whether regional integration offers the same benefits when there already exists deep global integration is an open question. Moreover, European integration took place against the backdrop of the Cold War, which meant that efforts to buttress regional solidarity received strong outside support from the United States. Now, when it is not obvious that an integrated Asia would be seen as a bulwark against communism, terrorism or any other "ism," it is far from clear that faster progress toward regional integration would receive support from the U.S. or other extra-regional powers.

Thus, lessons must be drawn carefully, both because Asia is not Europe and because 2007 is not 1957. But none of this is to question that the process of Asian integration can be informed and shaped by the experience of Europe. This paper attempts, once again, to identify the lessons.

Integration in Europe has five dimensions: trade integration, financial integration, monetary integration, regulatory integration, and political integration. One way of organizing the discussion is separating it accordingly. One can ask what facilitated European integration in each of these areas and what obstacles have worked to limit its extent. Necessarily, some of the discussion here is about how different functional dimensions interact and about the sequencing of reforms. In Europe, completion of a regional free trade area preceded financial integration. In Asia, in contrast, the creation of a free trade area and efforts to build an integrated regional financial market are proceeding in tandem. In Europe, efforts to foster monetary cooperation preceded full financial integration: the Snake and the European Monetary System were established prior to the removal of controls on cross border capital flows, not to mention the elimination of barriers to cross listing of securities and full freedom to complete cross-

[1] Some would say even more deeply globalized now than then (Bordo, Eichengreen and Irwin 1999).

border bank mergers and acquisitions. In Asia, in contrast, efforts to foster regional financial integration have preceded the creation of formal monetary arrangements.[2] Europe has taken extensive steps in the direction of regulatory harmonization where in Asia such cooperation remains at an early stage. In the literature on Europe, it is argued that sequencing matters – that the ultimate design of Europe's regional architecture is not independent of the timing of decisions taken along the way. Regional integration is a path-dependent process, in other words. In turn this points to the question of how the sequencing of initiatives may similarly shape the outcome in Asia.

A second way of organizing analysis of European experience is in terms of decision making. In part this is the story of the institutions of the European Union: the Commission, Council, the Parliament, and the Court of Justice. I describe the powers of these entities, the subtext being that there may be limits on Asian integration insofar as there is a reluctance to cede significant powers to transnational institutions. But I also show that the powers of the principal EU institutions have evolved. There has never been a static line between the powers of EU institutions and the powers of national governments, nor has there a fixed point beyond which regional integration cannot go without national governments ceding significant powers to EU institutions – although the reluctance of governments to pool their decision-making authority creates complications for the integration process. I show how recent developments in decision making in the EU, notably the Open Method of Coordination, suggest promising directions for Asia.

A third way of organizing the analysis is in terms of the principal expenditure programs of the EU: the Common Agricultural Policy and the Structural Funds. These programs illustrate how it is not always obvious what policies will result from a regional

[2] The Chiang Mai Initiative of 200 notwithstanding; for more on this exception, see below.

initiative – something that Asia might usefully bear in mind. They demonstrate how building a broad-based coalition supporting regional integration may require the extension of side payments, sometimes with enduring consequences.

These are the three approaches taken in the present paper. Section 1 looks at the European integration from a functional perspective, distinguishing issue areas and analyzing sequencing. Section 2 turns to the institutions of the European Union, with an eye toward understanding the scope for and constraints on institution building in Asia. Section 3 then considers policies and programs with a focus on the CAP and the Structural Funds. Section 4, in concluding, returns to the implications for Asia.

1. Sequencing

A stylized description of European integration would distinguish five phases, starting with the customs union and proceeding serially to the single market, financial integration, monetary integration, and political integration. From an economic standpoint, there is a logic for this ordering (or at least its first part): it is consistent with conventional wisdom regarding the sequencing of external reforms, according to which trade opening should precede financial opening. This ordering also resonates with a venerable thesis in political science, due to Haas (1958), according to which the customs union created political and economic pressures ("neofunctionist spillovers") for further economic, financial and monetary integration, which in turn created pressure for political integration.

Asia is similarly proceeding with the creation of a trade arrangement through a combination of bilateral and regional free trade pacts. Will this engender demands for deeper forms of integration, such as free labor and capital mobility and regulatory harmonization? And will this in turn intensify the pressure for financial integration? Will economic and financial integration in Asia ultimately create a demand for monetary integration, culminating in a single currency? And if deep integration results in the establishment of a regional competition authority, a regional financial regulator, and a regional central bank, will this in turn create a demand for a regional political entity so that there exists a body capable of holding these decision makers democratically accountable for their actions?

This framing of the issue prompts two immediate thoughts – or, more precisely, two objections. First, European experience was in fact more complicated. The five phases in the European project, if they may be called phases, were not disjoint. They overlapped, and a number of them proceeded in fits and starts. Thus the nature, extent, and even existence of spillovers can be reasonably questioned.

Second, even if there was a logic for the order in which the different aspects of the integrationist project unfolded in Europe, it does not follow that this is the only conceivable logic or that it must be followed in Asia. Already there are signs, for example in Asia's early initiation of efforts to integrate its financial markets, that the sequencing of initiatives is proceeding differently there. But the comparison with Europe is still valuable for highlighting the differences and pondering their implications.

In Europe, the conventional story about spillovers and sequencing takes the customs union as the catalyst for further integration. Commercial integration was the logical place to start because production and trade had been extensively integrated in prior years (Eichengreen and Irwin 1995). Transport costs being relatively high, trade was disproportionately concentrated among geographic neighbors. The structure of the neighboring economies was complementary: Germany specialized in the production of capital goods, while its neighbors disproportionately produced consumer goods, supporting high levels of intra-regional trade. At the same time, financial openness and integration had been discredited by the financial instability of the 1930s. Thus, the elimination of most barriers to intra-European trade in the 1960s was not yet accompanied by the removal of capital controls.

The customs union resulted in a rise in the share of trade that the members conducted with other European countries. Trade among the six founding members of the European Economic Community (France, Germany, Italy, the Netherlands, Belgium and Luxembourg) rose from 35 per cent of their total trade in 1960 to 44 per cent in 1965 and 49 per cent in 1970, by which time their customs union was complete.[3] Although traditional patterns of comparative advantage reconstituted themselves, with Germany exporting capital goods and France consumer goods, a growing share of this trade was intra-industry, as firms developed regional production networks and vertical supply chains. Both trends created natural constituencies of firms with an interest in maintaining and enhancing their access to other European markets. These firms then began to lobby for the removal of barriers behind the border. Where governments acceded in principle but were slow to implement, producers could obtain relief from the Court of Justice. Thus, successful completion of the customs union created pressure for regulatory harmonization, mutual recognition of product standards, and other steps to create a true single market – and progress in that direction.

A true single market also implied freedom for capital to move throughout the integrated economic zone, for otherwise it would not be possible reorganize production in

[3] Eichengreen (2007), p.179.

efficiency-maximizing ways. The same large banks and firms that benefited from the growth of intra-European trade saw themselves as benefiting from the removal of barriers to foreign investment and lobbied for financial integration. The growing volume of intra-European trade also allowed corporates and banks to exploit arbitrage opportunities when financial conditions differed among European countries and there were expectations of exchange rate changes, which made the effective operation of capital controls more distortionary and problematic.

