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South Asian Economic Integration and Institution Building: Some Insights from EU Experience[1]

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Abstract

Does the integration of markets for goods, services and capital drive the creation of regional institutions? Or, does the creation of regional institutions drive the integration of markets? The short answer is that the relationship is reciprocal but not deterministic; it varies across regions and is conditioned by several contextual factors.

This paper examines the reciprocal relationship between economic integration and institutional integration. The paper addresses key factors that affect the political dynamic between markets and institutions – such as political regionalism, multilateralism and private networks – and derives some lessons from the European experience for institutions in other regions. The paper concludes that aspirations for political union are not a necessary precondition for building regional institutions that foster economic integration. Strengths and weaknesses of multilateral economic institutions provide critical explanations for regionalism; and regions should pay due regard to the multilateral regime when designing their institutions and collective practices. The paper tried to compare different regions including Asia.

Introduction

The South Asian countries are opening-up their economies with a view to accelerating their economic growth through greater trade and investment. In this context, attempts have also been made to encourage regional trade under the aegis of the South Asian Association for Regional Cooperation (SAARC). In particular, the South Asian Preferential Trade Agreement (SAPTA) provides for reductions in tariffs and other restrictions on specific commodities on a reciprocal basis, and the eventual objective is to integrate the South Asian economies into a free trade area through SAFTA, which has come into force on January 1, 2006.

This trend toward regionalism occurs as markets become more integrated on a regional

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and global basis. Does the integration of markets for goods, services and capital drive the creation of regional institutions? Or, does the creation of regional institutions drive the integration of markets? The short answer is that the relationship is reciprocal but not deterministic; it varies across regions and is conditioned by several contextual factors.

This paper examines the reciprocal relationship between economic integration and institutional integration. It begins by briefly surveying the regional orientation of international trade and its importance to national economies. It then addresses the role and function of regional institutions, defining more precisely what we mean by "institutions" and presenting some of the theories about how the integration of markets generates institutions. This section draws from the insights of a branch of political science that attributes independent causal significance to international institutions. The paper then addresses key factors that affect the political dynamic between markets and institutions - such as political regionalism, multilateralism and private networks - and derives some lessons from the European experience for institutions in other regions. The paper concludes that aspirations for political union are not a necessary precondition for building regional institutions that foster economic integration. Strengths and weaknesses of multilateral economic institutions provide critical explanations for regionalism; and regions should pay due regard to the multilateral regime when designing their institutions and collective practices. Successful international institutions are not necessarily those that enforce hard rules, but instead those that provide information, monitor agreements and facilitate bargaining among governments in the context of a web of agreements that span a number of issues. Domestic political support is crucial to the success of regional institutions, which should be designed with roots in societal constituencies.

A large body of theoretical and empirical literature has investigated the role of regional economic integration. However, despite greater attention on regional economic cooperation initiatives, there has been little progress in regional trade expansion: intra-regional trade continues to be minimal, not exceeding 5 percent of the total trade of the South Asian economies. Is it due to lack of strong or even any kind of institutions in South Asia .This paper highlighted the fact that for economic integration some institutions are required. It is not necessary to have EU-like institutions.

Regional Economic Integration?

Regional integration agreements (RIAs) are groupings of countries formed with the objective of reducing barriers to trade between members. They have long historical antecedents, sometimes being a stage to nation building (most famously in the Zollverein of nineteenth century Germany), and sometimes as part of colonial trading arrangements.

In the post-war period, developments were led by the European Union (EU, originally the European Economic Communities, founded in 1958), and in the 1960s and 1970s there was a number of rather inward looking (and largely unsuccessful) RIAs between developing countries. Since the mid-1980s there has been a dramatic increase in regional integration activity. Of the 194 RIAs notified to the General Agreement on Trade and Tariffs/ World Trade Organization (GATT/WTO) at the beginning of 1999, 87 were notifications since

1990. Now almost all countries are members of at least one RIA, and more than one third of world trade takes place within such agreements. The new developments include the expansion and deepening of the EU; the construction of new and more open RIAs between developing countries; and the advent of RIAs in which both high income and developing countries are equal partners, lead by the North American Free Trade Area (NAFTA) which, in 1994, extended the Canadian-USA free trade agreement to Mexico. RIAs come in many shapes and sizes. They vary in income levels, in openness to trade, and in the share of trade that takes place within the RIA, (60% for the fifteen members of the EU, but just 10% for the eight members of the West African Economic and Monetary Union). Structures vary, from the loose agreements to facilitate trade of the African Cross-Border Initiative and Asia Pacific Economic Cooperation (APEC forum, through to the deep integration of the EU, involving the construction of shared executive, judicial and legislative institutions. The focus of this article, in common with most of the economics literature, is on RIAs as mechanisms for trade liberalization, not addressing the integration of factor markets, monetary systems, or political institutions. Even with this focus, RIAs differ widely in structure. 'Free trade areas' remove internal tariff and non-tariff barriers, but permit members to retain independent external tariff policies. 'Customs unions' go further, in fully harmonizing external trade policy. And it is increasingly recognized that effective integration of markets requires more than reducing tariffs and quotas. Many other barriers – such as differing national product standards and a host of minor border frictions -- impede trade and support market segmentation, and some RIAs are now pursuing 'deep integration' policies to eliminate these barriers.

