Towards Establishing a Research Institute for Asian Integration Introducing European Experiences

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Over the past five years, there has been a big debate on how to further Asian integration. Visions and plans have emerged from the East Asian Vision Group (2001), the findings of the East Asian Study Group published in 2002, and the East Asian Summit in Kuala Lumpur in 2005. The time now seems ripe for political leaders to make concrete proposals to transform the policy debate into political reality.

The process of deeper integration in East Asia needs to be anchored in intellectual debate. The establishment of a Research Institute for Asian Integration will provide intellectual inputs to assist further economic integration. The goal of academic research on Asian integration is to produce rigorous scientific research on the multiple dimensions of the integration process in a global context.[1] Such research is vital for informed policy making at national, regional and global levels. It is also essential to promote informed public debate on the pros and cons of the regional integration process.

There must be a strong link between scientific research and policy making. If the results of scientific research are to reach the policy makers, then they must respond to the needs of policy makers. Those needs can be summarised as '*the right information, in the right form, and at the right time*'.[2] Policy makers need to receive timely information that is presented in a clear and succinct manner. Therefore, scientific research must be 'translated' into policy reports for the policy advisers who make recommendations to policy makers. Timely information depends on what stage the policy making process is at. In general terms we can identify eight stages:

- Developing the policy agenda
- Identifying specific objectives and policy options
- Evaluating options
- Making recommendations
- Building a consensus
- Legislation
- Implementation
- Policy evaluation and impact assessment

The Research institute for Asian Integration needs to collaborate closely with East Asian governments and with the ASEAN Secretariat to determine the research agenda. It can facilitate the policy process by preparing policy options and evaluating them on a costs-benefits basis. It can prepare recommendations as policy inputs for the meetings of East Asian leaders and the relevant ministerial meetings. Those recommendations will provide the basis for political discussion and contribute to consensus building for integration policy.

There is growing interest in the 'European model' in Asia right now. This interest ranges from the political model of Franco-German reconciliation, to the trade model of the European internal market, to the monetary model of European monetary union. In a general sense, the idea of a 'model' implies the possibility of imitation, or transfer of certain elements of the model. In this context, however, the European model is not

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* The views expressed in this paper are the personal views of the author and do not represent any position of the United Nations.

[1] See Tomasso Paduo Schioppa (2005) for an analysis of regional economic integration in a global framework.

[2] The model of policy making outlined here has been developed by Klaus von Grebmer (2004).

understood as a definitive concept, but rather as a research project that serves to develop certain channels of reflection.[3]

European integration has always been a pragmatic process. This was underlined by Robert Schuman in his 1950 declaration saying that Europe would not be built all at once or according to a single plan, rather it would be built through concrete achievements. The Treaty of Rome in 1957 clearly stated the goals of a common market but contained no detailed plans how to achieve those goals. What the treaty provided was a general framework. Within that framework, the strategy had to be developed on the ground, day by day, year by year. There was no master plan as European integration was an 'adventure' in the true sense of the word - an undertaking involving unknown risks. There was no model for how a group of old, established, nation states could merge their national markets into a single regional market. The strategy was developed by practical men and women who thought about the problems of integration primarily in terms of action and what needed to be done. So the European experience provides a 'living laboratory' of a regional integration process. That laboratory has advanced our scientific knowledge and understanding of the regional integration process.

There are many excellent text books that give comprehensive coverage of European integration. In this paper I will focus on a few key European experiences that I believe are of most direct relevance to Asian policy makers today. My paper will be confined to trade integration as monetary integration has been treated in depth in the first two sessions of the conference. I will address the following themes:

- Free trade agreements versus customs unions
- The European internal market
- Regional policy and balanced economic development
- Governance and institutions

Free Trade Agreements vs. Customs Unions

Most regional integration initiatives start with the establishment of a free trade agreement (FTA). The proliferation of FTAs in Asia over the past decade has been likened to a 'noodle bowl' of overlapping, criss-crossing trade arrangements. Further steps towards integration would do well to pause and evaluate the costs and benefits of FTAs versus customs unions.