Hence, the single market program of the second half of the 1980s entailed not just the removal of regulatory barriers to trade but also the removal of statutory barriers to capital mobility. And with the removal of capital controls, the pegged but adjustable exchange rates of the European Monetary System became more fragile and crisis prone. The currency crises of 1992-3 convinced governments and central banks that only two options remained: more flexible exchange rates (the choice of the UK and Sweden) and monetary unification (the choice of other members starting in 1999).[4] But a generalized move back to flexible exchange rates would not have been compatible with the desire to complete the single market; it would have opened the door to capricious exchange-rate changes and arbitrary shifts in national competitiveness, which would have undermined popular support for product- and factor-market integration. The single market thus created irresistible pressure for the single currency. And with the advent of the European Central Bank, a transnational institution with significant policy-making prerogatives, demands naturally developed for a political counterweight at the European level – for a more powerful European Parliament – capable of holding the ECB democratically

[4] Denmark being the one EU member state that is difficult to place in either category.

accountable for its actions. That the establishment of the ECB in 1999 was followed in short order by a constitutional convention in 2002-4 was no coincidence in this view.

As flagged earlier, this familiar story is too simple to do justice to what actually happened in Europe. For one thing, there was a desire for political integration, at least in some circles, virtually from the start. Demands for political integration did not just flow from the progress of economic integration; to an extent they preceded it. It was possible to create the European Commission and the European Court of Justice, two institutions that became active agents of integration (the Commission as advocate, agenda setter and policy entrepreneur, the Court as a settler of disputes and interpreter of integrationist doctrine), only because there was already at least a limited willingness to contemplate the transfer of significant national prerogatives to these two transnational entities.[5] This allowed not just these transnational institutions but also human agency – in the person of European Commission President Jacques Delors – to act as agenda setter and push forward both the single market and single currency projects (Ross 1994).

Similarly, demands for monetary integration did not just reflect the effects of the customs union and the single market. In fact the possibility of a single European currency had already been mooted in the 1960s in response to anticipations of the breakdown of the Bretton Woods System – that is, well before the Rubicon of removing all remaining capital controls had been crossed. The Werner Report, issued in 1970, which proposed a three-step transition to monetary unification to be completed within a decade (one that, in the event, was derailed by financial instability later in the 1970s),

[5] Sandholtz and Zysman (1989) emphasize the role of the European Commission as policy entrepreneur For more on the Commission and the Court, see Section 2 below.

was drafted by officials whose motivations were as much political as economic.[6] The Snake and the European Monetary System may have reflected more narrowly economic motives: they were attempts to limit exchange rate variability that might disrupt intra-European trade and sour intergovernmental relations among the member states. But they were established well before the removal of capital controls.

Moreover, to the extent that there was a linkage between the customs union and the single market on the one hand and the desire to limit exchange rate flexibility on the other, it reflected not so much pressure from sectors that were tightly integrated as a result of early initiatives as from sectors such as agriculture that were not. Constructing a coalition of support for the customs union required maintaining price supports and other subsidies for agricultural goods. But fixed support prices and flexible exchange rates were incompatible; if the exchange rate changed significantly, there would be incentives for cross border arbitrage: cheap farm products would flood the country whose currency had appreciated, undermining support prices there. Thus, it was the Common Agricultural Policy more than the Common Market itself that applied pressure for monetary integration and cooperation.[7]

That said, there is no disputing that the removal of capital controls as part of the single market program and, more generally, the progress of financial integration helped to precipitate the move to the single currency. But financial integration was not just a catalyst for monetary integration; in addition, it was itself a result of progress on the monetary front. There is now ample evidence that the single currency has lent significant

[6] Essentially, Georges Pompidou and Willy Brandt sought to deepen political cooperation between their respective countries and saw monetary integration as a grand project behind which their respective polities could unite.
[7] This is the argument of Giavazzi and Giovannini (1989).

impetus to the further growth and integration of European financial markets.[8] Interest rates on government bonds in different euro-area countries covary more closely.[9] Money markets have integrated.[10] Cross-border capital flows are larger. Other measures of financial integration bear out the point.

What are the implications of this more complicated tale for Asia? First, Asia's more limited appetite for political integration may slow the move from a free trade area to deeper forms of regional integration akin to Europe's single market. In Europe that transition required an agent – in effect, an instigator – a role played by the European Commission. Given the more lightly-institutionalized approach to integration taken in Asia, it is hard to imagine that a regional institution, such as the ASEAN Secretariat or the Asian Development Bank, will acquire comparable agenda setting powers and take on an equally pro-active role. Similarly, to the extent that a single market requires tightly harmonized regulation, and conceivably a single regulator (a true single market can have only a single competition authority, for example), reluctance on political grounds to cede authority to a transnational entity is likely to slow this transition. In Europe, moving from the customs union to the single market took two decades. If history is a guide, it may take longer in Asia.

Second, that high capital mobility is a financial fact of life in the 21st century means that moving forward first with trade integration and only much later with financial integration will not be feasible. Whereas in Europe full financial integration followed trade integration by two decades, in Asia today there are too many channels through which capital can flow for it to be effectively bottled up for such an extended period. The

[8] See Danthine, Giavazzi and von Thadden (2000).
[9] See Rey (2005)
[10] See Gaspar and Hartmann (2005).

process of integrating regional capital markets and harmonizing regulatory standards in order to stabilize capital flows will have to proceed faster. The Asian Bond Fund and Asian Bond Market Initiative are signs that regional policy makers have taken this imperative on board. But if the conventional wisdom regarding sequencing remains correct – that trade liberalization should precede financial liberalization to prevent capital from flowing into or out of the wrong sectors – then the completion of Asia's free trade area should proceed more quickly as well.

Third, these pressures for financial integration mean that the issue of how to deal with monetary problems within the region will also have to be addressed earlier. If regimes involving soft pegs, like the Snake and EMS, operate smoothly only when there are limits on capital flows – whether or not there exist modest mutual support systems like Europe's Very-Short Term Financing Facility and Asia's Chiang Mai Inititive – then progress on financial integration will force Asian countries to abandon soft pegs earlier in their integration process. This is why the feasibility of greater exchange rate flexibility backed by inflation targeting on the one hand and a single regional currency on the other are so widely discussed. But European experience suggests that the single currency option is only viable if there is a willingness to contemplate political integration, initially by ceding significant national prerogatives to a transnational entity and then by creating a regional political counterweight to hold that entity democratically accountable.[11] This suggests an early move to greater flexibility rather than an attempt to progressively limit intra-regional exchange rate fluctuations to narrower bands, and that if a single Asian

[11] At the time of writing there are discussions in Europe of how to restart the process of redrafting and ratifying the constitution – partly because Europe's transnational policy entities, notably the ECB, show no signs of going away.

currency is ultimately created the transition will have to be more abrupt than was the case in Europe.[12]

Europe did not real deal serially with trade, domestic market, financial, and monetary integration, as the lengthier analysis toward the middle of this section reveals. But there is still a sense in which the emphasis changed over time. Asian countries, in contrast, will have to take on the entire menu from the start.

Finally, Asia's limited tolerance for ceding national prerogatives means that deep integration, if and when it occurs, will have to result from intergovernmental cooperation (incentive-compatible agreements by governments to, say, coordinate on a similar set of regulatory standards) rather than what is in Europe referred to as the Community Method (ceding powers to a self-standing regional entity, which then enforces the standards to which countries are obliged to adhere). This brings us to the issue of how decisions are made in the European Union and whether that model can be adapted to the circumstances of Asia.