Trade creation and diversion of Economic Integration.

The modern analysis of RIAs dates from Viner, who drew the distinction between the trade creating and trade diverting effects of RIA formation. The classical source of gains from trade is that global free trade allows consumers and firms to purchase from the cheapest source of supply, hence ensuring that production is located according to comparative advantage. In contrast, trade barriers discriminate against foreign supply, inducing domestic import competing producers to expand even though they have higher costs than do imports. This in turn starves domestic export sectors of resources and causes them to be smaller than they otherwise would be. Since a RIA liberalizes trade, reducing at least some of the barriers, doesn't it follow that it too will generate gains from trade? Viner's contribution was to show that the answer is; not necessarily. The gains from trade argument applies if all trade barriers are reduced, but need not apply to a partial – and discriminatory – reduction in barriers, as in a RIA. This is because discrimination between sources of supply is not eliminated, it is just shifted. If partner country production displaces higher cost domestic production then there will be gains – trade creation. But it is possible that partner country production may displace lower cost imports from the rest of the world, and this is welfare reducing trade diversion.

The analysis of trade creation and trade diversion constitutes one of the first formal analyses of the more general problem of 'second-best welfare economics'. Given that distortions remain in place in some activities in the economy, it is not necessarily the case that removing just some of the distortions (e.g. eliminating trade barriers on partner countries and leaving them in place on external countries) is welfare improving. In the literature on regional integration the response to the fundamental ambiguity created by the second-best took three main forms.

Market integration

A basic comparison of market integration in Europe, Asia, North America and other regions is presented in Tables 1-2 Table 1 displays the global pattern of regional trade in 2003. As the second panel illustrates, the percentage of each region's total trade that occurred intra-regionally was greatest for Western Europe (67.3), second for Asia (48.9) and third for North America (40.3). The third panel shows that these figures represent 28.5 percent, 12.6 percent, and 6.1 percent of world trade respectively. For each of the other regions, intra-regional trade is small compared to extra-regional trade, particularly with North America in the case of Latin America, with Western Europe in the case of the transition economies and Africa, and with Asia in the case of the Middle East.

Regrouping Latin America with North America under the proposed FTAA, and/or North America with Asia under APEC, would alter the picture, but progress in these broader regions has disappointed proponents.

In North America, trade among the three partners has grown quickly since the introduction of NAFTA more than a decade ago. Intra-regional trade, again, amounts to somewhat more than 40 percent of the total trade of the region. However, large asymmetries exist among the three member states (as in East Asia and the European Union). US trade with Canada and Mexico was roughly one-third of its total trade in 2003, whereas Mexico and Canada's trade within NAFTA was more than three-quarters of their total trade. Imports plus exports within the region represented 45.7 percent of Canadian GDP and 38.1 percent of Mexican GDP, but only 5.8 percent of US GDP Table 1.2. See also Pastor 2001, Tables 1.1 and 1.3). South Asia has a very small part of it.

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

Table 1: Intra- and inter-regional merchandise trade, 2003 (billion dollars and percentage)

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

Source: World Trade Organizations.

1.2 : NAFTA: intraregional trade, 2003

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

Institutions: concepts and approaches

While the integration of markets is reasonably well defined - as the interpenetration of national markets, measured by flows of goods and capital and convergence of prices and interest rates - the concept of "institutions" is worth brief elaboration. After defining the term, we then review the explanations developed in the international political economy literature for the origins of institutions and the role that market integration plays in that process. Some analysts employ the term "institution" narrowly to refer exclusively to formal bureaucratic organizations with a legal charter. Other analysts refer to formal rules and procedures for collective governance, while still other writers include informal norms, expectations and patterns of behavior under the definition of the term. Colloquial usage can be broader still and refer to things as varied as the currency, income tax, democracy and marriage as "institutions." This paper examines the relationship between market integration, on the one hand, and institution-building and institutional design, on the other. We are interested in institutions that either eliminate or facilitate the elimination of barriers to trade and investment, including the harmonization of national regulations, regulatory frameworks and other legal, tax and policy changes that facilitate markets. We are also interested in the mechanisms through which common policies - such as the CAP, monetary union and "economic governance" in the EU context - are created and administered. This paper thus requires a broader concept than that employed by economists' "new institutionalism" (Williamson 1985; North 1990).

