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Economic Integration in Asia

− European Perspectives −

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Abstract: This paper reviews European experience of economic integration and discusses the key similarities and difference between the European and Asian models. Europe has been able to achieve 'deep integration' because of the vision of a united Europe, the political balance within Europe, and the development of the institutions of the EU. None of these features are present in Asia. Complementarities between Asian economies create gains from trade liberalisation, but it seems unlikely that Asia will follow the European path of 'deep integration', or attain the consequent economic benefits.

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1. Introduction

Europe's integration project has now been running for half a century, a period spanning the postwar birth of economic cooperation and the more recent enlargements and deepening of the union. The project has been enormously successful in both political and economic terms, although there have been frequent tensions and undoubted failures.

This paper draws out some of the main messages from the European experience of integration. We look at both the political and institutional development of the European Union, and at its economic development. What have been the driving forces behind the integration process? What institutions have developed to manage integration? What has been the impact of integration on trade flows and income levels across European countries?

We then endeavour to draw out some of the lessons that the European experience may have for integration in Asia. Evidently, the two continents are very different in both political and economic terms. On the economic side, integration has had a large impact on European trade and incomes, both through trade creation and through intensifying competition. One might argue that the heterogeneity of countries in Asia offers an even greater potential for trade creation, and also for using integration as a force to facilitate the development of production networks.

On the political level, European experience suggests that achieving the economic gains has required continuing and far reaching policy measures. These, in turn, require a deep political commitment to integration and the existence of institutions to promote integration and protect it from the inevitable inter-member frictions and preoccupations with national goals. In Europe progress has been driven largely by the Franco-German partnership and by the Brussels institutions. It is hard to see what their equivalents in Asia might be. Therefore, for Asia, the economic arguments are compelling but the lack of political commitment suggests that trade integration will not necessarily be followed by deeper economic integration.

The remainder of the paper comprises four sections. Section 2 explores the political economy of European integration, considering the history of, and commitment to, integration among its members, the roles of the institutions that it has created and the particular nature of its inter-member relations. We suggest that the key driving forces in Europe do not have any close parallels in Asia. Section 3 deals with economics, arguing that Europe has seen both trade creation and trade diversion, and that integration has generally been a force both for promoting efficiency through specialisation, and for increasing competition and industrial efficiency. With its greater diversity between members, Asian integration may generate greater trade creation, investment flows and competitive pressures than did European integration, but possibly at the expense of greater divergence between members. Reaping the economic benefits, however, will require ongoing integration, gradually rolling back the various barriers and frictions on intraregional trade. Section 4 considers the dynamics of the integration. Regional integration creates its own dynamic as 'domino effects' come into play. In Europe this took the form of continuing enlargement of the EU, but in Asia the dynamic seems to be leading to countries competing to gain hub status and to a proliferation of agreements. Section 5 concludes.

2. Political economy

This section reviews the history of European integration and institutions to see what lessons they contain for Asia. It will become plain that the two exercises are fundamentally different and that the casual drawing of parallels could be very misleading.

2.1 Europe

A Grand Vision

European integration is an ancient aspiration, although its current manifestation arises from the geo-politics of the mid-twentieth century: the desperate need, following World War II, to find a way of preventing future Franco-German conflict, coupled with a strong sense of internationalism that saw the future in terms of institutionalised co-operation between countries[1]. Perhaps the most important factor in understanding the history of post-war European integration is to see that it was essentially a political-ideological phenomenon. It was not driven by the careful calculation of economic costs and benefits, still less by trade negotiators, but by a grand vision which had fortunate economic side effects.

This fact has had fundamental effects on Europe's evolution, for the grand vision helps to move internal debates beyond mercantilism and the calculation of benefits issue-by-issue. It induces a generalised reciprocity, whereby every party gains in the end, but where every one recognises the value of the system as a whole and is prepared to accept losses on some deals. The day-to-day compromises necessary to achieve co-operative outcomes become easier to make, or, which is basically the same thing, easier to sell at home.

Political Institutions

The first major step in modern European integration was the European Coal and Steel Community (ECSC), founded in 1951, whose origins illustrate the political motivation for integration. Its purpose was to stimulate the recovery of heavy industries in

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he same internationalism that produced the UN, IMF, World Bank and the GATT.

(West) Germany while making it impossible for their output ever to be used to wage war again. The proposal - due to Jean Monnet and Robert Schuman - was that, by establishing a truly common European market in coal, iron and steel, countries would become so interdependent that war would be not only ‘unthinkable, but materially impossible’. The customs union was supplemented by a ‘High Authority’, which had the power to dictate national output quotas, establish maximum and minimum prices, and enforce competition. The High Authority was an administrative body, controlled in policy but not day-to-day matters by a Council of the Community on which the separate governments were represented, and also by a European Parliament. A Court of Justice was established to oversee the legal aspects of the Community.

Following the ECSC, attempts were made to establish both a defence community (the EDC) and a political community (the EPC). Both failed, so the ‘integrationists’ were thrown back onto economic integration in the form of the European Economic Community (EEC), and the atomic energy community (Euratom), which were created in the Treaties of Rome in 1957. At first, the EEC and Euratom existed separately but parallel to the ECSC, but in 1967 the three bodies were merged, to from the European Communities (EC) with one Commission (successor to the High Authority), one Council, one Parliament and one Court. The Maastricht treaty, in 1992, turned the EC into the European Union (EU), creating European citizenship, some cooperation in foreign and security affairs, and paving the way for monetary union.

These institutions of integration have evolved and expanded, but the basic structures remain as they always were. Thus although the EU now has a common currency (introduced for the ‘Eurozone’ countries in 2002) and (limited) powers to make common political and foreign policies, it is in essence just a continuation of the old EEC, with institutions designed primarily for deep micro-economic integration. Its governance is shared between a Commission, a Council, a Parliament and a Court.

The *Commission* comprises commissioners appointed by member states for four-year terms, two from each of the larger members and one from the others. It initiates Union policy and executes it, but it cannot actually make policy — that falls to the *Council*. The Commission is explicitly supranational, and is charged with preserving and promoting the European ideal.

The *Council* formally comprises the foreign ministers of all member states, although much business is conducted by ministers concerned with specific issues, e.g., agriculture ministers discuss the Common Agricultural Policy (CAP).[2] The Council shares executive power with the Commission. It may adopt the latter’s policy proposals, in which case they become law, but it may not generally amend them. Decisions are theoretically taken by qualified majority vote, where votes are allocated to member states according to size.

[2] The meeting of heads of government is known as the European Council. It has regular bi-annual meetings.