2. Decision Making

The European Union is not a federation with a central government empowered to dictate policies to its members, but at the same time it is more than loose collection of sovereign states. It is something in between: one might think of it as a confederation,

---

[12] Moreover, if Asia is slower to move from a free trade area to a single market in factor services as well as goods, then it will be slower to satisfy, or to come close to satisfying, the optimum currency area criteria for a single currency – one of which is high labor mobility. Another worry is that exchange rate flexibility may undermine political support for a true single market, if governments complain that arbitrary exchange rate fluctuations are capriciously redistributing competitiveness – in which case the region may never transcend the first stage of its integration project. However, to the extent that more flexible exchange rates were anathema in Europe not so much because of generalized competitiveness concerns as because of the threat they posed to the Common Agricultural Policy, the absence of a CAP-like apparatus suggests that it may be possible to reconcile regional integration with more freely flexible rates. To be sure, this begs the question of whether Asia is doomed to develop a CAP-like program; on this see Section 3 below.

defined as a group of states united for a common purpose and prepared to cede limited sovereign prerogatives in pursuit of a specific goal. This confederate structure has emerged from the tension between those (such as the majority of Britons) who have envisioned the EU as a narrowly economic grouping in which, aside from a few essentials like the common trade policy, significant policy prerogatives continue to reside with the member states, and others (historically, members of the French and German elite) who have always seen the EU as a political project and economic integration as a stepping stone to political integration. Thus, whether there has been a tendency to cede significant sovereign prerogatives to the transnational institutions of the EU has depended on the political ebb and flow between those adhering to these two points of view. That there is less than agreement even among opinion leaders is evident in the contentious process extending over more than two years that resulted in a draft constitution for the European Union in 2004. That publics and even opinion leaders do not necessarily agree is similarly evident in voters' rejection of the draft in popular referendums in France and the Netherlands in 2006.

The very structure of the EU embodies these tensions.[13] The Commission, which functions as the EU's executive, is a supranational institution: it is divided into functional directorates overseen by politicians from the member states. The work of these commissioners is coordinated by a president appointed by the Council (in effect, by common consent of member governments) and confirmed by the Parliament.[14] The Commission is responsible for initiating legislation and administering the EU's activities.

[13] The powers and responsibilities of the principle EU institutions are laid down in the series of treaties negotiated among the governments of the member states and ratified by their parliaments or in some cases by popular referendum. These treaties specify the rules and procedures to be followed by EU institutions.

[14] The Parliament must also confirm the commissioners, although it can only accept or reject the entire team.

It has agenda setting power as a result of its ability to initiate legislation, and depending on its efficiency it can influence the compliance of the member states with its directives. Under certain circumstances it can levy fines on member states that exhibit a pattern of noncompliance (or at least recommend their imposition) – something that is relatively hard to imagine in the Asian context – although in practice the Commission is reluctant to recommend that members be fined so as not to bite the hand that feeds it.[15]

But the Commission's right of initiative only extends to certain issue areas, and even there its legislative proposals proceed only with the assent of the Council of Ministers and the Parliament, which resemble the union's legislative branch. The Council may be loosely thought of as the upper house, with one member per country (national ministers for agriculture when agricultural policy is discussed, finance ministers when monetary and fiscal matters are discussed, foreign ministers for political and diplomatic issues).[16] In particular, the Council retains the power of the purse, since the Commission must secure its approval of spending proposals. The Council is clearly an intergovernmental body. Ministers are officials of their national governments; their power resides in their ability to commit their governments. They represent the national interest; their failure to do so would result in recall or, more likely, loss of support in the next national election.

This is in contrast to the European Parliament, the other arm of the EU's quasi-legislative branch, which functions more like a supranational institution. While parliamentarians are chosen in elections organized at the national level, they are members of transnational parties (the Party of European Socialists, the European Peoples Party),

[15] For examples, in the context of industrial policy and fiscal policy, see below.
[16] Currently there are a total of nine Council configurations.

and there is growing evidence that they vote as members of those European parties rather than along national lines.[17] The fact that the Council has historically had more power than the Parliament has meant, when it comes to the actual adoption of legislation, that the EU has functioned more like an intergovernmental organization. But this has had a tendency to change over time as supranational voting patterns in the Parliament have become more evident and, importantly, as the Parliament has acquired additional prerogatives, reflecting the natural tendency to create a more powerful transnational political counterpart to hold the transnational institutions of the EU accountable for their actions. Where its power was once largely symbolic, the Treaty of Amsterdam, signed in 1997, gave the Parliament co-decision authority (that is, the right to amend and reject most EU legislation). In principle, the Parliament can even reject the Commission's budget proposals when these have been approved by the Council of Ministers. It can dismiss the entire Commission with a vote of censure. Evidently, there is no hard-and-fast border between transnational and intergovernmental decision making in Europe.

The judicial branch of the EU similarly has two components: the European Court of Justice, with a judge appointed from each member state, and the Court of First Instance (created in 1989 and associated with the Court of Justice). The Court of Justice has jurisdiction over disputes between the EU and its member states and citizens.[18] The Court of First Instance specializes in adjudication of matters related to the EU's competition policy. It decides disputes between individual firms and governments and can levy fines or force divestiture in response to uncompetitive practices. The Court of Justice more commonly sits as a Grand Chamber of 13 members (as opposed to an

[17] See Hix, Noury and Roland (2007).

[18] In addition, it interprets the application of treaty provisions to the EU's external relations with non-member states.

unwieldy full court of 27) and in chambers of 3 to 5 justices. It is assisted by eight advocates-general who serve six-year terms and interpret European law (as opposed to representing a national interest). The Court of First Instance is organized similarly.[19] Its domain has expanded with the development of the single market. The Court has issued judgments on, inter alia, whether the Office of Harmonization in the Internal Market can reject as invalid elsewhere in the EU a trademark already recognized as valid in an individual member state; whether a proposed merger can be rejected by the Commission as creating a dominant firm with anti-competitive market power; whether the Commission is entitled to fine colluding firms for anti-competitive practices; and whether the Commission can declare transfers between governments and companies as unlawful state aids and require their repayment. The Court making these decisions is clearly transnational. To the extent that the power for a transnational entity not allied with any national government to make such decisions is indispensable for the operation of a European-style single market, this reminder of the considerable powers of the Court raises questions about whether Asia can succeed in creating a truly unified regional market, absent willingness on the part of governments to cede analogous powers.

The implications for regional integration are, to put it mildly, complex. One can see this in a prominent instance where the EU has sought to constrain national independence, namely the Stability and Growth Pact. The SGP (originally the Stability Pact) was adopted at the Amsterdam Council of European heads of state in June 1997 in the run-up to the inauguration of Europe's monetary union. It was becoming apparent that it would be difficult to keep countries with a history of money-financed budget deficits out of the euro area, since the decision to proceed would in effect require the

[19] Although there are no advocates-general to assist the justices.

unanimous consent of candidate countries.[20] Germany, which was especially inflation adverse, therefore demanded additional measures to strengthen the Excessive Deficit Procedure of the Maastricht Treaty, leading to negotiation of the SGP.[21]

The original German proposal was for a three per cent ceiling on budget deficits that would be strictly applied to all members of the monetary union and enforced by the Commission, with significant sanctions and fines for violators after a short grace period. This would have been tantamount to ceding key sovereign prerogatives – what is more central to national sovereignty than the budget? – to a transnational entity, the Commission, and would have made national governments hostage to its procedures and rules. This Germany was willing to do both because the government of Helmut Kohl was a strong proponent of supranationality and because it thought it unlikely that Germany itself would ever be subject to these procedures. But the majority of other member states were reluctant to go as far down the road of supranationality.