The conventional wisdom on FTAs vs. customs unions (CU) was that a customs union represents a 'political test' of how far a group of countries want to go in their integration process. The formation of a CU, which implies the acceptance of a common external tariff and common trade negotiations with third countries, requires a certain sacrifice of sovereignty. The fact that the EU chose a CU from the very beginning, was interpreted as Europe's 'specificity' as its members were committed to the goal of political integration.

Traditional economic research on regional integration was largely based on the work of Jacob Viner (1950). Little analysis was done on the differing economic impact of CUs and FTAs. More recent research on the North American free trade agreement (NAFTA) has shown that the welfare effects of FTAs can differ significantly from CUs. Anne Krueger's (1995) article showed that CUs are always superior in economic welfare terms to FTAs.

A customs union makes for a qualitative difference with FTAs, on one crucial issue. Because members of an FTA maintain their respective external tariffs against non-members, rules of origin (RoO) are required to determine which products can enter duty free. Border inspections among FTA members are needed to ensure that goods entering the country have not been imported into the member country with low import duties, only to be re-transported across the border into another member country in order to avoid its higher tariffs.

Recently, Canadian researchers have produced empirical evidence on the economic costs of RoO resulting from high administrative costs and the complex legal machinery needed for their implementation in the

[3] Wolfram Vogel (2006) analyses the role of the Franco-German ' model' in political discourse

NAFTA framework. By contrast, the European customs union avoided the need for RoO, thereby providing significant gains in terms of reducing delays for goods and people at border crossings. The formation of the European customs union marked the start of moves towards harmonisation of customs procedures that have facilitated trade by reducing transactions costs. Because of this, Canadian researchers now advocate that NAFTA should be traded for a North American Customs Union (NACU).

The point here is that new economic research, coupled with the experience of the European Union, have shed new light on the comparative costs and benefits of FTAs versus CUs. In practice, a CU need not necessarily imply sacrifice of sovereignty by delegating tariff policy to an autonomous regional institution, as was the case in Europe. The members of the CU can co-ordinate their efforts to redistribute the revenue that comes from the CET. But where there are numerous conflicts of interest, it becomes practically impossible to internalise the various trade-offs through co-ordination. Agreements on such sensitive topics as revenue sharing are never easy and the costs of continuous negotiations are high.

The European Internal Market

The European internal market programme, that was launched twenty years ago, started the process of deep integration in Europe.[4] The policy reforms were undertaken in response to increasing international competition from Asia and North America. There was also recognition that the goals set out in the founding treaty had not been achieved.

Regional integration in Europe was conceived as a model of deep integration from the start. The goal of creating an internal market with free movement of goods, services, capital and labour called for a process that would go far beyond classical free trade. It would have to address the effects of national regulations on free movement of goods and services. It would have to provide a framework for capital mobility and free movement of financial services. It would have to address the issues related to labour migration. And, although the goal of monetary integration was not explicitly stated in the founding treaty, the goals of the common market implied the need for consistency between capital mobility, exchange rate stability and macroeconomic policies.

Asia is now moving towards deeper integration (Kuroda, 2006). The quest for deeper integration is the driving force behind the 'new regionalism' that has proliferated in Asia over the past five years. As active participants in the multilateral trade system (MTS), Asian countries have progressively reduced their tariffs and average tariffs are now generally low. The greatest challenge for Asian countries now is to address the technical barriers to trade (TBTs) that are behind the border. The most important TBTs consist of standards - technical standards relating to products and regulatory standards relating to services. Although not specifically designed for protectionist purposes, many national regulations can have a protectionist effect. Conflicting national standards will fragment the emerging regional Asian market and obstruct the 'level playing field' that facilitates intra-regional trade and investment.

The economics of deep integration are more closely associated with 'regulatory competition' than the traditional concept of comparative advantage associated with tariff liberalisation. Regulatory competition arises from the conflict between national regulations that have been put in place by governments - mostly for legitimate reasons.. Prior to the 1980s, national governments in Europe had regulated manufacturing and service industries for purposes of economic efficiency and to resolve problems of market failure.