Until the 1990s, however, all countries informally had a right of veto on issues of alleged fundamental national interest (under the “Luxembourg Compromise”). As a result decisions had to be reached by trading compromises (often on unrelated issues) to obtain a unanimously acceptable package. Recently strong efforts have been made to re-establish majority voting in most spheres (but not, for example, fiscal policy and various ‘pet areas’ such as audio-visual policy) and there is hope that this will reduce the horse-trading. Nonetheless, the tradition of consensus remains strong within the EU.

The *Court of Justice* interprets Union law. Its findings are binding even on member governments. The judges are appointed by member states, but they are required to be quite independent of national interests and cannot be removed by member governments. The *European Parliament* has a small but growing role in the Union. It must be consulted by the Commission and the Council before they decide many issues, and it has some power over the Union budget. Its greatest power is to dismiss the Commission *en masse,* although this is such an unwieldy weapon that it is of little practical use.[3]

These institutions form a constitutional structure just as complex and delicately balanced as the US Constitution, but without, of course, its democratic legitimacy. Like the latter, they have to balance “states' rights” against the centre and rely on powerful legal bodies for enforcement. Arguably such balances are necessary to create the confidence that allows member governments to proceed with deeper aspects of integration that impinge directly on issues of sovereignty and internal distributions of income.

Although it is fashionable, and to some measure warranted, to decry Brussels' bureaucracy and interventionism, one should not lose sight either of its origins or of its role in the integration process. The institutions stem from a period when there was much greater faith in governments than now, when governments were much more heavily involved in economic management than now, and when the essential task was political. Arguably, the subsequent difficulties were not due to the original structures *per se*, but their inability to evolve as circumstances changed. Such flexibility is an important lesson for today’s would-be integrators. Inflexibility is similarly the problem with agriculture. The CAP stems from a period when agriculture provided a substantial part of employment in all six original members, and was strongly protected. The error should be seen less in the original policies, which were thought to make sense at the time, but in the danger of giving particular sectors special constitutional standing (agriculture is singled out in the Treaty of Rome) and/or their own bureaucracies. Each makes reform very difficult when circumstances change. As integration occurs, it is important to avoid institutionalising the special cases that are bound to arise. Recognise them as explicit failures and exceptions so that they can be addressed later.

[3] In 1999 the entire commission resigned, under parliamentary pressure, over allegations of fraud and mismanagement.

Guardians of the Vision

European integration has always been a rather 'on and off' affair with periods of enthusiasm and rapid advance followed by periods of doubt and retrenchment. The former are, understandably, associated with economic booms and the latter with recessions. Thus the early 1980s found the EU very much down in the dumps. After the severe anti-inflationary policies at the beginning of the decade, the US and Japanese economies began to recover, but those of the EU seemed firmly stuck in the mire. Moreover, the rapid increase in intra-EU trade that had characterised the early stages of integration seemed to have halted or even gone into reverse. The cry was frequently heard that 'the steam had gone out of integration' and doubts were expressed about the viability of the EU as an institution, let alone any further progress.

During such 'depressions', the Commission's role as the guardian and champion of the European ideal has been vital to the goal of integration. While member governments, and thus the Council of Ministers, are focusing on their local problems, the Commission is constitutionally required to take a broader, longer, and more European view. In the mid-1980s its response to the lethargy of the European economy was dramatic and imaginative. It had long been recognised that the actual integration of the EU economies fell short of the aspirations of the Treaty of Rome. Recalling the stimulus that the initial creation of the EEC had induced, and following the prevailing intellectual trend towards economic liberalism, the Commission proposed a bold step towards complete economic integration with the launch in 1986 of the Single Market Initiative.

Similarly, the Commission was the driving force behind the Maastricht Treaty of 1992, which formally created the EU and extended the competences of the Union to foreign affairs and justice. This was far from popular, being rejected by a referendum in Denmark and very nearly so in France. It illustrates a further cycle in the dynamics between the Commission and the states: flushed with one success (in this case the Single Market), the Commission attempts to follow it by further deep integration and centralization, only to find it rejected by governments and electorates. A further cycle followed, with the adoption of monetary union (2002), and then the rejection of the proposed EU constitution by the voters of France and the Netherlands (2005). These rejections, however, do not threaten the basic fabric of the common market: tribute to its deep foundation in European perceptions, and to its pragmatic and non-confrontational mode of progress.

The balance of power

The preceding section showed the importance to EU development of political will, and following from that, institutional depth. A key driver of both has been, and continues to be, the Franco-German relationship.

It is at this fundamental level that Asia looks most different from the EU. Not only is the post-war political imperative absent, but so too is the balance of power that obtains within the EU. Table 1 gives income shares and population shares of countries in the Asia and in the EU. The motivating force in Europe has been the need for two roughly equal-sized powers to co-operate and create something new that is different from either of them. The third power, the UK, is large enough to be taken seriously but not to derail the whole enterprise. As table 1 shows, France, Germany and the UK accounted for 19.7%, 26.6% and 14.1% of EU output in 1973. The Asian predicament, on the other hand, is that China and Japan together would account for 82.7% of output in an ASEAN + 3 bloc, dominating its output. And of course, these two countries are at different stages of development. The rise of China is viewed with suspicion in Japan and there is not yet a recognition that the two economies may one day become roughly equivalent in size and should cooperate. The third power, Korea, is not nearly the size of Japan and China, and would not necessarily have the influence of the UK. As China's economy expands at nearly 10% per annum, it and Japan will be the key to the success of an ASEAN+3 FTA. The same is true when population is taken into account as China alone is more than double the population size of the 10 countries of ASEAN. Overall, the different size distributions of members in Asia and the EU make it difficult to perceive strong parallels in the two groups' political dynamics.

Table 1. GDP shares

Europe (EU15)				**Asia (ASEAN + 3)**	
	1958	1973	1998		2003
Germany	20.1	26.6	25.1	Japan	62.8
France	21.2	19.7	17	China	19.9
UK	23.2	14.1	16.7	South Korea	7.5
Italy	11	12.9	14	ASEAN	9.8
Other EU	7.3	11.7	27.2		
Other Non-EU (future members of EU15)	17.2	15	0		

ASEAN: Brunei, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam.

Decision taking in the EU

We have seen that institutional reform in the EU has proved difficult, but day to day decision taking has been broadly successful. The key features have been the initial and continuing European vision, the balance of power, and the role of the commission. To this must be added the fact that it has generally proved possible to buy off dissent. This is partly because the broad agenda of EU competencies creates scope for deal-making. There is a 'generalised reciprocity' – losses on some issues can be accepted in expectation of gains on other issues. It is also because direct, if limited, fiscal transfers are available.