The result, predictably, was a compromise between transnationalism and intergovernmentalism that satisfied no one. Under the Stability and Growth Pact and its associated Excessive Deficit Procedure, the Commission has only the power to recommend whether a deficit exceeding three per cent of GDP should be judged as excessive (or whether it is exceptional, temporary and close to that reference value, and therefore can be ignored). Within three months of this report, the ECOFIN Council (the Council of national economics and finance ministers) is then required to decide whether

[20] Thus, early expectations had been that the founding members would be limited to France, Germany, the Benelux countries and possibly Denmark. In the event, Italy, Portugal, Spain and Ireland were also admitted.
[21] Feldmann (2007) describes how the German government had first proposed a fiscal pact to supplement and strengthen the Excessive Deficit Procedure of the Maastricht Treaty in the autumn of 1995, but how resistance from other countries to having their sovereignty compromised caused the German proposal to be watered down.

to accept the Commission's recommendation, in which case it gives the government in question fourth months to take "effective action" and a further deadline (typically a year) for eliminating the excessive deficit. If, after the initial four months, the ECOFIN Council concludes that the member is not implementing adequate corrective measures, it has a two-month window to move to the sanctions stage of non-interest-bearing deposits and fines.[22]

Thus, what Germany had envisaged as a set of transnational rules was modified, becoming a hybrid system in which a transnational entity, the Commmission, initiated the procedure but an intergovernmental body, the Council, had to concur in order for the process to proceed. Technically, the Commission issued a recommendation, which then could be overturned by a qualified majority of members of the Council. Especially when it became evident that Europe's large countries, France and even Germany itself, would run budget deficits in excess of the three per cent reference value (in response to a combination of structural problems and the global recession that followed shortly on inauguration of Europe's monetary union), it became clear that those large countries would effectively veto efforts to push sanctions through this intergovernmental process. The framers of the Excessive Deficit Procedure had anticipated the conflict-of-interest problem; thus they had specified that the country whose excessive deficit was the subject of the procedure would be excluded from participating in the vote in the Council when its case was being decided. What they did not anticipate was that several countries might be in violation at the same time so that exempting only one and proceeding case by case would allow collusive behavior. When the Commission recommended applying the EDP

[22] Non-interest bearing deposits are first required, starting at 0.2 per cent of GDP plus a tenth of the deficit in excess of three per cent of GDP, and escalating from there If the excess has not been eliminated within two years after a deposit is made, the latter is converted into a fine.

to Germany and France, the two countries colluded with one another and assembled sufficient support from other countries anticipating that they might soon find themselves in a similar position to block the application of sanctions.[23] Austria, Finland, the Netherlands and Spain objected, but France and Germany rejected their efforts to apply the EDP as unwarranted outside interference with national policy decisions.[24] Not only was this problem evident at the sanctions stage, but ECOFIN was even reluctant to issue early warnings to countries at risk of breaching the three per cent limit subsequently, notwithstanding recommendations from the Commission.[25] Clearly, there was less than full willingness to make those national policies subject to supranational institutions or procedures.

What should be done in this particular instance is disputed. Some would say that there is no especially strong case for supranational constraints on national fiscal policies even in a deeply integrated regional grouping with a common currency, on the grounds that the cross-border spillovers of national fiscal policies are limited and the interaction of monetary and fiscal policy is not of first-order importance. Others insist that spillovers are important and recommend strengthened supranational enforcement of the EDP, typically by giving the Commission the power not only to recommend sanctions but to apply them. A more politically palatable reform would be to move from a Commission recommendation to a Commission proposal, since the Council must reject a Commission proposal unanimously whereas it can reject a Commission recommendation with only a

[23] Portugal, which had had the EDP applied to it in 2001-2, was a risk of again exceeding the ceiling in 2003, as were the Netherlands, Greece and Italy. On the earlier Portuguese episode, see Zsolt de Sousa (2004).
[24] See Thygesen (2004).
[25] See Annett, Decressin and Deppler (2005).

qualified majority.[26] In practice, however, there appears to be little appetite for moving in this direction.

In Asia there is even greater reluctance to cede significant national prerogatives to a supranational entity. Whereas in Europe World War II discredited nationalism and fostered intellectual support for the development of a transnational entity through which destructive nationalist tendencies might be channeled and suppressed, Asian countries, many of which were newly independent, took from the experience of war and occupation a newfound respect for national sovereignty. The "Asian way" emphasizes avoiding overt criticism and not infringing on the prerogatives of neighboring states (Manzano 2001). By implication, there is likely to be even less scope in Asia for arrangements like the Single Market and the Stability and Growth Pact, under which neighboring states intervene through the agency of transnational institutions in the policies of their neighbors.

The operative question is: to what extent will this constrain the progress of regional integration? A free trade area is possible without ceding significant sovereign prerogatives to a transnational entity: NAFTA is a case in point.[27] But given the wide variety of surreptitious means through which governments can ensure preferential treatment in the home market to domestic firms, it is hard to imagine that a true single market with harmonized trademark protection, effective limits on subsidies and state aids, and protection against uncompetitive mergers and cartels across borders could operate in

[26] See Buti, Eijffinger and Franco (2003).

[27] In practice, a variety of national policies complicate the operation of regional trade agreements like NAFTA. An example is California's ban on the use of MTBE in gasoline on public health and environmental grounds. NAFTA in fact provides for a three member (intergovernmental) arbitration tribunal to adjudicate such disputes. (In an August 2005 decision, the tribunal struck down the Canadian producers' claim.)

the absence of willingness on the part of national governments to cede significant sovereign prerogatives. But it is also possible to push these concerns about national sovereignty and the "Asian way" too far. That Asian countries have been willing to cede significant national prerogatives to the WTO and its dispute resolution body suggests that governments might in fact be prepared to cede them to an analogous regional entity, at least to some extent, if they were convinced that the benefits are substantial.

