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# The Sequencing of Regional Integration

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In den letzten Jahren ist eine zunehmende Verbreitung von präferenziellen Handelsabkommen zu beobachten, wobei gewisse Länder über die Zeit hinweg eine ganze Reihe von Verträgen abgeschlossen haben. Angesichts dieser Tatsache stellt sich die Frage, welche Faktoren die Reihenfolge bestimmen, mit der ein Land – oder eine Gruppe von Ländern – Handelsabkommen eingeht. Abgestützt sowohl auf die langjährigen Erfahrungen in Europa als auch auf neuere Entwicklungen in Ostasien werden in diesem Aufsatz fünf mögliche Erklärungsansätze für die zeitliche Abfolge von regionaler Integration aufgezeigt. Dieses Thema wird offenkundig trotz seiner Bedeutung für die nationale Wohlfahrt und für das Welthandelssystem zu wenig beachtet und verdiente in der wissenschaftlichen Forschung grössere Aufmerksamkeit.

*Keywords:* regional economic integration, preferential trading agreements, sequencing, RTAs, European Union, East Asia
*JEL-Codes:* F13, F15, K33, N74, N75.

## 1 Introduction

It is well known that the number of preferential trading agreements signed since 1990 far exceeds those concluded in previous years.[1] While scholars in economics, political science, international relations, and international business have devoted considerable attention to individual episodes of regional integration (analysing their causes and consequences), far less is known about the factors that determine the sequence of preferential trading agreements that a nation, or group of nations, enters into. Even in the case of European integration it was not until the mid-1990s that an economic theory, with solid microeconomic foundations, was advanced to account for the expanding membership of first the European Economic Community and then the European Union.

In this article I will describe and assess five explanations for the sequencing of regional integration over time, and discuss their relevance in the

* This paper is based on chapter two of an unpublished report that the author completed for the European Commission with ANTHONY J. VENABLES and L. ALAN WINTERS. The report was titled *The Sequencing Of Regional Trade Initiatives in Europe and East Asia.* Copies of this report can be downloaded from the Internet at http://www.evenett.com.

1 See WORLD BANK (2000) for the data on the number of preferential agreements signed in each decade.

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European and East Asian context. As the *Appendix Table* makes clear, the latter region has seen over thirty preferential agreements be proposed or negotiated since 1998.[2] Singapore and Korea have been particularly active in this regard and are parties to twelve and nine such initiatives, respectively. Meanwhile the European Union has recently expanded its membership to include twenty-five nations, and two more nations may well join by the end of the decade. My goal is to identify the key causal factors said to be at work. In so doing, readers will see that most of the arguments are qualitative in nature and that there is plenty of room for further empirical and theoretical development.

The focus here on sequencing of preferential trade agreements should not be taken to imply that other matters relating to the effects of regional integration on members, non-members, and on the multilateral trading system in general, are deemed unimportant.[3] These are indeed significant matters and I would argue that a better understanding of the sequencing of preferential trade agreements would enrich our understanding of these other topics as well. For example, a fully developed theory of sequencing that endogenises the membership of a free trade area must surely address the distribution of costs and benefits to members and non-members. Moreover, such a theory might identify the circumstances under which a sequence of preferential agreements leads to global free trade.[4]

This remainder of this article is organised as follows. So as to provide the necessary terminological and conceptual building blocks for the rest of this article, in *Section 2* four relevant dimensions of regional trade agreements are identified. The notion of sequencing in regional and preferential trading agreements is defined in *Section 3. Section 4* summarises three arguments concerning the determinants of the actual sequence of preferential trading agreements, while two arguments concerning optimal sequencing are analysed in *Section 5.* Concluding remarks are presented in *Section 6.*

2 For recent discussions of the spread of preferential trading agreements in East Asia see CHOI (2003), ELEK (2003), KRUMM and KHARAS (2004), LINCOLN (2004), MUNAKATA (2003), PANGESTU and FINDLAY (2001), and SCOLLAY and GILBERT (2001).

3 Useful surveys of the relevant economic literature can be found in BALDWIN (1997), BALDWIN and VENABLES (1995), HOEKMAN and KOSTECKI (2001), KRISHNA, PANAGARIYA and BHAGWATI (1999), PANAGARIYA (2000), and VENABLES (2001). The international relations literature on comparative regional integration is summarised in CHOI and CAPORASO (2002). The perspectives of political scientists are surveyed in FAWCETT (1995), HURRELL (1995), and MORAVCSIK (1998).

4 For a recent theoretical development that makes some progress in this regard see AGHION, ANTRÀS and HELPMAN (2004).

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## 2 Four Relevant Dimensions Of Regional Trade Agreements[5]

Regional agreements among customs areas[6] on *economic* matters can differ along (at least) four dimensions: their objectives, their scope, the nature of commitments made by the parties, and the institutional arrangements (if any) created by the agreement. The objectives could be broad and far-ranging (such as the desire to integrate all or most of a region's markets), narrow (such as the desire to harmonise a single government measure), or something in between (such as taking whatever measures are needed to reduce the volatility of bilateral exchange rate movements).