The role of fiscal transfers increased greatly from the 19890s onwards. The original 'Six' EEC members were fairly homogenous in terms of income levels, but later enlargements began to introduce a wider spread, especially the 'Southern Enlargement' to Greece (1981), Spain and Portugal (1986) and more recent enlargements to Eastern Europe (2004, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia, as well as Cyprus and Malta). This widening membership raised serious issues of intra-EU distribution, not only in helping the new poorer members to catch up, but also within existing members. Regional policy of one form or another – the 'structural funds' and 'cohesion funds' -- now account for more than one-third of the budget of the EU and 0.37% of total EU income. In fact, distribution is a major factor in much EU decision making, and the existence of institutions to address it helps to prevent it from becoming a barrier to progress and an impediment to efficiency enhancing decisions. The transfer mechanism - small as it is compared with those in federal and unitary states - has been essential to the running of the EU since the southern accession.

As a direct consequence of its relatively consensual nature, policy making in the EU is patchy, inconsistent and ragged. Compromise and pragmatism have been the watch-words, rather than efficiency and elegance, with particular members being granted derogations from some measures and the enforcement of others relying heavily on turning a blind eye. One might regret this, but it is notable that despite a number of shocks, European integration has avoided serious set-backs for half a century.

2.2 Asia

We have argued that key features underlying the success of the EU are a grand vision; the development of central institutions; a balance of power; and, arising from these aspects, a general ability to reach compromise agreements. How does Asia square up against these features?

It is interesting that statements of the motivation driving Asian integration are almost entirely defensive. For example, an overview of cooperation in Asia (Lamberte 2005) gives five driving forces: a defensive response to the rise of regionalism elsewhere; the slow progress in multilateral trade liberalisation; competition with other regions of the world for FDI; concern to tidy up bilateral agreements; and institutionalising the de facto increase in economic interactions. The leading countries in the region do not present integration as a means to heal historical conflict – on the contrary, discussions of integration tend to inflame old wounds and highlight political tensions. As for institutional development, there is no impetus for a pan-Asian framework, along the lines of Europe in the post-War period. The largest economy in the region, Japan, was closely tied to the United States after WWII and its development was accordingly western-oriented. China in the post War period turned inward when political turmoil and Communism kept its doors closed until the 1980s and 1990s. The ASEAN countries first established their regional alliance in 1967. The Association of Southeast Asian Nations was started by Indonesia, Malaysia, Philippines, Singapore, and Thailand. Later on, Brunei joined in 1984, Vietnam in 1995, Laos and Myanmar in 1997, and Cambodia in 1999. The original five members joined together to secure themselves against communist expansion in Vietnam. In 1976, it increased its scope to economic cooperation and in 1991 embarked on developing a free trade area known as the ASEAN FTA (AFTA). However, the extent of trade among ASEAN countries has always been limited despite the intent to create a FTA. Approximately 23% of exports from ASEAN countries are sold to other ASEAN countries. This is in contrast to intra-Europe trade which accounts for three-quarters of all exports. There is also little institutional framework in the ASEAN trade bloc. ASEAN has made some headway in developing a dispute settlement system, but the system is considered to lack transparency.

In general, there is no supra-national institutional structure to bring together the ASEAN+3 nations. The nations have vastly different political and legal systems, and two of the countries (China and Vietnam) are transition economies which have mixed state/market economies. The structures found in the EU – including a court and parliament -- are fundamentally lacking in Asia. Moreover, the institutional and political differences among these nations make it unlikely that there is a premise for deep integration.

The balance of power has already been discussed. The major economies of Japan and increasingly China make the region appear more similar to the dominance of the United States in discussions of the FTAA. The next largest economy is South Korea, which is considerably smaller than the two major economies, while the total GDP of ASEAN only just exceeds that of Korea. The highly unbalanced size of the economies in Asia will make the role of China and Japan critical in any FTA, and by the same reasoning means that their agreement will be essential in any successful regional economic agreement. However, these two nations have considerable political differences, manifested in public rebukes over the Japanese prime minister’s visits to the controversial Yasukuni shrine among others.

What are the implications of this for the day-to-day decision taking that has to take place in a regional integration agreement? The current ASEAN arrangements are rife with exemptions and exceptions. Without vision, or institutions, or breadth of agenda or transfer mechanisms, this is unsurprising. The challenge for ASEAN+3 will be to overcome political differences and adopt a pro-active stance toward a FTA. At the moment, the ASEAN-China discussions are underway to establish a FTA by 2010. This is causing Japan to act to establish an ASEAN-Japan FTA, and accordingly South Korea. This defensive stance does not hold the potential of the EU to compromise and work toward an integrationist agenda. Instead, Asia looks more likely to be characterised by multiple bilateral agreements among these nations driven by an economic agenda; to realise gains from trade from rising intra-regional trade in Asia which currently accounts for 50% of all trade and is increasing due to China's fast growth.

Therefore, in contrast to Europe, Asia lacks the successful features that have shaped regional integration in the EU. There is no grand vision, no impetus to develop central institutions, there exists a disparate set of economic powers and no evidence of an ability to reach compromise agreements. Asian integration is characterised by a defensive motive in reaction to regionalism elsewhere and the slowness of multilateral trade agreements as well as a recognition of the rapid development of regional trade. The moves toward integration are thus motivated by economic gains without a corresponding set of political will and institutional vision. The balance of power further suggests that one or two countries will dominate any arrangement, moving Asia more toward a hub and spoke system than an integrated region.

3. Trade and production

Since Asian integration is focussed around free trade, as opposed to an attempt at deeper political integration, we now turn to the economics of integration. The EU is far from being a perfect parallel, being more compact geographically, more homogenous in income levels, and more intent on deeper integration, but it provides our best view of the long-run economic effects of regional integration.

3.1 Europe

Enshrined in the Treaty of Rome are the four basic economic principles underlying European economic integration; freedom of trade in goods; freedom of trade in services; free mobility of capital; and free mobility of labour. We discuss progress in these areas (leaving labour mobility to one side), highlighting both the obstacles that have been encountered and the outcomes that have been attained. We look first at trade, where several quite distinct mechanisms have been at work. The first is that integration causes reorganisation *between* sectors of the economy; sectors expand or contract in line with efficiency differences between countries, although there are also concerns about trade diversion. The second is that trade changes the nature of competition between firms and induces an industrial reorganisation *within* sectors of the economy, this is often associated with foreign direct investment. Trade may also cause large changes *within firms*, as production networks develop; we postpone discussion of this aspect of trade until section

3.2, on Asia. Following discussion of these issues we turn to looking at outcomes, in particular the extent to which there has been convergence of incomes within the EU, and then to some of the policy questions that have arisen.