Recent developments in EU decision making suggest directions for Asia. The most notable such development is the so-called "open method of coordination," which acknowledges the preference of member states for an intergovernmental approach. The open method relies on guidelines, benchmarking, peer pressure, and the sharing of best practice while abandoning the notion of sanctions imposed by transnational authority. Its first stage involves the setting of broad policy goals by the Council. Member states are then responsible for translating these into concrete national policies. Next they agree on specific benchmarks and indicators of best practice. Finally they monitor and evaluate the results, relying on "naming and shaming" to encourage compliance.[28] All this is in contrast to the Community Method, where national prerogatives are ceded to the EU, which then possesses enforcement power.[29] Under the open method, in contrast, the Commission is limited to a monitoring role.[30]

The open method was devised to address concerns in Europe with slow employment growth and the need for wide-ranging reform. There was the perception that

[28] As Collignon et al. (2004, p.2) put it, key features of the open method are decentralization, the absence of formal constraints, and "[t]he setting up of procedural routines, which is aimed at encouraging the pooling of knowledge, and includes defining guidelines and indicators, periodic monitoring of national reports, and searching for best practices."
[29] Subject to various checks and balances. On the Community Method, see Devuyst (1999).
[30] Although insofar as different issue-areas are linked, the Commission's greater say in other areas can translate into greater informal influence even where the OMC prevails.

outside pressure should be enlisted to overcome vested interests but also the realization that effectively stimulating employment growth is likely to entail the reform of sensitive national social policies, rendering governments reluctant to cede control. Governments wanted to avoid "undue Commission interference in domestic policy-making."[31] The desirability of addressing employment problems using the open method was alluded to in the Amsterdam Treaty in 1997 and then defined and endorsed at the Lisbon Council in 2000. Since then it has been applied not just to employment strategy but to problems of social inclusion, pensions, immigration, education, culture, and asylum. Long-term budgetary policies were made subject to the open method through the development of the Broad Economic Policy Guidelines, which involve discussions between the Commission and the governments of each member state, followed by the issuance of a report evaluating the country's medium-term economic and fiscal prospects. Some (e.g. Eichengreen 2004) have argued that short-term fiscal problems should be addressed in the same way, while others (e.g. Thygesen 2003) insist that stronger transnational oversight of national fiscal policies is required in a monetary union.

In fact, there already exists a range of issues where Asian countries utilize something resembling the open method. The effort to develop regional bond markets, which relies on guidelines and indicators, benchmarking, peer pressure, and the sharing of best practice but does not extend to proposals for policy uniformity or the creation of a regional regulator, is an example.

At the same time, the weaknesses of the open method of coordination as applied in Europe may be even more debilitating in an Asian context. The open method requires concrete targets or benchmarks as focal points for coordination; otherwise false claims

[31] Schafter (2004), p.8. The author actually writes "unduly" but almost certainly means "undue."

are easy and actual coordination will be minimal. But uniform targets that are unrealistic or otherwise ill-suited to the circumstances of individual countries lack credibility. Countries cannot reasonably be expected to aspire to them or be criticized when they fail. In the case of the Lisbon Agenda, it has not been possible to reconcile the need for simple, transparent targets with respect for variations in national circumstances and aspirations. Given that national economic structures and circumstances vary even more widely in Asia, this could be an even more serious problem there.

Moreover, the peer-pressure element of the open process has not been effective "because members are not willing to name and shame their peers."[32] Governments criticizing their neighbors for lack of progress fear that they will become targets of retaliation, given that they too can be criticized for lack of progress along some dimension. And, in the absence of peer pressure, there is little incentive for closer coordination.[33] One can imagine that this reluctance to name and shame would be even more prevalent in Asia.

This disquisition on decision making in Europe suggests a line between forms of regional integration that are and are not feasible in Asia. Where some harmonization or coordination of policies to limit undesirable cross-border spillovers is necessary, and where the open method relying on benchmarking and peer pressure can achieve the requisite level of harmonization or cooperation, regional ties can be deepened without requiring unacceptable compromises of national sovereignty. In contrast, where uniformity of policies is essential and transnational enforcement is required, forms of integration that might be acceptable in Europe, where tolerance of transnationalism is

[32] Collignon et al. (2004), p.9.
[33] Ibid.

greater, will not be feasible in Asia. This suggests a distinction between, inter alia, the integration of regional bond markets on the one hand and the move to a single currency (complete with a regional central bank with the power to pursue a single monetary policy) on the other (Eichengreen 2003).

3. Expenditure Programs

This section looks at two prominent expenditure programs with which the EU is identified: the Common Agricultural Policy and the Structural and Regional Funds. Both can be thought of as efforts to construct support for the integration process. The CAP was intended to secure the support or at least the acquiescence of Europe's farmers, while the Structural and Regional Funds were designed to address the concerns of the region's low-income countries. European experience thus suggests that Asian leaders seeking to advance an integrationist agenda will similarly be tempted to devise programs and policies with the purpose of building coalitions of support and buying off opponents. It also offers a cautionary tale in that short-term coalition-building efforts can have long-term consequences. Even now, the European Union's budget is dominated by programs of dubious efficacy that were adopted as much for reasons of political expediency as because of any coherent economic rationale.

The Common Agricultural Policy. From a strictly economic standpoint, the Common Agricultural Policy is not one of the highlights of the European project. But the CAP was not adopted for strictly economic reasons. Rather, it was designed to inoculate the integration process from opposition by farmers. European countries already had a tradition of subsidizing small farmers with price supports and other policies. A customs union, which was identified as the Community's first significant objective in the Treaty of Rome, would have destroyed the operation of these price supports, since any member state attempting to maintain prices above the levels prevailing elsewhere in the union would have been flooded with agricultural goods. Maintaining traditional forms of agricultural support thus required harmonizing the level of support prices at the Community level, agreeing on ways of financing them, and devising means of addressing exchange rate changes and other disturbances that might create incentives for cross-border arbitrage.

The need to enlist agriculture's support was acknowledged in Article 40 of the Treaty of Rome. In 1960 the Council agreed to establish a single market in agricultural goods, but with price supports and export subsidies, subject to joint financial responsibility through the creation of a common agricultural fund. Initially, not all agricultural products were covered: dairy, cereals and meat and eggs accounted for the vast majority of guarantee payments. Over time, new products, mainly from Southern Europe, attracted a growing share of guarantee payments. In addition to support prices, which cover about two-thirds of CAP products, a quarter of such products (notably wine, flowers, poultry and some fruits and vegetables) enjoy external protection. Finally, producers of selected goods (olive oil, durum, wheat, cotton and tobacco) enjoy income supplements not directly tied to prices.

From the start, agreement required hard bargaining, because farmers in different European countries operated at different levels of efficiency.[34] While a customs union without free trade in agriculture was unattractive to France, Italy and the Netherlands as exporters of fruit, vegetables, wine and other agricultural goods, Germany and France

[34] The analysis here draws on Eichengreen (2007).

also had many high-cost farmers willing to accept free trade in agricultural products only if married to price supports. The result, to no one's surprise, was a scheme for an integrated market with temporary levies to smooth the harmonization of domestic policies and permanent price supports.[35] The Community would support prices by purchasing surplus production, while the cost of its operations would be limited by restricting imports of cheap agricultural goods from outside and temporarily assigning customs revenues to the Community budget. This would require developing a system of variable import levies that rose as world prices fell. With European agricultural markets thereby insulated from supplies from outside, farm products could ultimately be traded within the Community at a single EEC-wide price.

The decision to harmonize agricultural price supports at high levels rather than abolishing them in favor of lump-sum transfers was an opportunity missed. At the same time, that decision had indirect effects conducive to further integration. It provided impetus for further integration insofar as it occasioned the growth of an extensive bureaucracy in Brussels. It also encouraged the pursuit of monetary integration, since the operation of a uniform system of price supports was incompatible with fluctuations in intra-European exchange rates. Currency movements disturbed the alignment of domestic-currency support prices and created the danger of massive cross-border flows of agricultural goods. In August 1969, when the French franc was devalued, and later that year, when the deutschmark was revalued, the Community was forced to devise a convoluted system of "green exchange rates," artificial rates for agricultural products, and "monetary compensatory amounts," levies on exports of agricultural products from

[35] The alternative of allowing prices to be determined in world markets and extending deficiency payments to farmers if prices were lower than costs of production (as in the UK) was deemed infeasible given the limited Community budget.

the devaluing countries and subsidies on exports from its revaluing partners to make green rates differ from market rates. This encouraged additional subsidization, since it was harder to eliminate bonuses for farmers in the revaluing countries than to abolish taxes on exports from its devaluing partners. It also increased the drain on the Community budget owing to the CAP. The system of green exchange rates had to be adjusted repeatedly as prices and production costs responded to the exchange rate change. An apocryphal story had the German chancellor emerging from a meeting of the Council complaining that he had only one official who understood the system of green exchange rates but could not explain it and one official who could explain it did not understand it.