Turning to the scope of an agreement, this can differ in terms of national membership, sectors and entities covered, and policy instruments affected by the agreement. With respect to the latter, one can distinguish between agreements covering only trade policies (such as *pure* free trade areas and customs unions), agreements covering investment matters (such as bilateral investment treaties), agreements concerning immigration policies, and agreements covering financial instruments (such as the swapping of foreign currency reserves). Over time many regional agreements have grown in scope to include not only trade measures but also investment measures and the like, yet (perhaps confusingly) the term regional trade agreements (RTA) is still used to describe these multi-policy initiatives. Some have preferred to use the term "regional integration initiatives"[7] and, even though this term is probably more accurate, it has not gained widespread currency. For the purposes of this article the term regional trade agreement is used.

The third important dimension of regional trade agreements concerns the nature of the commitments entered into. Here there are two distinctions worth drawing. The first is between binding and non-binding commitments; and where the former are found, the associated matter arises as to the nature of any enforcement mechanism or dispute resolution mechanism. The second distinction is between commitments by parties *not* to do something (such as discriminating against foreign firms in some fashion)

5 Throughout this article I use regional trade agreements synonymously with preferential trading agreements. I am well aware of the caveats here; not the least of which is that some preferential trading agreements are not entirely comprised of customs jurisdictions in the same region, however the latter is defined.

6 I use the term customs areas rather than nation states because some non-state entities have the right to set the terms upon which goods enter their jurisdictions. The case of Hong Kong comes to mind.

7 See, for example, SCHIFF and WINTERS (2003).

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and commitments to do something (such as to enact and implement a new regulatory law). Sometimes this second distinction is stated as one of *negative* versus *positive* commitments; and it is worth noting that both the economic effects of, and enforceability of, these two types of commitments tend to differ markedly.

The fourth dimension of such agreements concerns the balance between inter-governmental components of such agreements and any supra-national elements. Some trade agreements involve the creation of independent secretariats with clearly defined policy-planning, policy-proposing, enforcement, monitoring, or implementation roles.

Having identified four relevant dimensions of regional trading agreements, I now turn to the definition of the sequencing of regional integration.

## 3 Defining The Sequence Of Regional Trade Agreements And Other Preliminary Remarks

Before turning to the analytics of the *sequencing* of regional trade measures it is important to specify precisely what is meant by this term. By sequencing I mean the *steps* that a *number* of customs jurisdictions take – along the four dimensions described above – *during and after* the formation of a RTA.[8] This definition implies that sequencing refers to more than the creation of a RTA; therefore, an explanation of RTA formation is not an explanation of sequencing. It should also be noted that this definition does not imply that the *same* number of jurisdictions must be involved in the RTA over time, thus allowing for admission of states to a RTA.

One desirable characteristic of an explanation of sequencing is that policymakers and private sector interests are *forward-looking* in their decision-making and not myopic. This is not to say that decision-makers accurately perceive all of the potential shocks or technological changes that can impinge upon an economy or group of economies; rather that, when

8 I note that CHISIK (2003) has provided a theory of "gradualism" in trade agreements that emphasises the role of sunk costs by exporters and opportunism. CHISIK's analysis, however, relates to all trade agreements, not regional trade agreements where there is an additional element of discrimination against non-members.

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considering a set of intertemporal steps that a RTA can take, policymakers take account of the likely effects over time.

As will become clear when reviewing the extant literature, another important distinction is between an explanation of the steps that a RTA has taken and an argument about the most desirable set of steps that a RTA should take. What has been and what ought to be are quite different matters. Given that the relevant literature on regional integration has identified a large number of motives for signing RTAs (including geopolitical, economic, and technocratic reasons), as well as the fact that numerous shocks that impinge on regions (financial, exchange rate-related, macroeconomic, and even disease-related – recall the SARS virus[9]), the likelihood that the predictions of any elaborate explanation of sequencing will be at all accurate is pretty slim. Moreover, since economic analyses tend to focus on a limited number of variables so as to generate sharper predictions, the likelihood that in fact some omitted factor undermines the predictive power of such analyses is quite high. Perhaps the best one can hope for is to shed light on some of the effects and dynamics that are triggered by policymakers' decisions and exogenous shocks.

With these preliminary comments in mind, I now turn to the leading conceptual arguments in the economics and international relations literatures concerning the sequencing of RTAs. The first point to be made in this regard is that, unlike accounts of single episodes of regional integration, very few scholars and analysts have actually offered rationales for the sequence of steps taken by a region towards further integration. There is a slightly larger literature that examines the complementarities between trade policy and other reforms that can be accomplished in a RTA – and, as we shall see, arguably these have some bearing on the optimal sequence that a regional trade agreement ought to take.

## 4 Three Explanations Of The Sequence Of Actual Measures Taken In Regional Trade Agreements

In this section I describe and then assess three explanations for the observed intertemporal sequence of regional integration. Since these explanations are motivated in large part by European experience, so as to avoid

9 Severe Acute Respiratory Syndrome (SARS) spread to many nations in 2003. East Asian countries were particularly adversely affected by this virus.

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allowing one region's history to unduly influence the arguments advanced here, I also relate each explanation to the recent proliferation of free trade agreements and other bilateral agreements in East Asia.