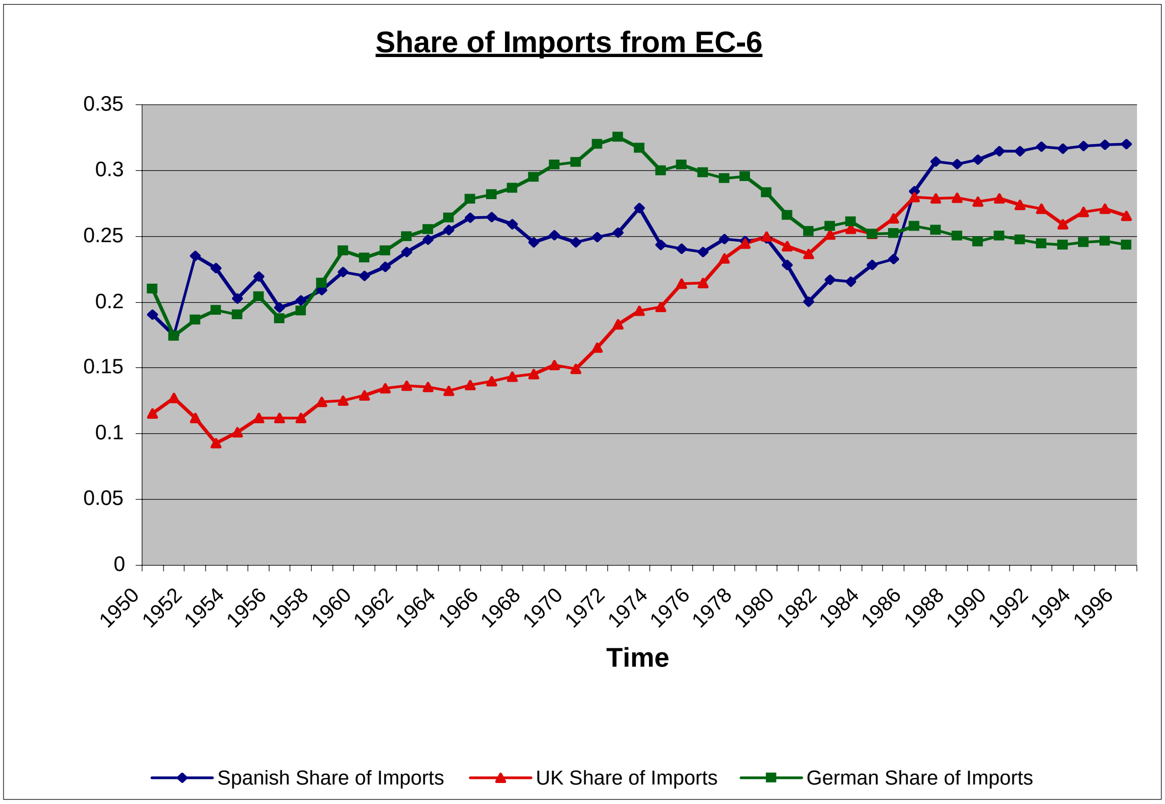
The growth of trade

European integration had a dramatic effect on the geographical patterns of members' trade. Every member has seen a strong re-orientation of its trade towards other members following accession or the formation of the EEC. Moreover this is as true of manufacturing (and probably services) as of the grotesquely distorted agricultural trade. Figure 1 plots the shares of three EU members' imports coming from the original EC-6. As an original member, Germany experienced increasing integration with the remaining five from 1957, with duty-free and quota-free access from 1968. The UK acceded on January 1st 1973 and Spain on January 1st 1986. The pattern is very clear: starting slightly before the formal date of the integration, the trade share starts to rise. It rises for 10-12 years and then stabilises. For Spain the growth is still continuing at the end of the period. Freund and McLaren (1999) have explored the dynamics of regionalism more formally using both trade shares and trade intensity indices[4]. For the latter - the more appropriate measure analytically - they find some evidence of anticipation effects - starting on average 2½ years before formal integration - followed by 9½ years of higher growth before achieving a new steady-state[5]. On average EU countries increased their intra-bloc trade intensity by 53 percentage points over this process.

[4] The trade intensity index for i's trade with j is $(T_{ij}/T_{iw})/[(T_{wj}-T_{ij})/T_{ww}]$, where T represents trade in both directions and where subscript w represents the world.

[5] Anticipation effects have been noted previously - e.g. in Winters (1983) for the UK.

Figure 1. Shares of Members' Imports coming from EC-6, 1950-1996



Sectoral specialization

The growth of trade can lead to economic gains through increased specialisation. The specialisation may arise in response to technological or factor endowment differences between countries, or may occur because of the benefits of clustering related activities in one place. In either case, market integration should promote an increase in specialisation, as the cost of trade is reduced.

There is evidence that EU integration has been associated with a rather modest increase in manufacturing specialisation. Measures of the difference between the industrial structures of EU countries have been computed (at the level of 36 industrial sectors, Midelfart-Knarvik et al. 1999). All EU countries except the Netherlands have, since the late 1970s, seen their industrial structure becoming more dissimilar from that of other EU countries. For the initial six members of the EU there is a more or less steady increase in specialisation throughout the period. Later entrants experienced increasing specialisation starting from around their date of entry. However, despite this, EU countries and regions remain very much less specialised than comparable size geographical units in the US. So far at least, integration has not caused specialization and clustering of activity to go as far as the US experience suggests would be expected in a single country.

Econometric analysis of these changing patterns of specialization indicates that it is largely in line with intra-union comparative advantage. For example, skilled labor intensive activities have tended to relocate towards skilled labor abundant countries, and R&D intensive activities have relocated towards scientist abundant countries (Midelfart-Knarvik and Overman 2002). However, reallocations in line with intra-union comparative advantage are not necessarily welfare increasing as they could be at variance with countries' comparative advantage with the rest of the world. This is the phenomenon of trade diversion.

Trade creation and trade diversion

Increased intra-bloc trade is frequently taken as indicating successful economic integration, especially in popular debate, but, of course, it shows no such thing. The traditional economic question hinges around whether the share increases as a result of trade creation or trade diversion. There is no doubt that European integration has been accompanied by a good deal of trade creation, both internally as well as so-called external trade creation, in which imports from outside the bloc displace members' domestic production and/or expand consumption. Thus, Truman's (1975) decomposition of apparent consumption of manufactures into shares due to imports from partners, imports from non-partners and domestic supplies, shows both sources of imports growing strongly at the expense of the domestic share. Truman finds that out of 53 country-sector combinations observed over 1960-68, 31 display such 'double trade creation' while a further 13 display internal creation and external diversion. Over 1975-82 Jacquemin and Sapir (1989) find roughly similar proportions of 'double trade creation' and less evidence of trade diversion, while Sapir (1992) finds 'double creation' for aggregate EC-9 trade over 1980-91.