It is fair to say that officials devising the Common Agricultural Policy did not anticipate that it would become the single most important spending program of the European Community, accounting for nearly half of its budget, or that their initial design would remain largely intact for three decades. It is hard to imagine a better illustration of how expedients adopted to advance the course of regional integration can have persistent unintended consequences. Only relatively recently – in response to pressure first from the UK (a net contributor to the CAP – see below), then from the U.S., and finally from other regions (through the World Trade Organization) – has there been significant reform. In 1992 EC spending on agriculture was capped at 45 per cent of the EC budget and 1.27 per cent of EC GDP. Support prices were lowered, and farmers were compensated with deficiency payments. Export subsidies and various forms of import protection were, however, maintained. Direct payments were then "modulated" – that is, allowed to vary by farm size, crop mix, and geographic location. This allowed the new Central and

Eastern European members with their large rural populations to be brought into the EU with reduced levels of agricultural support for a transitional period.

Might Asia find itself traveling down this same road? Agriculture's share of employment remains high (48 per cent in East Asia, 52 per cent in South Asia, as of 2006).[36] Even in high-income countries like Japan and South Korea, farmers remain a consequential lobby and command political support.[37] Public support accounts for 60 per cent of farm receipts in Korea and Japan, compared to 38 per cent in the European Union.[38] Prices are supported by trade restrictions on imported rice and other products: average weighted import tariffs on agricultural products and foodstuffs are 29 per cent in Japan and 55 per cent in Korea and Taiwan compared to 14 per cent in the EU25 and EFTA.[39] China, Thailand and Vietnam are not far behind. Japan is right alongside the EU (and the U.S.) in terms of subsidies as a share of agricultural output, with South Korea just behind. Predictably, the ASEAN Free Trade Agreement exempted unprocessed agricultural goods initially. Subsequently there have been reductions in agricultural tariffs, relative to MFN levels, among the AFTA countries, although the subsequent increase in agricultural trade has been limited. Concerns over the effects of an ASEAN-China bilateral initially centered on the impact on agriculture. An extreme case was Japanese farmers' protests against a Japan-Singapore bilateral, despite Singapore not exactly being an agricultural powerhouse.[40]

---

[36] ILO (2007), Table 5. Output shares are much lower of course, but it is arguably employment shares that should matter for policy outcomes (according, for example, to the median voter model).
[37] Rice farming is the classic case in point; see David and Huang (1996).
[38] See Legg and Viatte (2001).
[39] As of 2001. United States Congressional Budget Office (2005), Table 2.
[40] See Pasadilla (2006).

The main thing protecting Asian countries against pressure for some regional equivalent of the CAP is their reluctance to turn over delicate national prerogatives to their neighbors, much less to a regional body. Japan and Korea, to continue with the earlier examples, would be reluctant to allow levels of support for domestic rice farmers to be determined by a majority vote of the countries forming the regional grouping. They would hesitate to delegate the power to adjudicate disputes to a transnational commission.

If this is right, then Asian countries are left with two options. One is to exempt agriculture indefinitely from their regional free trade agreement. But this would make it hard to take another step in the direction of deep integration by removing border controls and creating a true single market. It would still be necessary, in other words, to check ships and trucks for farm products at borders. It might then become impossible for Asia to become as deeply integrated as Europe. The other option would be for Asian countries to transform price supports buttressed by import restrictions into lump-sum transfers to farmers. Economists would support this on efficiency grounds. But farmers would oppose it for fear that those payments would not rise with the cost of living.[41] They might see the conversion to lump-sum income transfers as the first step toward phasing out support.

The Structural Funds. The structural and regional programs were established in the 1970s in conjunction with the first enlargement of the EC and expanded in the 1980s around the time of the second enlargement in response to the recognition that member states were becoming increasingly heterogeneous. Notwithstanding the gap between Italy and the other five founding members, the Treaty of Rome had been signed by a

[41] This is what happened with the EC's Commissioner of Agriculture, Ray MacSharry, proposed shifting from price supports to deficiency payments – despite his proposing to increase actual expenditures on agricultural subsidies over the transitional period.

relatively homogeneous collection of countries. But Ireland, which joined in the 1970s, was considerably poorer than the incumbents.[42] And Greece, Portugal and Spain, the participants in the second enlargement, were very much poorer than prior members. Their concern was that their industry would be unable to withstand direct competition from more efficient producers in the more advanced European economies. The Structural Funds were intended to provide them with improved infrastructure and other advantages that would help them face down this competition and enable them to capitalize on the advantages of free access to a large regional market. One can understand these programs as a corollary of the single market: without measures to foster convergence of income levels, removing barriers to labor mobility might unleash such high levels of migration from low- to high-income countries as to be socially unacceptable. One can readily imagine that completion of the ASEAN Free Trade Area, encompassing middle-income economies like Malaysia and Thailand but also low-income members such as Cambodia, Laos and Myanmar, might elicit similar concerns – more so to the extent that the integrated economic zone encompasses China, South Korea and Japan and extends beyond trade.

While the factors cited above sustained political support for the regional funds, the initial impetus was in fact provided by a different consideration, namely UK accession in 1973 and resentment in that country over the fact, owing to its small agricultural sector, that the country ended up making significant net transfers to the other members through the CAP. (Here again we see how this earlier agricultural program had unintended consequences.) When a new Labour Government assumed power in 1974, the UK position hardened: given the consensual nature of decision making in the

[42] Not so, of course, Denmark and the UK.

Community, the UK was in a position to block progress, and it intimated that it might even withdraw depending on the outcome of a popular referendum in 1975. This threat led the Community to establish the European Regional Development Fund (ERDF) as program from which the UK could benefit. The political nature of the new program was evident in the fact that there was no real attempt to target low-income regions: there was simply a formula by which monies were doled out to countries, which then had more-or-less complete discretion about how to spend them.

The political nature of this side payment was also a source of discomfort. This was acknowledged in 1979, when a financially-modest but symbolically significant 5 per cent of ERDF funds was set aside for the European Commission to allocate to low-income regions. The ERDF was then rationalized and expended with Portuguese and Spanish accession in 1986. These countries, together with Greece and Ireland, then demanded a significant expansion of the program as the price of agreeing to the program of completing the single market by 1992: spending on the EU's regional programs doubled between 1987 and 1992, and "cohesion" (European jargon for fostering the convergence of living standards among member states and their citizens) was officially recognized as a goal of EU policy in the Single European Act. A further revision of these programs followed the northern enlargement (encompassing Sweden and Finland) and the decision at Maastricht to move to monetary union by 1999. An additional criterion for transfers – promoting rural development by providing aid for structural investments – was added so that new high-income members with underpopulated regions could receive transfers as well. Finally, a Cohesion Fund was established to address the concerns of Spain, Portugal, Greece and Ireland that monetary unification, as a further step in the direction of deep integration, might disadvantage their struggling industries. The Cohesion Fund financed up to 95 per cent of qualifying projects in regions with a per capita GDP less than 90 per cent of the EU average. While projected to wind down at the end of 1999, the Cohesion Fund has become a permanent fixture on the EU landscape – again attesting to the potential long-term consequences of short-run coalition-building policies.