The fundamental problem of regulatory competition - which is how to find a modus *vivendi* for conflict between national standards, is very similar in Europe and Asia. Unlike the US, which developed much of its economic regulation after it had already become a single internal market, both Europe and Asia have to start from a different point, that is, how to integrate national standards that have a long history in practice. As Asian policy makers consider policy options for deeper integration, it may be useful to look at the major

[4] See Gavin and de Lombaerde (2005) for a discussion of what deep regional integration means.

challenges faced by Europe in building its own internal market - a process that started in the late 1980s but which is still, in many ways, a work in progress today.

■ ***The new approach to standards***

The problem for policy makers presented by standards is to find a balance between market forces and official standard, known as the dilemma between de facto and de *jure* standards. When standard setting is left completely to the market, this may result in conflicting and overlapping standards that fragment markets and/or lead to costly standard wars. Official standard setting organisations (SSOs) try to avoid this problem by setting standards through legislation before companies make irreversible decisions in the market place. But this approach faces problems too, such as vested interests and other organisational problems (Grindley, 1996).

The theory of regulatory competition developed in the late eighties is based on Tiebout's (1956) work on fiscal competition. His model has now been applied to a wide range of economic sectors, as a result of which we have guidelines for deciding when regulatory competition should be left to the market and in which conditions there is a case for government intervention. In a regional market, where there are no cross-border 'externalities' or other sources of market failure, then regulatory competition can be left to market forces. For this purpose, the mutual recognition of standards will lead to de facto harmonisation through the market. We have seen examples of this in the electronics industries where large companies have set the standards. By contrast, it would not be acceptable to leave the safety of automobiles or childrens' toys entirely to the market . Service industries like tourism could be governed by mutual recognition and market forces. By contrast, liberalisation of financial services could not be left entirely to mutual recognition.

The old approach to product standardisation in Europe was based on consensus among national regulators to harmonise their standards. After two decades of struggling with this approach, which was leading to very slow progress, it was abandoned in favour of a more flexible approach. The new approach to standards is a form of co-regulation which provides for structured, but flexible, co-operation between European policy makers and SSOs that represent private sector interests.[5]

While the basic work is done by professionals in the private sector, it is the Commission which writes the single document that sets out the performance requirements. This then becomes a European directive that must be transposed into national law. National standards that are not in conformity must be withdrawn. Compliance on the part of manufacturers operating in the single market is on a voluntary basis. But this creates the presumption of compliance, which acts as a 'safe haven' for regulators, because in the case of non-compliance, firms must provide proof that their own standard meets the EU performance requirements. If a standard goes out of date, the EC just publishes the new updated standard in the Official Journal, without the need of new negotiations.

The European regulatory model is based on two complementary strategies of minimal legislative harmonisation and maximal functional harmonisation based on the principle of mutual recognition. For example, legislative harmonisation of essential requirements for health, safety, consumer and environmental protection is required. But mutual recognition also has a role to play. Where national objectives are considered to be 'equivalent', for example, consumer protection, then similar products must be allowed to enter and be sold on all markets. In the case of beer, for example, some countries allow the use of chemical additives to preserve the life of the product, and others do not. But as long as there is no proven danger to health, then both products may be sold on the market.

■ ***The Liberalisation of Services***

The second major issue of the EU internal market programme was the liberalisation of services. The importance of service activity in the European economy has grown significantly to the extent that it is

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[5] See Pelkmans (2001) for a comprehensive discussion of the new approach to standards

economically far more important than manufacturing today. A similar trend can now be observed in Asian economies. Successful economic development was dominated by manufacturing in the past, but now service activity accounts for an increasing share of gross domestic product (GDP). As a result, Asian countries need to address barriers to trade in services in order to increase the share of services trade at regional and global levels.

The EU envisaged free movements of services from the very beginning. Free movement of services was one of the four central freedoms on which the internal market was based. But very little progress was made before the 1992 programme was launched in the latter half of the 1980s. The most important barriers to trade in services were national regulations that existed in a number of key service sectors such as banking, telecommunications and transport. The challenge was to find a regulatory mechanism that would allow for an acceptable degree of 'regulatory competition' to serve the purposes of economic efficiency but also to provide the conditions of economic stability that are crucially important in sectors like financial services.

Trade in services is more complex than trade in goods. Hence the first task was to define the four different modes of delivery for trade in services - a format subsequently adopted by the World Trade Organisation (WTO). While free movement of services across borders becomes increasingly possible- many of which can be delivered electronically - there are situations where providers need the right of establishment abroad, and other situations where the posting of workers abroad require the (temporary) free movement of labour.