The predominant pattern of 'double trade creation' does not imply absence of trade diversion, as external trade should be compared with what it would have been in the absence of integration. There is an unavoidable need to specify the *anti-monde* when estimating integration effects. Two approaches exist to modelling the *anti-monde* more explicitly. First, one can model trade flows in terms of prices and incomes and explicitly allow for the different tariffs faced by different suppliers. This requires considerable information and some effort to model the determinants of trade flows through time in a theoretically coherent fashion. Winters (1983) takes this approach to UK manufacturing trade following its accession to the EEC in 1973. He finds relatively little trade diversion, but certainly some evidence of it.

The second approach is to use a gravity model, which essentially uses trade between other (unrelated) countries to identify the *anti-monde* for partners' trade. The gravity model explains trade between two countries in terms of their incomes, populations, location and geographical characteristics, plus at least two sets of dummy variables to capture the effects of each regional arrangement: one on intra-bloc trade and one on trade between partners and non-partners. The coefficients on such dummy variables reflect a huge variety of effects and can be highly significantly different from zero at any point in time. Hence to measure integration effects one needs to observe not their levels but their changes over periods when regional integration has occurred.

Within Europe, Bayoumi and Eichengreen (1997) find strong signs of EEC-EFTA trade falling below expected values as the EEC was formed, and some evidence of the acceding countries' trade with non-members similarly falling below par as they joined.[6] Sapir (1998) similarly finds EU-EFTA trade penalised by EEC formation and enlargement. Soloaga and Winters (2001) use a much wider range of countries than just Europe to define their *anti-monde*, but at the expense of considering only the period 1980-96. They use three dummies to capture trade effects, breaking the extra-bloc trade effect into an export and an import effect. In 1980 the EU shows unusually strong trade with non-partners and lower than expected trade within the bloc. (This is a common result in gravity models based on large samples of countries.) As integration deepens and Iberia enters the Union, however, these effects decline absolutely - that is, intra-trade grows relative to expected and extra-trade falls. Moreover, Soloaga and Winters show that these changes are statistically significant, suggesting the presence of trade diversion.

The overall message from these studies is then that there has been rapid trade growth and trade creation, but there is some evidence of trade diversion occurring as well. Of course, the extent of trade diversion varies across sectors, and the grossly distorting Common Agricultural Policy has certainly been trade diverting for members who would otherwise have had a more liberal agricultural trade regime.

Industrial reorganisation; competition, scale, and market integration

A central feature of EU trade is that a large part of it has been intra-industry, rather than inter-industry. Such trade is not (necessarily) based on cost or comparative advantage differences between countries, but can instead arise simply from competition between firms in imperfectly competitive markets. Small, national, segmented markets are liable to be dominated by a few national producers, possibly operating at sub-national scale and exploiting considerable monopoly power. Market integration should remove this segmentation, allowing firms to compete more effectively in other national markets and permitting expansion of relatively efficient firms. Market integration permits firms to

[6] Just as with the apparent consumption exercise, these exercises are coloured by the reduction in the accedants' tariffs on other countries as they adopted the common external tariff. In this case, however, the external trade changes may reasonably be attributed to integration.

be larger (and better exploit economies of scale) *and* competition to be more intense.

EU experience has indicated that, in some sectors at least, achieving truly integrated markets can be quite difficult. Even when tariffs have been eliminated, markets appear to remain segmented, with substantial price differentials between countries, and borders still having a strongly negative effect on trade flows. These observations were amongst the motivations for the Single Market Initiative, launched in 1986.

The Single Market Initiative (SMI) was launched in 1986 for completion in 1992, with the objective of eliminating market segmentation and 'completing the internal market'. The economic policy measures introduced fall into four main categories: (1) the simplification or removal of frontier formalities, facilitating and speeding the flow of goods across borders; (2) the simplification of product standards, in particular the adoption of the 'mutual recognition principle', whereby goods approved for sale in any member state are deemed acceptable in all; (3) the deregulation of transport sectors, allowing for improved efficiency in the internal distribution of goods; and (4) the opening up of public procurement to supply from all member states.

Although individually small, these measures were estimated collectively to reduce the costs of trade across borders by an amount equal to several percent of the value of goods traded. More importantly, their indirect effects were predicted to lead to gains equivalent to several percent of EU GDP, as markets became more competitive *and* firms reorganised, increasing their scale to that of the larger integrated market. Evidence on actual gains is patchy. The SMI was accompanied by a burst of merger activity, and there is some evidence of further trade creation (Pelkmans 2001). Griffith (2001) in a study of UK manufacturing finds a significant increase in both labour productivity and total factor productivity in establishments in sectors that were particularly affected the SMI. Increased scales of operation have been attributed to the SMI, particularly in sectors where liberalization of public procurement was important, although the size of firms in the EU remains generally smaller than their US counterparts.

The Single Market Initiative left countries with different national currencies, until monetary union was introduced for 12 core (Eurozone) currencies in 2002. Part of the motivation of this initiative was to promote price transparency and achieve further market integration, although most of the analysis has surrounded its macro-economic impact.

What messages come from this experience of market integration for Asia? The European experience points to the importance of 'deep integration'. The pro-competitive and scale economy gains of market integration can be impeded by frontier frictions that individually appear quite minor, but collectively allow firms to retain dominant positions in their home markets. The list of such frictions is long. A free trade area, as opposed to a customs union is bound to retain border formalities as well as rules of origin. Contingent protection has been widely used both by the US and within Asia, and its 'trade chilling' effects are well known (ADB 2005). Meeting national product standards is costly, and harmonisation of standards almost impossible. Europe took the mutual recognition route, but this involves a level of acceptance of foreign standards and a willingness to delegate product approval to foreign institutions that is inconceivable in Asia.

Despite the success of the Single Market Initiative, it has not reached all – or even many of the largest – areas of economic activity. Opening up of service sectors to competition was one of the objectives of the Single Market Programme, imposing on member states the obligation to abolish restrictions on the free movement of services and extend mutual recognition to professional qualifications. However, progress remains slow, with differing legal standards and regulatory regimes still impeding cross border investments and competition. This remains an area where the European Commission is still performing its role of trying to secure further market integration, while encountering stiff opposition from a number of member states.

Foreign direct investment

Accompanying the rapid growth of trade in the EU there has been expansion of foreign direct investment (FDI). World FDI stocks have grown faster than both income and trade in recent decades, and the EU-15 holds around one-third of the stock of inwards FDI. This share surged to over 40% at the time of the Single Market Initiative driven by a cross-border merger wave. The importance of FDI for EU economies is illustrated by the fact that 47% of Irish manufacturing employment is in foreign owned firms, and this share is substantial even the larger EU countries (France 26%, UK 16%).