The latest installment of this story is the eastern enlargement of 2004. The former transition economies of Central and Eastern Europe being anxious to become members, they had relatively limited bargaining power. Hence the access of the new member states to the Structural Funds was restricted for an initial five-year period. Following that, the threshold for receipt was reduced to 75 per cent from 90 per cent of EU GDP. The first of these measures was designed to protect the interests of incumbent members (of whom the most vocal was Spain) that might have blocked the eastern enlargement, while the intent of the second was to avoid having a larger share of the EU budget and therefore EU GDP going for regional transfers.

Turning from politics to economics, the questions are whether low-income economies are justified in worrying about the inequalizing effects of regional integration, and if so whether transfers of this sort can have offsetting effects. Neoclassical growth models with constant returns suggest that integration should foster factor-price equalization – that is, it should lead to the convergence of per capita incomes. In addition, capital and technology should flow to low-income economies where they are scarce, while labor should flow to high-income countries where it is in short supply. In contrast, new growth models where there exist increasing returns due to agglomeration effects (where a producer's efficiency depends on his proximity to other producers or, alternatively, where there are efficiency advantages from producing close to the final consumer) suggest that integration will result in high-value-added production being concentrated in the most advanced regions, where the bulk of such producers are located initially and where consumer demand is greatest.

Real-world economies have sectors and characteristics that resemble both models; thus, the question of whether integration causes convergence or divergence must be answered empirically. In addition, models in which divergence is possible suggest that different kinds of transfers can have very different implications for the process. Lump-sum transfers of purchasing power will foster convergence insofar as the pattern of industrial location depends on local expenditure levels. But whereas this rationale for transfers could conceivably be relevant in Europe, levels of income in Asia are so different that it is hard to imagine that a modest transfer from, say, Japan to Myanmar would alter the location decision of a producer that benefited from proximity to high-income consumers. As noted by Martin (1998), the relevant class of models suggests the relationship between geography and the attractiveness of low-income regions as a site for production is nonlinear. Thus, a small transfer in spending power between two countries with very different market sizes and living standards will have no impact on the location decisions of firms (whereas a large one, while politically infeasible, would have a substantial impact).

The effect of infrastructure-spending-linked transfers will depend on the details of the model and structure of the participating economies. If agglomeration economies depend on proximity to the consumer, then infrastructure projects that better link up regions within the low income countries create larger markets there, making them more attractive to firms whose efficiency and profits depend on the existence of a large local market. Again, however, the likelihood that such effects are nonlinear raises questions about whether a modest increase in spending on internal infrastructure in Asia's low-income countries would, practically speaking, have much impact on such firms' location decisions. In contrast, infrastructure spending that better links up the different economies of the region (spending on port facilities, for example) will only accentuate existing inequalities, since it will reinforce the dominance of the most efficient firms located in the high-income countries with the largest markets by now enabling them to penetrate the low-income markets, at lower cost, and to compete out of business producers there. But if efficiency is a function of proximity to other firms rather than proximity to consumers, then infrastructure that better links different countries will diminish the tendency for industry to cluster in those with a head start on development. The rapid development of vertical intra-industry trade in Asia (viz. Wakasugi 2007) suggests that this last possibility may be the practically relevant one.

Over the second half of the 20th century, there has been a clear tendency toward convergence across European countries, albeit one that is disturbing slow to some observers. Sala-i-Martin (1996) finds a speed of convergence of approximately 2 per cent per year.[43] A number of studies have concluded that this process has been faster among EU members than other European countries.[44] However, there have been exceptions. Neven and Gouyette (1995) find a general tendency toward divergence in certain subperiods, such as the 1980s. The failure of Portugal to close the gap vis-à-vis

[43] At 2 per cent, it takes more than 30 years to eliminate half of the initial per capita income gap between regions.
[44] See e.g. Eichengreen and Ghironi (2003).

the EU since 1999 is another prominent exception to the rule. The 1980s having been a period of policy instability and Portuguese policies in the run-up to and early years of EMU – how should one put it? – having lacked prudence, these examples suggest that any tendency for regional integration to foster convergence is contingent on the maintenance of appropriate economic policies. And what is true of countries is not always true of regions: even in periods when convergence across countries is apparent, there is evidence of divergence within them – between the relatively high- and low-income regions of countries. Why this is the case is not entirely clear.[45]

Finally, one can inquire into the impact of Structural Fund transfers in this framework. Martin (1998) analyzes the impact of four forms of structural spending in 104 regions of ten EU member states. He finds that past infrastructure investment is positively related to growth. By implication, transfers to finance additional infrastructure spending should foster convergence. De la Fuente and Vives (1995) and Rodriguez-Pose and Fratesi (2004) reach similar findings. But these authors disagree on the form of spending that matters. Martin finds that convergence is fostered by spending on telecommunications infrastructure but not on transportation, energy and education. In contrast, de la Fuente-Vives and Rodriguez-Pose-Fratesi find that convergence is fostered by spending on schools and other education-related capital but not on other forms of infrastructure.

On balance, EU experience with convergence and with regional policies conveys a mixed-message for Asia. Regional integration creates tendencies both of convergence and divergence. But their sources and dynamics are not adequately understood that

[45] It could be that integration fosters convergence across countries but not within them because some factors of production, notably labor, are more mobile within countries than between them, creating more scope for the operation of agglomeration effects.

reliable policies can be designed to address concerns that less well-developed regions will be permanently left behind. It remains unclear exactly what kinds of regions should be targeted and whether they should be targeted with transfers directed at telecommunications infrastructure, transportation infrastructure, educational infrastructure or something else. Getting the answers wrong may be costly, since regional programs and interstate transfers, once established, develop constituencies and gain lives of their own. The dilemma is that building a broad-based coalition of support for deep integration may be difficult in their absence.

4. Conclusion: Implications of Europe's Experience for Asia

There is a long tradition of looking to Europe as a way of drawing inferences about how regional integration might play out in Asia. Implications cannot be drawn mechanically, both because Asia is not Europe and because 2007 is not 1957. This paper suggests the following "lessons."

First, the sequencing of integrationist initiatives will be different in Asia. Unlike Europe, Asia will not be able to proceed from a free trade area to a single market and from there to financial and monetary integration. The capital controls with which Europe was able to delay the move to financial integration are not likely to be available to Asia. The growth of financial markets and instruments and the de facto development of cross-border financial linkages make their operation more problematic than was the case in Europe in the 1970s and 1980s; Thailand's experience in December 2006 is a graphic reminder, if one was needed. The fact that the integration of regional bond markets is already proceeding, under the aegis of the Asian Bond Fund and Asian Bond Market

Initiative, means that Asia will have to address the compatibility of its monetary and exchange rate arrangements with its regional integration ambitions at an early date. And unlike Europe, Asia will not be able to rely on a transnational policy entrepreneur or delegate competition policy and regulatory harmonization to a supranational authority. This will make the transition from a free trade area to a true single market relatively drawn out and complex. Governments will have to address the entire menu of integration tasks simultaneously, rather than tackling them one at a time.