The EU treaty contained no clear guidelines for the liberalisation of services. Neither was there a body of case law from the European Court of Justice that could be referred to. Key questions concerning the establishment of a regime for services were, first, whether to adopt a horizontal approach to services liberalisation or take a vertical sector-by-sector approach? Secondly, to what extent the principle of mutual recognition could be relied on to introduce competition and how to manage harmonisation of national legislation.

In the 1992 programme, the Commission adopted a sector specific approach and European legislation was extended to some of the most important service industries such as banking, telecommunications and transport etc. Despite some progress, however, the overall internal market for services has not worked as well as wished by some Member States. Starting in 2002, the Commission initiated a new phase of liberalisation activity that was more comprehensive and has moved towards a horizontal approach. The new proposed legislation was met with much social opposition, however. Its critics say that it will foster 'social dumping', erode standards for environment and consumer protection as well as undermine the concept of public services, for example in the health sector. The new proposed legislation is currently going through the EU legislative process and it is expected that the new directive will not come into effect before 2008.

It is, perhaps, the EU model of liberalisation of financial services that is of most interest to Asia in the aftermath of the financial crisis of 1997-98.[6] The sector is of major economic importance in its own right in Asia as well as Europe. It is also essential for the functioning of the whole economy, which makes the public good aspect of financial stability so crucially important. The EU has the most integrated financial markets in the world and has had the greatest experience of financial liberalisation in practice. Therefore, the European regulatory model may provide some helpful insights for future policy making in Asia

It is in Asia's interest to develop deeper financial integration that will provide a stable framework for the productive investment of its large pool of savings for overall development in the region. Since the financial crisis, the amount of international reserves in Asia have reached the phenomenal sum of 1.9 trillion dollars (Montes and Wagle, 2006) Efficient, long term investment of that capital in Asia requires a well functioning, regionally integrated, financial market that provides both efficiency and stability

Financial liberalisation can increase economic growth through two channels: by making the financial system more efficient and by channelling capital into the most productive investment projects. Liberalisation

[6] See Gavin and Haegeli (1999) for an analysis of the role of the banking system in the financial crisis.

introduces competition into the banking system, which reduces the costs of financial intermediation, thereby increasing the amount of savings available for investment. Liberalisation will also lead to a more efficient allocation of capital in the economy by channelling it into investment projects with the highest return.

But financial liberalisation is a risky business so it needs to be accompanied by flanking measures to ensure the stability of the financial system. Market failures derived from asymmetric information are pervasive leading to the well known problems of adverse selection and moral hazard. Therefore, the prudential regulation of banks to prevent financial crises, must be part and parcel of the whole process of deregulation and liberalisation .

The 1992 programme to create an internal market in financial services involved a sequence of policy steps ranging from deregulation of national financial institutions, to liberalisation of financial trade, to harmonisation of prudential standards at European level.[7] First, the day to day business of banking was freed from government control at national levels. Then, the provision of a 'single European passport' allowed banks to provide their services throughout the internal market. Regulatory competition based on mutual recognition, was introduced through the principle of home country control. For example, a British bank could provide services in France but according to British rules. National treatment was accorded to banks wishing to establish a permanent presence in a foreign country.

Liberalisation of banks had to be flanked by new European measures for prudential control. The harmonised European standards adopted were practically equivalent to the guidelines of the Bank for International Settlements (BIS) for risk management. Among other things, banks were obliged to set aside adequate capital assets to cope with potential future risks to ensure stability of the financial system and consumer protection. But harmonised European standards were not adequate to provide comprehensive prudential regulation. A 'general interest' clause provided discretion for national regulators to take further measures. While necessary to prevent financial risk and ensure financial stability, this clause has resulted in a large carve out of services from liberalisation.

The liberalisation of financial services was underpinned by complete free movement of capital in the internal market. Free movement of capital was one of the four central freedoms of the European market from the very beginning. However, restrictions on capital account transactions - especially short term capital flows - were maintained by many members states until the 1990s. The Maastricht treaty of 1993, which established the road to European monetary union played an important role in achieving consistency between the requirements of financial liberalisation, capital mobility, macroeconomic stability, and exchange rate policy.