Much of the growth of FDI within the EU has been intra-EU investments, which accounts for a majority of the total. Investments from outside the region have also been important as economic integration has allowed outside firms to supply the entire European market from a single plant. Indeed, for many suppliers FDI is a much more important means of reaching the European market than is foreign trade. For manufacturing as a whole, sales of goods by US subsidiaries in the EU were, in 1998, 3.75 times larger than EU manufacturing imports from the US. There is also considerable evidence that some of the inwards Japanese investments of the 1980s was driven largely by EU tariff and non-tariff barriers.

These investments are perceived to have important positive effects. Productivity is generally higher in firms that are multinational than in firms that supply only the domestic market (Martin, R. and C. Criscuolo 2001). Particular importance attaches to FDI in services, as this may be the only means through which foreign competition can enter the domestic market. Consequently both the entrenched interests of incumbent firms and the potential economic gains from liberalisation are large. Opening up of service sectors to competition was one of the objectives of the Single Market Programme, imposing on member states the obligation to abolish restrictions on the free movement of services and extend mutual recognition to professional qualifications. However, progress remains slow, with differing legal standards and regulatory regimes still impeding cross border investments and competition.

Income convergence

Some of the most important economic questions concern the effects of regional integration on growth. Is regional integration likely to be good for growth in the region as a whole, and for poorer countries in particular?

Standard neo-classical trade theory gives the presumption that integration should lead to convergence of factor prices and incomes – with the limit being factor price equalisation. However, a number of qualifications need to be made to this benchmark case. Even if integration brings convergence of per-capita income, it need not bring steady convergence of all factor prices. Feenstra and Hanson (1997) show how the relocation of production activities to low wage countries can reduce wages of unskilled labour in these countries. The argument is that the activity that relocates may be unskilled labour intensive relative to other activities in the high-wage country, but skilled labour intensive relative to activities in the low-wage host country. In a more general model in which comparative advantage stems both from endowments and from location (with remote regions having a comparative disadvantage in high transport costs goods), reducing trade barriers brings peripheral countries into the trading system and raises their real incomes. However, changes in the prices of individual factors can go either way, depending on both the location and the endowments of individual countries (Venables and Limao 2002).

Some analyses of wage differences across Europe have focussed less on factor endowment differences across countries, and more on the relationship between locations with good market access (the center) relative to those with worse access (the periphery). Empirically, European cross-country wage differentials follow a strong 'center-periphery' wage gradient, and there has been concern about the possibility that integration might draw activity out of peripheral regions and into the centre. Theory suggests that this gives rise to a U shaped relationship between the ratio of wages in the periphery to those in the center as the degree of integration changes (Krugman and Venables 1990). When trade barriers are high local manufacturing is protected, allowing higher wages to be maintained; at the other extreme, perfectly free trade brings factor price equalisation. It is at intermediate levels of trade barriers that firms are drawn into 'central' regions which offer large markets and from which they can supply the periphery. Peripheral regions are poor locations for manufacturing, and as a consequence have lower wages in equilibrium. In the European context it has generally been argued that barriers are low enough that countries are on the upward sloping section of the U. Further reductions in trade barriers cause firms to relocate to lower wage peripheral regions, this flattening wage gradients. Empirically, the evidence on convergence suggests that this has – to a limited extent – happened.

Turning to the evidence, the EU has experienced significant, although by no means steady, convergence of per capita income across member states. The outstanding features are the rapid catch up of Ireland, Spain and Portugal, and at the same time the continuing poor performance of Greece. The overall experience of convergence has been analysed by many authors and can be summarised in many different ways. Summary measures of the cross-country dispersion of per capita income in the EU indicate significant convergence through the 1960s and 1970s, although no further aggregate change during the 1980s. There was some resumption of convergence between countries from the late 1980s, although this was accompanied by divergence at the sub-national level (Puga 2002).

The role of EU policy

A continuing message is that the economic benefits outlined above have not been achieved simply by removing tariffs, but have required continuing leadership from the EU institutions and from some of the member states. The best examples are the Single Market Initiative and monetary union, as discussed above. However, in addition to these positive interventions, there have also been repeated interventions by the EC to prevent the use of national policies to distort competition.

While increased mobility of firms can reduce the incentives to use burdensome regulation, it can also increase incentives to use distortionary subsidy policies, and this has been an issue in the EU. National interventions can take many different forms. At one extreme are direct state aids to industry, which amounted to some 4% of EU manufacturing value added in 1986-88, a figure that had declined to below 3% by the late 1990s. The bulk of this goes to R&D support and to meet regional policy objectives. Of the part that goes to specific industries, aid is highly concentrated on a few sectors, particularly shipbuilding and steel. Other national policies include general infrastructure and training schemes and use of corporate taxation; low corporate taxes in Ireland have been viewed as highly effective in attracting mobile FDI projects to Ireland from other potential locations in the EU.

Aware of the possible distortions to competition that would arise if countries were free to subsidise industry, articles 92 and 93 of the Treaty of Rome explicitly prohibit such subsidies. These articles are policed by active monitoring and intervention. For example, between 1998 and 2000 more than 1500 cases were reviewed by the Commission and in 7% of these cases negative decisions were reached requiring recovery of aid (European Commission, 2001). As for corporate taxation, Ireland has had several instances of conflict with the EU. Negotiations with the Commission led to termination of a complete corporate tax holiday on profits related to export sales and to an increase of the basic rate of corporate income tax from 10% to 12.5%. The weakness of these policies lies in the number of loopholes. For example, state aids are allowed in order to reduce regional disparities, and can take the form of regional incentives to enterprises in selected (but large) regions. Total expenditures to an enterprise are capped, and aids to new investments are preferred to ongoing subsidies.

While policy in these areas is still developing, the broad conclusion of the research literature is that these policies have done little to distort the location of industry. Midelfart-Knarvik and Overman (2002) show that specialisation is taking place according to comparative advantage, despite the use of state aids. Braunerhjelm et al (2000) conclude that competition for activity generally takes the form of measures that count as good economic management, rather than wasteful tax or subsidy competition.

3.2 Asia

We have argued that the EU has received gains from trade creation and specialisation, and perhaps more important gains from market integration and the associated pro-competitive effects and industrial reorganisation. However, achieving market integration has required continuing policy effort from the EC to secure liberalisation. What might the experience of Asia look like compared to this?