### 4.1 Technocratic Entrepreneurship

This explanation was advanced by amongst others JEAN MONNET, arguably one of the fathers of European regional integration (see DUCHÊNE 1994). MORAVCSIK in his masterful overview of the theories of regional integration characterises this explanation as follows:

> "(European) integration has been driven primarily [...] by a technocratic process that reflects the imperatives of modern economic planning, the unintended consequences of previous decisions, and the entrepreneurship of disinterested supranational experts" (MORAVCSIK 1998, p. 4).

Here pride of place is not given to national policymakers or to sectional economic interests, but rather to a group of integration-minded officials that shape the ongoing process of regional integration taking account of the imperatives of the day. Admittedly these imperatives may have changed since MONNET's day (from an era of widespread and growing state intervention to support the post-World War II social settlement to one where relatively less intervention in markets is coupled with greater flows across national borders of capital, labour, and ideas) and with it the necessary technocratic expertise. Yet, in principle, the size and composition of a region's community of technocratic experts could – once economic co-operation is formally permitted – shape the subsequent sequence of sectors and policies that come under the influence and control of regional agreements and institutions. Indeed, the very dependence of generalist political leaders on technocrats for policy advice could strengthen this dynamic.

Turning to the implications for East Asian integration, an interesting question is whether financial sector, exchange rate, and trade experts could ever acquire the same influence that some feel MONNET and his colleagues had in the 1950s and 1960s. While groups of East Asian technocrats have undoubtedly made sector-specific recommendations, as of yet there is no equivalent group of officials located in a region-wide institution that is taking active steps to propose and implement measures in the way that MONNET did. This is not to say that such a group will not emerge in the future, but it does call into question the current importance of technocratic entrepreneurship in integrating East Asia's markets.

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### 4.2 Geopolitics And Mercantilism Or Concerns About Competitiveness

A group of international relations experts, known as neo-realists, have argued that regional integration in Europe was spurred on by the geopolitical factors impinging on that continent after the Second World War, by persistent pressure from the United States during the Cold War, and then by mercantilistic motivations by European policymakers in the 1960s and 1980s. In his survey of such thinking (and of theorising on regional integration in general), HURRELL argues that:

> "Proponents of such a view, for example, emphasize the fundamental importance of the geopolitical framework within which the moves towards European integration took place [...] the ending of the Cold War makes it easier to understand the extent to which the dramatic shift within Europe in the 1940s and early 1950s from war and competition to regional co-operation and then to the promotion of regional integration depended on a very particular set of geopolitical circumstances: the erosion and then collapse of the colonial empires on which the power of Britain and France had been built; the immense physical destruction and psychological exhaustion of the thirty-year European civil war; the perception of a burgeoning threat from the Soviet Union; the long-predicted transformation in the scale of power and the emergence of a new class of superpowers (with whom the traditional nation states of Western Europe acting alone could no longer hope to compete); and the powerful pressure from the USA to move towards greater regional co-operation" (HURRELL 1995, p. 47).

He goes on to note that:

> "For the neo-realist, US hegemony was especially important. Neo-realists highlight the degree to which integration was spurred by direct US encouragement and pressure. [...] They also stress the extent to which European integration – which was in reality subregional integration – was embedded within a transatlantic security framework. This meant that the immensely difficult tasks of politico-military co-operation and security could be left to one side. The acceptance of security dependence was therefore one of the essential compromises on which European co-operation and integration was built – a fact that makes it vital to examine the relationship between economics and security issues in other parts of the world.

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> Neo-realism focuses attention both on power-political pressures and on the dynamics of mercantilist economic competition. This suggests to the neo-realist that 'outside-in' pressures have continued to influence the path of European integration, but that these have had ever more to do with mercantilist economic rivalry. Thus already in the 1960s de Gaulle placed greater weight on European cooperation (albeit in the form of a *Europe des parties*) as a means to countering *le défi americain* and reducing what he saw as the 'exorbitant privilege' of the USA. Equally, the relaunch of European integration in the 1980s can be interpreted as a response *au défi japonais* and the loss of competitiveness [...]. From this perspective the economic objectives of regional integration do not derive from the pursuit of welfare, but from the close relationship between economic wealth and political power and from states' 'inevitable' concern with relative gains and losses" (HURRELL 1995, p. 48).

On this view, the initial choice of economic sectors for regional integration (coal, steel, and atomic energy) was driven by the legacy of past *and* the potential for future conflicts. Moreover, the emphasis of market integration initiatives, and to some extent the deregulation and harmonisation in the 1980s, was driven in part by the perceived need to expand scale and to consolidate into larger firms so as to better compete against stronger non-European competition. What is less clear, however, is whether the steps undertaken in the 1950s and early 1960s in response to geopolitical factors were taken with the expectation that mercantilism (or at a minimum, concerns about competitiveness) would play a more important role in subsequent decades.