Second, how agreements are reached will differ in Asia. Asian countries are reluctant to build strong institutions of transnational governance and to delegate significant sovereign prerogatives. History and political circumstances being different, the Community Method under which agreement by a qualified majority becomes binding on other members and in which transnational entities and their leaders become influential policy entrepreneurs is unlikely to be feasible in Asia. Rather, the Open Method of Coordination, in which countries share information on best practice and use peer pressure to encourage convergence to it, is more likely to find favor. But the Open Method works better when a reasonable level of regulatory harmonization will suffice than when full harmonization is needed. It is better for encouraging policies to foster the development of Asian financial markets or for helping central banks to learn how to back regimes of greater exchange rate flexibility with inflation targeting than for, say, establishing a single regional competition policy or agreeing to move to a single currency. The Open Method is likely to result in a more loosely configured regional grouping than the European Union, in other words. And to the extent that Asian countries are reluctant to name and shame their neighbors, it is likely to be even less effective than in Europe.

Finally, European experience suggests that policy will be actively used to build coalitions favoring regional integration and to buy off interest groups that see themselves as adversely affected. But European experience also warns that these kinds of compensatory arrangements acquire a life of their own. Political expedients that are good for cultivating support in the short run but have long run costs are less efficacious to the extent that they tend to be long lived.

References

Annett, Anthony, Jorg Decressin and Michael Deppler (2005), "Reforming the Stability and Growth Pact," IMF Policy Discussion Paper 05/02 (February).

Bordo, Michael, Barry Eichengreen and Douglas Irwin (1999), "Is Globalization Today Really Different Than Globalization a Hundred Years Ago?" *Brookings Trade Forum*, pp.1-72.

Buti, Marco, Sylvester Eijffinger and Daniele Franco (2003), "Revisiting EMU's Stability Pact: A Pragmatic Way Forward," *Oxford Review of Economic Policy* 19, pp.100-111.

Collignon, Stefan, Renaud Dehousse, Jean Babolde, Marjorie Jouen, Philippe Pouchet, Robert Salair, Rolf-Ulrich Sprenger and Hugo Zsolt de Sousa (2004), "The Lisbon Strategy and the Open Method of Coordination," Policy Paper no 12, Paris: Notre Europe.

Danthine, Jean-Pierre, Francesco Giavazzi, Ernst-Ludwig von Thadden (2000), "European Financial Markets After EMU: A First Assessment," CEPR Discussion Paper no. 2413 (April).

David, Christina and Jikun Huang (1996), "Political Economy of Rice Price Protection in Asia," *Economic Development and Cultural Change* 44, p.463-483.

De la Fuente, Angel and Xavier Vives (1995), "Infrastructure and Education as Instruments of Regional Policy: Evidence from Spain," *Economic Policy* 9, pp.11-54.

Devuyst, Youri (1999), "The Community-Method after Amsterdam," *Journal of Common Market Studies* 37, pp.109-120.

Eichengreen, Barry (2003), "What to Do with the Chiang Mai Initiative," *Asian Economic Papers* 3, pp.1-49.

Eichengreen, Barry (2004), "Institutions for Fiscal Stability," *CESifo Economic Studies* 50, pp.1-25.

Eichengreen, Barry (2007), *The European Economy Since 1945: Coordinated Capitalism and Beyond*, Princeton: Princeton University Press.

Eichengreen, Barry and Fabio Ghironi (2003), "EMU in 2010,"in Marco Buti and Andre Sapir (eds), *EMU and Economic Policy in Europe: The Challenge of the First Two Years*, Cheltenham: Edward Elgar, pp.381-408.

Eichengreen, Barry and Douglas Irwin (1995), "Trade Blocs, Currency Blocs, and the Disintegration of World Trade in the 1930s," *Journal of International Economics* 38, pp.1-24.

Feldmann, Horst (2007), "From Initiating to Breaching to Diluting the Stability and Growth Pact," in Jens Holscher (ed.), *Germany's Economic Performance from Unification to Euroization*, Basingstoke: Palgrave, pp.107-142.

Gaspar, Vitor and Philipp Hartmann (2004), "The Euro and Money Markets: Lessons for European Financial Integration," in Adam Posen (ed.), *The Euro at Five*, Washington, D.C.: Institute for International Economics, pp.87-115.

Giavazzi, Francesco and Alberto Giovannini (1989), *Limiting Exchange Rate Flexibility: The European Monetary System*, Cambridge, Mass.: MIT Press.

Haas, Ernst (1958), *The Uniting of Europe*, Stanford: Stanford University Press.

Hix, Simon, Abdul Noury and Gerard Roland (2007), *Democratic Politics in the European Parliament*, Cambridge: Cambridge University Press.

International Labour Office (2007), *Global Employment Trends Brief* (January)

Wilfrid Legg and Gerard Viatte (2001), "Farming Systems for Sustainable Agriculture," *OECD Observer* (July), www.oecd.org.

Manzano, George (2001), "Is There Any Value in the ASEAN Surveillance Process?" *ASEAN Economic Bulletin* 18, pp.94-102.

Martin, Philippe (1998), "Can Regional Policies Affect Growth and Geography in Europe?" *World Development* 26, pp.757-774.

Neven, Daniel and Claudine Gouyette (1995), "Regional Convergence in the European Community," *Journal of Common Market Studies* 33, pp.47-65.

Pasadilla, Gloria (2006), "Preferential Trading Agreements and Agricultural Liberalization in East and Southeast Asia," Working Paper no. 11, Asia-Pacific Research and Training Network on Trade (April).

Rey, Helene (2004), "The Impact of a Five Year Old Euro on Financial Markets," in Adam Posen (ed.), *The Euro at Five*, Washington, D.C.: Institute for International Economics, pp.116-121.

Rodriguez-Pose, Andres and Ugo Fratesi (2004), "Between Development and Social Policies: The Impact of European Structural Funds in Objective 1 Regions," *Regional Studies* 38, pp.97-113.

Ross, George (1994), *Jacques Delors and European Integration*, Oxford: Polity Press.

Sala-i-Martin, Xavier (1996), “Regional Cohesion: Evidence and Theories of Regional Growth and Convergence,” *European Economic Review* 40, pp.1325-1352.

Sandholtz, Wayne and John Zysman (1989), “1992: Recasting the European Bargain,” *World Politics* 42, pp.95-128.

Schafer, Armin (2004), “Beyond the Community Method: Why the Open Method of Coordination was Introduced to EU Policy-Making” *European Integration Online Papers* 8, pp.1-20 (September).

Thygesen, Niels (2004), “Reform of the Stability and Growth Pact,” Note for the Economic and Monetary Affairs Committee of the European Parliament (2^{nd} Quarter).

Wakasugi, Ryuhei (2007), “Vertical Intra-Industry Trade and Economic Integration in East Asia,” *Asian Economic Papers* 6, pp.26-45.

Zsolt de Sousa, Hugo (2004), “The Future of the Stability and Growth Pact as a Tool for Economic Policy Coordination,” Policy Paper no.9, Paris: Notre Europe.