In summary, the EU has not yet achieved a comprehensive framework for financial integration. Partial harmonisation of prudential standards has been achieved at the regional level but national regulators have kept considerable control over regulation through the general good exemption.. The EU has not yet provided the regional public good of financial stability. Neither has it created a real regional market with free movement of financial services.

Regional Policy for Balanced Economic Development

The East Asian region currently shows considerable divergence between levels of economic development and has very large disparities between levels of per capita income. A major challenge facing East Asia, as it now moves towards further integration, is how to assure balanced economic development in the whole region. The key question for policy makers is whether market forces alone will be sufficient to help the poorer countries and regions catch up? Or are there forces at work that would automatically lead to increasing divergence? In other words, does regional integration have an inherent tendency towards polarisation, or does it even out disparities.

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[7] See the chapter on Trade and Finance in Gavin (2001) for a full discussion of the EU model of financial liberalisation.

Regional integration has powerful market forces working towards convergence. Liberalisation will allow those countries and regions that have uncompetitive industries to improve their performance and move into higher value-added products. Furthermore, regional integration fosters the growth of intra-industry trade which facilitates new specialisations and alleviates the adjustment problem. The ultimate solution to the problem of adjustment is increased competitiveness. And, to achieve that goal, businesses need the stimulus of additional competition which comes with liberalisation.

However, the historical evidence of the EU showed very little convergence during the first thirty years of its existence. Data for the EU-12 countries at the end of the 1980s showed large divergence between countries, with the four poorest countries that had come into the EU during the first rounds of enlargement, well below the EU average and the eight other countries above the EU average. So the rich countries stayed rich and the poor countries stayed poor. The figures also showed that there were large disparities between regions within countries. The EU had no special instrument for regional development during the early period other than the European Investment Bank which provided project funding.

Since 1989, regional policy has become a key policy of the EU. The amount of funding available has increased significantly and management of the funds has been completely reformed. The increased importance of regional policy reflects the fears of policy makers that the accelerated integration resulting from the Internal Market programme of 1992 and the commitment to EMU adopted in 1993, could exacerbate regional disparities unless remedial measures were taken. It also signalled a political message of solidarity about regional integration to reassure the poorer regions and countries that they would receive assistance to help them overcome the adjustment costs that would result from the quickening pace of integration. Clearly targeted funding and decentralised management have contributed to considerable success in improving overall economic conditions in the poorest countries.

Management reform moved regional policy moved away from the old style policy of funding large scale projects, a practice that involved heavy administration costs. In its place a decentralised, multi-level, system based on partnership between the European Commission, national governments and local authorities was instituted. The core element of the new approach was the introduction of 'operational programmes'. They were rolling, multi-annual programmes, comprising several projects, that involved co-ordination between all three levels of governance. Partnership was the key to co-ordination between local, national and European actors, where the Commission played the role of policy co-ordinator but at no stage worked on its own. The principle of partnership was reinforced by the principle of additionality - another new approach. Member states were expected to contribute additional funding to EC funding which is now considered as partial. Support for regional development has also become the most important task of the European Investment Bank especially in the development of transport and communication infrastructure. In 1994 it set up a new credit facility to finance the construction of trans-European networks in those sectors.

Governance and Institutions

The creation of institutions has been the chosen mechanism in Europe to achieve political, economic and monetary integration. Political integration was given priority in the 1950s with the creation of the first supranational European institution. The European Steel and Coal Community was designed to overcome old nationalist rivalries and to make another war in Europe 'not only unthinkable but materially impossible' (Schuman, 1950). Since the creation of the European Economic Community in 1957, economic integration has been in the driving seat.

One frequently hears the argument that what fundamentally distinguishes European from Asian integration is the different approach to institutions. ASEAN is taken as the example of 'the Asian way' in which policy making is conducted through an informal process based on consensus. And the general perception in the region is that the leaders of ASEAN countries have no political will to change that situation.