In the East Asian context, the potential role of geopolitical factors is perhaps more difficult to chart. Some such factors are of long standing, others are more recent but are likely to endure into the future, and include U.S. economic and military prowess and growing Chinese clout. It is quite unclear how these longer term factors will affect the sequence of regional integration measures. On the one hand, a confident and outward-looking United States could encourage the formation of an East Asian trade block so as to facilitate subsequent trade negotiations on pan-pacific liberalisation measures. On the other hand, the U.S. may fear that the emergence of an East Asian block will be too economically powerful, too disadvantageous to American exports, and a threat to its competitiveness. As a result, the U.S. may negotiate enough bilateral trade agreements with key East Asian economies, pressuring the latter not to sign up to any

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proposals for a region-wide free trade area. Such pre-emptive bilateralism on the Americans' part may forestall regional moves towards freer markets in East Asia. Likewise, the growth of Chinese clout may encourage or repel other nations in the region from entering into bilateral trade agreements with her. Indeed, it is possible that a U.S.-Japan-Korea free trade area could, along with reinforced security guarantees, emerge in response to aggressive behaviour on China's part.

Worse still, some of the potential geopolitical factors may be uncertain in timing, if they occur at all. Five such events can be readily identified: worsening Japanese and Chinese diplomatic and military relations, a conflict between North and South Korea, a Chinese invasion of Taiwan, and political instability and disorder in China and in Indonesia. The latter two potentialities may, respectively, result in "defensive" integration by Japan and Korea and may galvanise a sub-regional initiative in the Association of Southeast Asian Nations (ASEAN) (excluding Indonesia). Worsening Japanese and Chinese relations may put a halt on moves towards free trade in manufactures in North East Asia. Alternatively, moves towards freer trade may be part of a set of measures to patch up any major disagreement between Japan and China. Concerning conflicts between North and South Korea and between China and Taiwan, it is inconceivable that regional integration initiatives would remain on the front burner during such a conflict, and for a time afterwards. Such conflicts would immediately draw the United States into the fray, adding a further geopolitical element. All in all, perhaps the best way to think about the likely impact of these geopolitical factors is that they are likely to punctuate the steps towards regional integration in East Asia that follow from the economic determinants mentioned in this article.

### 4.3 Domino Regionalism

The most developed economic theory as to why RTAs grow in members over time (or "enlarge") is that of "domino regionalism", which was first formalised by RICHARD BALDWIN (see BALDWIN 1994). BALDWIN sought to explain why nations were eager to join regional trading agreements and, in particular, how initiatives within a RTA can induce other nations to apply to join that agreement. He motivated his theoretical analysis by developments in North America and in Europe in the late 1980s and early 1990s, arguing in the former case:

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> "The idiosyncratic event in the Western Hemisphere was the US-Mexico FTA [free trade agreement], which was itself motivated by the unilateral reforms undertaken by Mexico in the 1980s. Announcement of the US-Mexico FTA destroyed the *status quo* of trade relations in the Americas. Other countries in the region, which are heavily dependent on the US market, were faced with a *fait accompli.* Mexico-based producers would gain preferential access to the US market, thereby increasing the competition facing third country exporters and diverting foreign investment to Mexico. Despite continuing opposition to its first regional liberalization – the US-Canada Free Trade Agreement – Canada decided that it had to be at the negotiating table. Other countries in the Hemisphere, such as Chile, Brazil, Argentina, Uruguay and Paraguay enquired about the possibility of bilateral FTAs with the US. Faced with a flood of requests for bilateral FTAs, the Office of the US Trade Representative encouraged South American countries to form regional groups among themselves before applying *en groupe* for an FTA with the US." (BALDWIN 1994, p. 14).[10]

BALDWIN contends that a political economy dynamic can trigger falling dominoes of enlargement. Firms, he argued, would lobby to protect their profits (formally their quasi-rents) that accrued from prior and unrecoverable investments in product development, training, marketing, and production capacity which are necessary to export to an important foreign market. A firm that currently exports goods *into* a RTA from outside will find its relative "competitiveness" and profitability reduced by any measures taken by members of that RTA which either lower the costs of firms within the RTA or results, more generally, in more intensified competition within the RTA. To protect its profits stream an exporter outside the RTA will be willing to finance the lobbying of its government, and possibly of its country's political parties and industry associations, to gain admission to the RTA in question. Here admission is not sought because the "outsider" firms are publicly-minded – rather it is because such firms want to narrow any differences in treatment (whether at the border or within the RTA) between firms inside the RTA and those outside of it. In sum, the creation of a RTA or "deeper" integration within an existing RTA can trigger subsequent demands for enlargement – and nothing pre-

10 In Europe BALDWIN argued that the completion of the Single Market programme of reforms – reinforced by the collapse of the Soviet Union – was the event that triggered enlargement negotiations with the remaining members of the EFTA agreement and the formerly communist states of Eastern Europe.

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vents this process "snowballing" with one phase of enlargement inducing other applications for admission which, in turn, could result in further enlargement.[11]

It should be noted, however, as PANAGARIYA (2000) does, that although BALDWIN's analysis accounts for why nations want to join an existing RTA, it does not consider the willingness of existing RTA members to permit enlargement. Moreover, BALDWIN's framework does not explain why the RTA deepened integration in the first place (recall that geopolitical or technocratic factors are not considered in his analysis). Furthermore, as a positive analysis of why nations join regional trade agreements, Baldwin's approach does not consider the normative question of whether such domino regionalism enhances world welfare.[12] Nevertheless, BALDWIN's approach identifies clear economic lines of causation which he contends can be applied to understanding the entire evolution of *certain aspects* of European regional integration and that – in his view – has clear implications for the potential course of regional integration in East Asia (see BALDWIN 2002).