The share of emerging Asia in world trade has doubled, to nearly 20%, over the last 20 years, and trends in Asian trade and investment are widely documented elsewhere (IMF 2002; Ng and Yeats 2003; Zebregs 2004). Two points are particularly noteworthy. First, there has been particularly rapid growth of intra-regional trade, with the share of emerging Asia as a destination for exports from other countries in emerging Asia doubling to 40% over a 20 year period. And second, much of the growth is in intra-industry trade. The rise in intra-industry trade in Asia can be seen in Table 2 which gives the estimates since the 1980s (IMF 2002). It shows that for East Asia, three-quarters of total trade growth can be accounted for a rise in intra-industry trade.

Table 2. Intra-industry Trade as a Percentage of Total Trade Growth

Averaged over 5 Years

	1986-1990	1991-1995	1996-2000
East Asia	42.5%	46.9%	75.0%
South Asia	31.2%	21.8%	34.5%

Source: IMF 2002.

Superficially, this looks similar to experience in the EU, but there are important points of difference. The first is that the greater heterogeneity of Asian economies creates more scope for gains from comparative advantage than was the case in EU, particularly with its initial membership. Second, in Asia much of the growth in trade is through vertical specialisation, so intra-industry and intra-regional trade both reflect a rise in cross-border production chains and supply chains. Whereas in Europe high levels of intra-industry trade reflected ‘horizontal’ trade in similar products, in Asia it reflects high levels of ‘vertical’ trade in products at different stages of the production process in a particular sector. Similar comments apply to FDI. In the EU most FDI is ‘horizontal,’ while much Asian FDI is ‘vertical’. The former occurs mainly in order to serve the local market, and involves making investments that duplicate investments in the home country, as when an assembly plant is built in each market. The latter are made to minimise production costs, and involve moving stages of the production process to lowest cost locations, such as the relocation of unskilled labour intensive stages of production to low wage economies.

A measure of the extent of vertical specialisation is the ratio of merchandise trade to merchandise value-added. Increasing numbers of parts and components that travel across borders for further processing would result in a higher trade-to-value added ratio. In spite of the difficulty of distinguishing final from intermediate goods, the rising ratios of total merchandise to value-added indicate the growing presence of cross-border production chains in Asia, as seen in Table 3. This evidence is also consistent with the export-oriented growth strategy undertaken by Asian nations. Local capacity building would be much slower than plugging into an existing global production chain of a multinational firm.

Table 3. Ratio of Merchandise Trade to Merchandise Value-Added in Percentages

	1980	1990	2000
Asian region	**93.8**	**115.6**	**168.5**
China	12.1	23.7	32.9
Taiwan, Singapore, Hong Kong, South Korea	216.5	259.3	365.5
Pakistan,Bangladesh, Malaysia, the Philippines, Thailand, Indonesia	39.4	52.4	84.3

Source: IMF 2002

If much of the growth in Asian trade has been of a different sort of trade from that in the EU – ‘vertical’ rather than ‘horizontal’ intra-industry trade – what implications does this have for policy making? The first point is that trade frictions and trade costs are particularly important, as vertical specialisation means that products cross borders multiple times during the various stages of the production process. The second point is that reducing these costs may require much less institutional effort in Asia than in the EU.

Horizontal intra-industry trade involves existing firms in each country becoming more exposed to import competition (as well as having more export opportunities). There is therefore always a constituency of incumbent firms that will seek to retain import barriers, and it is this that has made market integration in the EU so difficult, and required repeated policy interventions, such as the SMI. By contrast, vertical intra-industry trade involves much of a plant's output being exported. It therefore poses no threat to existing firms in the same line of business – indeed, there may not be any such firms. Thus, while the institutional mechanisms that Europe has needed to secure 'deep integration' are absent in Asia, their absence may be relatively unimportant, at least for the development of production networks. The historical record already indicates that the lack of deeper integration has seemingly not hampered the growth of intra-industry trade in Asia.

It would however be incorrect to see trade and FDI in Asia as entirely 'vertical' in nature. For example, the opening of the Chinese economy is attracting 'horizontal' investment in China, given the current higher costs of accessing the Chinese market through trade. As China itself is a large market potentially 2-3 times larger than the US and EU, the economies of ASEAN would benefit from integration with such a market given their small domestic economies. In other words, the opening of China's market has attracted FDI for production reasons on account of its low cost labour but also increasingly due to the high trade barriers in China's domestic markets. For ASEAN in particular, the trend of inward FDI moving to China raises questions and concerns about the location of industry. Economic integration, rather than just reduction in tariffs, would allow Asia to benefit not only from trade creation and specialisation, but also the pro-competitive effects of market integration and industrial reorganisation.

Table 4. Foreign direct investment inflow (in billions $), 1996-2004

	1996	1997	1998	1999	2000	2001	2002	2003	2004
China	41.7	45.3	45.5	40.3	40.7	46.9	52.7	53.6	60.6
ASEAN	29.9	33.9	22.2	27.3	23.4	19.4	13.5	19.4	25.6

Sources: China Statistical Yearbook, various years; ASEAN Statistical Yearbook, various years.

However, the benefits from integration are likely to be uneven, given the difference in size and income of the ASEAN+3 countries. With the EU institutional framework, there is scope for redistribution and transfers, particularly seen with the accession of 10 new countries mainly from Central and Eastern Europe in 2005. In Asia, there would no similar framework and less room for bargaining and trades.

Therefore, although the heterogeneity in income levels and endowments of Asia suggests that traditional comparative advantages can be exploited with the lowering of tariffs, the lack of deeper integration could limit the gains from trade. The shift of FDI to China and the development of a potentially large domestic market which is beginning to transform the nature of investment suggest that an integrated market would be potentially beneficial. However, the lack of a vision or a supra-national body to implement economic policies as well as the historical rifts among these nations makes such deep integration unlikely. The lessons from Europe should well be heeded, though, including the evidence on trade diversion and the entrenchment of special cases such as agriculture which is a concern for Japan and South Korea.

4. Integration dynamics

4.1 Europe

The refrain throughout this paper is that European integration has been successful because it has been a continuing process of steps to achieve deeper integration, going far beyond the removal of tariffs. In addition to this internal dynamic, the development of a large regional trading arrangement also creates powerful incentives for non-members. The point is essentially that in addition to benefiting insiders, regional integration may well harm countries left outside. Trade diversion is one mechanism. Countries come to source their imports from other countries in the bloc rather than from outsiders, this reducing the demand for outsiders' exports and depressing their terms of trade. Another mechanism arises from firms' location decisions. It will be profitable to relocate plants inside the bloc, in order to get the benefits of duty free access to a large market. These forces create 'domino effects' (Baldwin 1993), whereby a free trade area creates incentives for outsiders to either join the free trade area, or to create an alternative competing area.