In contrast, Europe is portrayed as a region with a passion for institution building. Europe has created a

formal, rules-based institutional order in which the member countries have agreed to sacrifice increasing sovereignty. Furthermore, implementation of the rules is backed up by a formally independent European court with quasi constitutional powers That kind of institution building is alien to ASEAN and probably to the whole of East Asia as well, it is argued

But scholars increasingly ask today whether deep economic integration is possible without some transfer of sovereignty to a supranational institution (Vandoren, 2005). The European experience has shown that the elimination of border tariffs and non-tariff barriers is not sufficient to create a regional market. Trade integration must go deeper, it must level the playing field that provides the basis for a competitive regional market to emerge. That requires the creation of regional market institutions for harmonisation of standards, competition, protection of the consumer etc. Regional institutions are fundamental public goods that facilitate trade transactions, create clear rules and provide procedures for the resolution of disputes (Wyplosz, 2004)

How real is the dichotomy between European and Asian perceptions of institutions? One way to approach this divide is to focus on the analytical distinction between forma l and informal institutions. Formal institutions refer to the codified rules as set down in a constitution or treaty. Informal institutions focus on how the formal rules are put into practice and how power is distributed within the system as it evolves.

The specific characteristic of formal European institutions is supranationality. In this light, the Commission is viewed as the most important European institution because of its dynamic integrating role of thinking and acting in the European interest. The Commission's mandate to propose new European legislation has given it considerable agenda setting power that has enabled it to play an influential role in shaping the European economy.

The Commission is also the guardian of the treaty which gives it powers to police member states' compliance with European rules. It also has strong powers in the field of competition which gives it considerable teeth as watchdog of anti-competitive practices in the market. The European Court of Justice (ECJ) tends to be the natural ally of the Commission as it also plays a powerful integrating role. The ECJ ruling as early as 1964 that European law would take precedence over national law in those sectors of economic activity covered by the treaty, was a landmark decision directing towards more integration.

The Commission was at the height of its power during the formation of the customs union. The transfer of national autonomy over tariff policy and tariff revenue to Brussels was quite a radical breakthrough for that time. But today, the Commission's regulatory power to shape the internal market, which is its most important power, is a careful balancing act between all the different stakeholders. This is a much more complex policy paradigm, based on a bottom up approach, and a balance of power between national and European interests.

The Commission plays the role of architect in designing proposals for legislation that is usually based on economic principles. However, it invariably engages in widespread consultations with the private sector and civil society groups before proposing a first legislative draft. The Council of Ministers, which is the European institution that belongs to the member states decides what will becomes EU legislation. The Council increasingly works together with the European Parliament within a framework of co-decision making. The Parliament, which is the only directly elected EU institution, feeds the concerns of citizens into the legislative process, emphasising social, consumer, and environmental issues, and they must be taken into account. The ECJ, which acts as the enforcer of the rules, is backed up by national courts so national stakeholders can still express their views through national channels. Furthermore, as the new regulatory approach relies to a greater or lesser extent on the principle of 'mutual recognition' for regulatory competition, national rules still have a role to play. So the belief that European institutions represent a powerful, monolithic supranational policy making machine is something of a mirage and more illusion than reality.

In any case, it is the European Council, which is composed of heads of state and governments, that is the supreme political power in the Union. Since its creation in the 1970s, it has shifted the balance of power

away from supranationalism to more inter-governmentalism. Without the support of the European Council, nothing important gets done. It has undoubtedly been the major political impulse behind all the big European decisions such as launching the Internal market programme in the 1986, European Monetary Union in the 1993 and enlargement to the East in 2000..

Conclusions

This paper has discussed how the creation of a Research Institute for Asian Integration could provide timely intellectual inputs into regional policy making. Each region has its own specific characteristics that are determined by its history and culture. So the Asian way will be different from the European way. But as regional integration becomes a worldwide phenomenon we can also observe growing convergence on key policy issues.

Poised on the threshold of deeper integration, many of the problems faced by Asian policy makers today are fundamentally similar to those faced by European policy makers yesterday: how to construct a rule-based regional market economy and how to provide the regional public goods needed to make that economy function properly; how to tackle technical barriers to trade, liberalisation of services and investment; and how to ensure equitable development throughout the whole region.

Europe's experience of dealing with those issues over the past fifty years provides a living laboratory on what works and what doesn't work in constructing a region. That experience can provide some valuable insights for future region building in Asia.

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