With respect to the sequence of European regional integration, BALDWIN argues that in the 1950s European nations split into two camps according to their preferences towards the depth and extent of integration. The "federalists" (as he terms them) went on to create the European Economic Community (EEC) by signing the Treaty of Rome, so laying the foundations for deeper economic integration, some pooling of sovereignty, and separate treatment for agriculture. The so-called "intergovernmentalists" created the European Free Trade Association (EFTA) with the United Kingdom as the dominant economy and here integration was limited to improving the terms upon which manufactures were traded between members. The discrimination inherent in these two agreements hurt EEC exporters to EFTA and *vice versa*. EFTA firms, however, were hurt more because the total size of the EEC's economy was larger; and this factor helped trigger the UK's application to join the EEC in 1961.

The UK application for membership to the EEC raised the prospect of even greater harm to the interests of exporters located in the other EFTA

11 See also MARTIN (1996) for a related theoretical model where the location of production of potential entrants and existing members of an RTA plays an important role.

12 The following analogy might suggest that it does not. Individuals may decide it is wise to join street gangs but that does not make street gangs a good thing. I thank ALAN WINTERS for pointing out this analogy.

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countries. As the realisation of the potential consequences of UK entry sank in, and as the likelihood of UK admission increased, these factors strengthened the support given by such exporters to those political forces in the remaining EFTA members that were supportive of EEC entry. Prospective UK membership triggered a domino in the form of applications for EEC admission by Denmark, Norway, and Ireland. Once the EEC enlarged to nine members, BALDWIN argues, the remaining EFTA members (Iceland, Sweden, Norway, and Switzerland) eventually signed free trade agreements with the EEC. According to BALDWIN this made Western Europe a "virtual free trade zone" for manufacturers.

The next domino that fell was set off by the creation of the Single Market reinforced, as we noted earlier, by the collapse of the Soviet Union. (The latter is said to have relaxed diplomatic pressure on Austria and Finland not to join the EEC – suggesting that some geopolitical arguments can reinforce the thrust of BALDWIN's economic calculus.) The consequence of this domino falling were discussed earlier and completes BALDWIN's account of the *evolution of the membership* of the EEC and the European Union since the 1950s.

Interestingly, BALDWIN also applied his framework to shed light on the potential trajectory of further regional integration in East Asia (again, see BALDWIN 2002). He starts by arguing that there is a loose historical analogy between Japan's and China's positions in East Asia and the UK's and France's corresponding roles in European integration in the 1950s and 1960s. Japan, he views, is a reluctant "regionalist" just like the UK. China, however, is seen as pursuing economic integration mainly for (alas unspecified by BALDWIN) political reasons. One such reason could be to expand China's "sphere of influence" in foreign policy.

BALDWIN argues that "real" regionalism has not started in East Asia – which could be taken to mean that the commitment to adhere to binding agreements on trade and commercial policies in the region has been, until recently, weak at best. Moreover, he claims that the ASEAN economies are too small to form a sufficiently important economic block (that conceivably could set off dominoes). Instead, he views two possible "sparks" that might set off regional integration in East Asia. These sparks could generate different paths to more liberalised trade in the region, and need not lead to the same end point.

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The first potential spark is a free trade agreement between China and the members of ASEAN. In BALDWIN's view such an agreement will be dominated by China and is so likely to benefit her exporters relatively more. (This outcome may result from the sectors that are deliberately excluded from any such free trade agreement[13]; i.e. China may demand the exclusion of sectors that harm its import-competing firms relatively more than in ASEAN. Of course, to be consistent with WTO rules on preferential trade agreements, all included sectors would have zero tariffs on trade between the members of this agreement.) BALDWIN argues that Japanese and Korean firms would soon want to join this agreement – encouraging their respective governments to apply for admission to the hypothesized Chinese-ASEAN FTA. (BALDWIN does not consider the interesting question as to whether a joint application for admission by Japan and Korea might redress the relative imbalance towards Chinese interests in a China-ASEAN agreement.) A FTA involving China, Japan, Korea, and ASEAN would then result.

The second "spark" could be the signing of a free trade area between Japan and Korea, which together account for approximately 17 percent of the world's gross domestic product. This sizeable (bilateral) block would trigger applications for membership from China and the ASEAN nations, spurred on by their respective exporters. BALDWIN argues that, in this case, Japan and Korea would surely anticipate the need to specify the means by which enlargement would be effected – what he calls the "docking arrangements". He identifies three such arrangements. The first are "hub and spoke" arrangements with Japan at the centre of a web of bilateral agreements. The second is a "matrix" of bilateral agreements between all interested parties; an outcome that would presumably take longer to negotiate and involve considerable amounts of "red tape" (in the form of rules of origin and the like). Thirdly, an EFTA-style East Asian-wide agreement could be signed where duty-free market access would be granted on members' exports of manufactures. The latter docking arrangement would require some form of inter-governmental structure to administer it, which BALDWIN anticipates could involve either decision-making by consensus or the allocation of one vote per member.