In Europe these forces played out in two ways. First, the European Free Trade Area (EFTA) was established as an alternative to the EC in 1960, with a membership including the UK and Scandinavian countries. But second, the attraction forces created by the larger EC meant that a stream of countries left EFTA to join the EC, with the residual EFTA countries (Norway, Switzerland, Iceland and Lichtenstein) forming the European Economic Area with the EU in 1994. In addition, countries that were in neither EFTA nor the EU sought to join the EU, taking it to its current membership of 25 countries, with further applications for membership being negotiated.

4.2 Asia

There has not been a political will behind a free trade area in East Asia. The major economies in the region also have a history of avoiding preferential trade agreements, namely, Japan and China. Even bilateral trade agreements are rare. South Korea signed its first ever FTA with Chile in 2003.

The driving force behind integration in Asia is therefore considerably different from Europe. The economic motives are the predominant ones. The dynamics would thus predict that countries will enter into FTAs to secure trade relationships, which could generate a 'domino effect.' This can result in a proliferation of bilateral trade agreements or a regional FTA (characterized by a hub and spoke system) that captured these bilaterals, but not necessarily a FTA that is characterized by deeper economic integration. Countries would aim to join a FTA if others did, but there is no mechanism (political or institutional) that would push the FTA to become more economically integrated. The rise of China has the potential of transforming the dynamics toward more economic integration in a way that is not dissimilar to the U.S. in the proposed FTAA, but the same concerns about the dominance of the U.S. would apply to China/Japan. Moreover, having two dominant and historically diffident countries would add a further dimension of tension.

Thus, unlike the European experience, the recent momentum behind the development of regional trade in Asia is based on defensive motivations rather than clear aims and objectives. The development of regional agreements elsewhere in the world, such as EU, NAFTA, alongside the slow progress of the development of the multilateral WTO framework provided some of the impetus behind the drive to form ASEAN+3. The fragility felt in the region after the Asian financial crisis of 1997-98 also contributed to a desire to increase the gains from trade.

However, the remarkable growth of China in the past 14 years since it implemented its "open door" policy undoubtedly has contributed to the momentum behind ASEAN+3. China since 1992 has increased its market share of global manufactured exports to an impressive 6% from just over 1% and joined the WTO in 2001, becoming a part of the global trading system. It has also become the world's third largest exporter and importer, as well as its fourth largest economy. The initial reaction in the Asian region was dominated by the perception that China would adversely affect the trade position of its neighbours. However, the evidence suggests that China is a magnet for foreign direct investment and has integrated into Asian production chains. Intra-industry trade during the 1990s increased to account for 75% of intra-regional trade growth in Asia (IMF, 2002). China's abundant, low cost labour and considerable domestic market are behind the increase. In 2002, China accounted for 14% of all exports from developing countries in Asia, of which approximately 80% was intermediate and capital goods for production and the remainder was goods for consumption (Zebregs, 2004). This figure is set to grow as trade barriers such as the Multi-Fibre Agreement are removed, which would allow China to sell more textiles and clothing with the elimination of the worldwide quota system in 2005.

A free trade agreement between an ASEAN country and China could fuel the impetus for other ASEAN countries to pursue a FTA. A FTA between Japan and South

Korea, or between China, Japan and South Korea could similarly start a domino movement among ASEAN countries whose firms would not wish to lose their trade positions in these large economies. Baldwin (2005) believes that a Northeast Asian FTA (NEFTA) comprised of China, Japan and South Korea could provide a trigger since their collective size would jeopardize between 35-45% of ASEAN exports. These bilateral trade agreements or a NEFTA could generate a momentum toward ASEAN+3. However, the lack of will for deeper integration among Asian countries as well as existing divisive political relationships make the prospects for regional integration less likely than in Europe. The development of bilateral agreements could, however, result in a "hub and spoke" system where the large economies of China and Japan are the main hubs while the others form spokes (Baldwin 2005). Baldwin (2005) argues that though this arrangement exists in Europe, it can have the effect of marginalizing the spoke economies because industrial firms tend to locate in the hub economies. In this system, the first best gains from trade are unlikely to be realized.

If Asia, on the other hand, does adopt a regional free trade area, then the effects on the economic performance of the region would be positive and indeed considerable. The Asian economies have different endowments and historically different specializations, which allow for considerable gains from trade. Most of the ASEAN countries are small in size; in fact, the sum of their GDP equals that of South Korea. They are economies without sizeable domestic markets and tend to be economies which are affected by cycles in the global economy, and particularly slowdowns in developed markets such as the U.S., EU, and Japan which are major export destinations.

With the rise of China in the region, the patterns of trade could potentially be dramatically affected. Although aggregate consumption is comparatively low in China, it has a population in urban areas that dwarves that of the U.S. and EU. With economic growth exceeding 9% per annum, incomes are expected to double approximately every 8 years. Economic integration with an economy the size of China's would generate considerable gains from trade for ASEAN, increasing the consumption/production possibilities of these economies as well as increasing efficiency. Moreover, China and Japan are major trading partners who are at different stages of development, and the gains from accessing this integrated market would again be notable. Including South Korea would extend this market considerably, particularly given its industrial development.

East Asia has the potential of becoming a formidable economic region. The gains from a FTA are significant for the developing countries in ASEAN as well as for the developed countries of Japan and South Korea. For ASEAN, economic integration would provide the market that they would individually lack. For Japan and South Korea, utilizing the different endowments of ASEAN and China would allow their economies to sustain economic performance. For China, economic integration would improve the efficiency of the proliferating production chains which already exist and are growing in the region, which would complement its economic development. In short, the potential gains from a FTA are considerable in Asia. However, the political will and institutional structures in ASEAN+3 are much less favourable than in Europe. There have been discussions of creating an Asian Monetary Fund, but the lack of a historical perception of Asia as a viable political goal and the tensions in the region make economic integration more remote than in Europe.

5. Conclusions

The refrain throughout this paper is that European integration has been successful because it has been a continuing process of steps to achieve deeper integration, going far beyond the removal of tariffs. The EU experience shows how these stresses can be handled and points to the importance of deep integration in achieving the full potential of a regional agreement. However, the EU performance is grounded in the deep political commitment of its members and in the creation of a political and institutional framework that can pursue integration and regional reform independently of national governments. It is in these dimensions that Asia is most fundamentally different from the European Union, and the possibility of following the European model is limited. While complementarities between Asian economies mean that there are benefits from regional integration, if 'deep integration' cannot be achieved, then the benefits of multilateral liberalization exceed those of regional integration, and should perhaps be the focus of trade reform in Asia.

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