13 It appears that BALDWIN developed this argument before China joined the World Trade Organization (WTO). Consequently, he raised the possibility that a China-ASEAN preferential trading agreement need not involve zero tariffs on imports into China. Such an agreement would violate WTO rules on RTAs which China, in principle, is now bound by. I have amended BALDWIN's argument without changing the spirit of it—namely that the distribution of benefits in a China-ASEAN free trade area is likely to be skewed towards China.

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BALDWIN developed these arguments in a presentation to Japanese policymakers and urged that country's officials to avoid the "UK's mistake" of seeking to join an important regional agreement four years after it came into being. (The cost to the UK of not being an initial member of the EEC was, on this argument, not having a "seat at the table" when the Treaty of Rome was negotiated.) Instead, BALDWIN argues that Japan and Korea should design a regional trading agreement in consultation with China and the ASEAN nations and should adopt an EFTA-like "docking arrangement" that is less threatening to the latter nations.

Whether or not one agrees with BALDWIN's final policy recommendations, arguably he has correctly identified the effect that a Japan-Korea free trade agreement[14] would have on focusing the minds of policymakers and exporters in the region. Indeed, such an agreement may well quickly trigger applications for admission, potentially transforming the role that binding intra-regional commitments play in shaping East Asian national trade policies in a decade or so. For this reason, it would be worth exploring whether the intensity of competition in East Asian markets for manufactures and the margins of tariff preference on manufacturing goods (implied by a free trade agreement) are sufficiently high that manufacturing exporters throughout East Asia are likely to respond aggressively in their respective domestic political arenas to the formation of either a Japan-Korea FTA or a China-ASEAN FTA.

It is also worth noting that BALDWIN's explanation applies exclusively to trade in goods and services and to trade policies that affect the profitability and interests of exporters. He did not apply his analysis to exchange rate fluctuations[15] which, arguably, can have the similar effects on exporters' profitability. I now turn to arguments that might shed light on the optimal sequence of initiatives by a set of regional trade partners.

14 Such an agreement is, in fact, being quietly explored in Seoul and Tokyo in "study groups" and the like.

15 Having said that, I know of no statement by BALDWIN to suggest that this framework could not be adapted to address the implications of exchange rate instability for the incentives of exporters to lobby their governments to join bilateral or regional initiatives to curb such instability. This consideration may be of greater importance now that financial capital flows relatively unimpeded across many nations' borders.

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## 5 Arguments Concerning The Optimal Sequence Of Regional Integration

The following distinct but related arguments can rationalise why a regional trade agreement expands beyond measures to integrate manufactured goods markets into other policy domains and into more elaborate institutional structures (including supranational structures).[16] As such, these explanations may account for the so-called deepening of regional integration over time.

### 5.1 Policy Complementarities And The "Preservation Of The Original Bargain"

As noted above, the initial motivation for many RTAs is to integrate markets for manufactured goods. Members of a RTA are said to reciprocally exchange market access "concessions" on a preferential basis. However, the extent to which those market access improvements are realised in practice can be contingent on government measures other than trade policy and on the reactions of firms. For example, a more competitive exporter may find its ability to compete in a regional trade partner's market impaired by foreign government subsidies to the firm's weaker rivals; providing a rationale for coupling goods market liberalisation with regional rules on state aids. Likewise, exclusive "vertical agreements" between a nation's manufacturers and distribution companies that require the latter only to sell the former's products can significantly impede regional trading partners' market access. *Securing and maintaining* market access, then, may require *certain* RTA-wide rules on, and institutional mechanisms to implement, competition law. This is another example of what is often referred to as a policy complementarity between a non-trade government measure and trade reforms, where the former is needed to secure the objectives of the latter.[17]

Policy complementarities of this nature suggest that effective RTAs *should* not confine themselves to trade liberalisation in manufactured

16 The following arguments differ from those advanced in LUDEMA and WOOTON (1997), who show that liberalisation in the presence of agglomeration effects can lead to an optimal sequence of regional integration with trade reforms preceding reductions in the impediments for factor mobility.

17 Another form of policy complementarity is relevant here; that is, when the gains from trade reform in one sector (manufactured goods) are contingent on the degree of reform in other sectors (perhaps in the transportation and communication sectors). In this case the complementarity is across distinct sectors within the same economy.

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goods. (In the service sector the argument is stronger as two of the four modes of supply are directly affected by policies that are not traditionally regarded as trade policy; specifically, measures towards foreign investments – both greenfield and cross-border mergers and acquisitions – and measures towards temporary migration of suppliers and purchasers). Having said that, policy complementarities *alone* may not account for the *sequencing* of reforms – although the former may shed light on a desirable end point of a sequence of regional reforms that commences with liberalising trade in manufactured goods. Once one allows for constraints *at a point in time* in technical expertise or limits on the willingness to pool sovereignty regionally, then one can conceive of a RTA moving sequentially over time towards an arrangement that more effectively exploits complementarities across policy domains.

Another important point to bear in mind is that the full extent of policy complementarities may be more readily apparent in hindsight than at the time when a RTA was initially conceived. Thus, a problem – response – problem – response – dynamic emerges where officials amend and expand the policies covered by (and the institutional structure of) a regional trade agreement. A pertinent example follows: despite the considerable EU experience with competition law reinforcing regional trade reforms, in East Asia one rarely hears acknowledgement that reducing trade barriers in that region needs to be coupled with an international initiative to tackle those anti-competitive practices that reduce the benefits of trade liberalisation. It seems that a certain amount of self-discovery (or learning from one's own mistakes) is necessary and this may account for a RTA taking measures that sequentially realise policy complementarities over time.

A similar dynamic that may account for policy complementarities being sequentially realised is what might be called exporter-led pressure *to preserve the original bargain* on trade in manufactured goods. Actual and potential exporters to a regional trading partner may discover that, after the original regional measures to liberalise trade in manufactured goods have been implemented, other government policies prevent market access improvements from translating into additional export sales. Such exporters may lobby their own governments to expand regional rules into those complementary policy domains to preserve what they regard as the originally-bargained for market access. In this manner, rules on standards (their nature and mutual recognition), on customs procedures, and on certain non-tariffs barriers (such as anti-dumping) may well follow the im-

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plementation of measures to liberalise manufactured goods trade. The process of self-discovery in a region, therefore, need not only be confined to government officials. In sum, the above arguments explain why a RTA should not confine itself to liberalising trade in manufactures *and* points to some of the other factors that have to be invoked so as to *develop* an argument based on policy complementarities *into* an explanation for the sequencing of reforms in a RTA.

## 5.2 Cross-border Spillovers From National Policy Measures, The "Grand Bargain", And Credible Commitment Mechanisms

A separate argument for a RTA involving many different policy domains can be based on the trade-offs across policies that generate cross-border spillovers. The latter are the effects of a government's policies on the economic interests of another nation that are mediated through the price mechanism. One recent salient example is the adverse effect that production and export subsidies to cotton producers in the United States are said to have had on cotton farmers in four developing countries in Africa. The recent debate over the potential European-wide consequences of French government subsidies to Alstom is another example. In short, with cross-border trade in goods and financial assets, the effects of a nation's policy mix (including policies traditionally thought of as "domestic measures") need not be confined to within its own borders.

While it has long been recognised that cross-border spillovers can rationalise international collective action with net potential benefits for the nations participating in such action, it need not be the case that each national participant individually benefits from every collective measure. Put another way, a collective act may be welfare improving overall but the distribution of gains may leave some nations worse off. This very fact is one of the reasons why "issue linkage" is said to have arisen in regional trade agreements. Policy measures can be combined in a RTA to form a "grand bargain" in which each national participant is better off if it *signs up for and implements* the *entire* package.

The possibility that a nation may be worse off should it implement an element of the grand bargain provides, in turn, the rationale for incorporating what are often referred to as "credible commitment mechanisms" into a RTA. These mechanisms can involve monitoring by a supra-national body, enforcement by a supra-national court, and the development at the

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national and international levels of a community of experts and commercial interests that push for the faithful implementation of agreements entered into by members to a RTA. In sum, then, cross-border spillovers can account for why a RTA could incorporate binding disciplines on many (perhaps on-the-face-of-it unrelated) issues as well as (subtle or overt) supra-national mechanisms to enforce compliance. However, yet again, other factors must be appealed to explain why a RTA would sequence reforms. What other factors must be added to the above explanation to yield a theory of sequencing of regional reforms?

The factors mentioned earlier as to why policy complementarities are exploited over time (limited technical expertise and political will as well as self-discovery) could be relevant in this context also. However, a distinct factor is technological change and other policy reforms that alter the strength of cross-border spillovers and, by implication, the set of feasible grand bargains. A RTA could, therefore, evolve from grand bargain to grand bargain over time; altering the relative weight put on different policy measures within a set of regional rules.

Technological and policy developments in the financial sector and the growing emphasis on macroeconomic policy co-operation and coordination among EEC/EU member states in the 1980s and 1990s could be an example of such a dynamic. For better or for worse, during the 1980s and 1990s many nations liberalised their financial markets and eased restrictions on cross-border flows of short-term funds. Coupled with innovations in information and communication technologies, a large pool of highly reactive "hot money" has developed. Three of the factors that such money reacts to are actual and expected interest rate differentials across countries for comparable assets, and the credibility of central government measures to fix exchange rates (or to limit their fluctuation), and its commitment to fiscal austerity. In such a world, national macroeconomic policy choices can have sizeable cross-border effects which, in turn, spill over into the trade arena as exchange rates are a determinant of exporters' competitiveness and profitability. Numerous studies of bilateral trade flows have shown that exchange rate volatility reduces observed trade flows – the political-economy counterpart to this finding, therefore, is that exporters may find such volatility just as inimical to their interests as trade policy measures that frustrate access to foreign markets more directly. Consequently, a bout of substantial or extreme exchange rate volatility may generate corporate pressure for regional measures to constrain exchange movements or, in the limit, to eliminate such fluctuations entirely. (In-

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deed, some have argued that these very factors account for the increasing prominence given to macroeconomic and exchange rate matters in regional trading agreements, see MORAVCSIK 1998.)

In short, new circumstances therefore can account for a RTA expanding its remit into macroeconomic and exchange rate matters. Moreover, on this view, the sequence of issues that ought to be tackled by a RTA evolves partly in response to technological changes and other non-RTA-related policy changes.

## 6 Concluding Remarks

In this article five distinct arguments were advanced for the evolution of, or sequencing of, regional trade agreements. Sequencing, it would seem, can be a function of many factors – technical expertise, intra-regional and extra-regional geopolitical factors, political dynamics triggered by current intra-regional block discrimination against exports from non-members, the logic of policy complementarities and cross-border spillovers reinforced by inertia, capacity constraints, and self-discovery, and technological and seemingly unrelated policy changes in the financial sector. The very fact that so many factors can interact to determine the sequence of regional integration is likely to make precise predictions infeasible. Even so, to the extent that empirical counterparts to these factors can be identified, statistical analyses may shed light on their relative importance.[18] Moreover, further research may point to the importance of other factors, or to the irrelevance of certain factors in specific contexts. Scholars will also have to discern just how relevant the experience of one region is for other regions of the world economy and whether any general lessons emerge.[19] My comparison of the East Asian and European experience suggests that some factors are not that general (such as technocratic entrepreneurship) whereas others work in different ways in different regions (such as geopolitical factors and concerns about competitiveness).

18 A recent (and rare) attempt to estimate the economic factors that account for two or more nations forming a free trade agreement is reported in BAIER and BERGSTRAND (2004). These authors examine the determinants of free trade area formation in a single year (1996) and, therefore, do not consider the sequencing questions discussed here. This is not to say that an extension of BAIER and BERGSTRAND's approach could not usefully address the matter of sequencing.

19 For some interesting thoughts on whether the "European model" provides general insights for other regions see FLIGSTEIN and STONE SWEET (2002), NICOLAÏDIS and HOWSE (2002), POLLAK (2001), and WALLACE (1995).

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**Appendix Table** A List Of Proposed And Actual Regional Trading Agreements Involving At Least One East Asian Economy

| Parties | Type of agreement | Status | Year initiative launched or latest relevant milestone |
|---|---|---|---|
| ***Bilateral or trilateral initiatives*** | | | |
| Singapore-Mexico | Free trade area | Under negotiation | 1999 |
| Singapore-Chile | Free trade area | Under negotiation | 2000 |
| Singapore-Korea | Free trade area | Proposal and under study | 2000 |
| Singapore-Taiwan | Free trade area | Proposal and under study | 2000 |
| Singapore-Canada | Free trade area | Under negotiation | 2001 |
| Singapore-New Zealand | Closer Economic Partnership | Implemented | 2001 |
| Singapore-India | Comprehensive Economic Cooperation Agreement (including free trade area) | Under study | 2002 |
| Singapore-Japan | New Age Economic Partnership | Signed | 2002 |
| Singapore-Australia | Free trade area | Signed | 2003 |
| Singapore-EFTA | Free trade area | Signed | 2003 |
| Singapore-Jordan | Free trade area | Signed | 2003 |
| Singapore-New Zealand-Chile | Free trade area | Under negotiation | 2003 |
| Singapore-Sri Lanka | Comprehensive Economic Partnership Agreement (including free trade area) | Signed | 2003 |
| Singapore-USA | Free trade area | Signed | 2003 |
| Korea-China | Free trade area | Proposal and under study | |
| Korea-Japan | Free trade area | Official discussions and under study | 1998 |
| Korea-Australia | Free trade area | Subject of official discussions | 2000 |
| Korea-Mexico | Free trade area | Official discussions and under study | 2000 |
| Korea-New Zealand | Free trade area | Official discussions and under study | 2000 |

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| Parties | Type of agreement | Status | Year initiative launched or latest relevant milestone |
|---|---|---|---|
| Korea-Thailand | Free trade area | Proposal and under study | 2001 |
| Korea-USA | Free trade area | Under negotiation | 2001 |
| Korea-China-Japan | Economic cooperation | Joint task force established | 2003 |
| Korea-Chile | Free trade area | Signed | 2003 |
| Japan-Mexico | Free trade area | Under negotiation | 1998 |
| Japan-Australia | Trade and economic framework | Official discussions | 2002 |
| Japan-Canada | Free trade area | Proposal and under study | 2002 |
| Hong Kong-New Zealand | Closer Economic Partnership (including free trade area) | Under negotiations | 2001 |
| Thailand-Croatia | Free trade area | Proposal | 2001 |
| Thailand-Czech Republic | Free trade area | Proposal | 2001 |
| USA-Taiwan | Free trade area | Proposal | 2002 |
| ***Region-wide or region-plus initiatives*** | | | |
| ASEAN | AFTA | Signed and implementation ongoing | 1992 |
| ASEAN-Australia-New Zealand ("ASEAN+CER") | Closer economic relations | Official discussions and under study | 1999 |
| ASEAN-China | Free trade area | Official discussions and under study | 2001 |
| ASEAN-Japan | Comprehensive Economic Partnership | Official discussions | 2002 |
| ASEAN-Korea | Free trade area | Official discussions | 2002 |
| ASEAN-China-Japan-Korea ("ASEAN+3") | Free trade area | Official discussions and under study | 2000 |
| Singapore-Australia-New Zealand-USA-Chile ("Pacific 5") | Free trade area | Proposal | 1998 |

*Source:* PANGESTU and GOOPTU (2003), updated with internet searches and newspaper reports and reported as Table 3.4 in EVENETT, VENABLES and WINTERS (2004).

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