The political economy of international regimes struck a broad and widely used definition of their focus of research that has sometimes been used synonymously with the term "institution". Regimes are "sets of implicit or explicit principles, norms, rules and decision making procedures around which actors' expectations converge in a given area of international relations" (Krasner 1983, 1). Goldstein, Kahler, Keohane, and Slaughter (2000, 387) define international institutions as "enduring sets of rules, norms, and decision-making procedures that shape the expectations, interests, and behavior of actors". The project on the Rational Design of International Institutions defines them somewhat more narrowly as "explicit arrangements, negotiated among international actors, that prescribe, proscribe, and /or authorize behavior" (Koremenos, Lipson and Snidal 2001, 762). As such they have five key dimensions: membership rules, scope of issues covered, centralization of tasks, rules for controlling the institution, and flexibility of arrangements. Another meaning, advanced by Milner (1998, 761), is "the means by which the diverse preferences of individuals are aggregated into choices or outcomes for the collective. Institutions here both shape and reflect the strategic interaction among agents". They are mechanisms to aggregate preferences (of individuals or states) and to exercise collective choice (See also Eichengreen 1998, 996).

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

Institutionalization is distinct from, but related to, "legalization". Legalization in its hard form refers to a particular variation of institutionalization. Hard legalization entails (a) binding rules of obligation, (b) precision in those rules, and (c) delegation to a third party of the interpretation, monitoring and implementation of those rules, dispute settlement, as well as perhaps the promulgation of further rules (Goldstein et al. 2000, 387; Abbott and

Snidal 2000). The European Union is often cited as a case of relatively hard legalization (Alter 2000), NAFTA as a case of hardening legalization (F. Abbott 2000), while cooperation in the Asia-Pacific is described as nonlegal (Kahler 2000).

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

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

Regional Economic Integration and Institutions

The implicit model of many analysts and policymakers through which economic integration leads to regional institution-building contains several channels. As trade and investment increase across borders, private actors demand elimination of costly barriers and provision of greater certainty in the security of contracts and investments. They petition governments to create regional agreements and institutions that underpin liberalization of tariffs and non-tariff barriers and harmonization of regulations. National politicians may accommodate those pressures as a matter of electoral necessity.

Governments can have their own motives for building regional institutions, such as managing the negative consequences of economic integration – policy externalities, regulatory arbitrage, races to the bottom, and dislocation of uncompetitive firms and their workers. States with autonomous policy preferences that are at odds with some private groups might also wish to move decision making to the regional level, where particularistic interests hold less influence over policy and legislation. The importance of economic integration for institutional integration is best appreciated by neo-functionalism, a school of integration politics championed by Ernst Haas in the early years of the European Community. Haas (1964) posited three specific mechanisms by which modest levels of integration produced an upward ratcheting of regional cooperation: functional spillover, political spillover, and cross-issue bargains mediated by autonomous institutions. Functional spillover captures the notion that cooperation in some areas (such as coal and steel) leads to cooperation in others (such as the Common Market) owing to interdependence among the sectors of advanced economies. Functional spillover is complemented by political spillover, through which societal groups interests' coalesce supra-nationally around expanding cooperation and institutions created to implement cooperative agreements become active (See, Kahler 1995, Moravcsik 1998 and Mattli 1999).

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

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

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

Subsequent approaches

Neoliberal institutionalists argue that states create international institutions in order to overcome dilemmas of collective action. In the classic formulation, Keohane argued that under conditions of high transaction costs and uncertainty, institutions could help states overcome market failure in reaching international agreements, such as that modeled by the prisoners' dilemma game. "Chiefly by providing information to actors (not by enforcing rules in a centralized manner), institutions could enable states to achieve their own objectives more efficiently. Institutions would alter state strategies by changing the costs of alternatives; institutionalization could thus promote cooperation." Institutions affected outcomes by (a) providing information, (b) monitoring compliance, (c) increasing iterations, (d) facilitating issue linkages, (e) defining cheating, and (f) offering salient solutions (Katzenstein, Keohane and Krasner 1998, 662; Keohane 1984). When the coordination problem among states has multiple equilibria, institutions can provide mechanisms for solving distributional conflict (such as side payments in the form of EU cohesion funds for accession to the Maastricht treaty), signaling salient solutions and reducing bargaining costs. Once a particular equilibrium solution is chosen, institutions tend to lock it in (Katzenstein, Keohane and Krasner 1998). The logic applies equally to the regional and multilateral levels.

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

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

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

Constructivism challenges the preceding causal arguments as far too rationalistic and adopts a sociological approach. For Katzenstein (1997), the key to understanding European integration lies not in the material interests of traded and nontraded goods sectors or their investors, but in the "Europeanization" of state identities, especially that of Germany, and shared norms. Norms about the conduct of regional relations shape regional institutions. In analyzing the Asian case, Katzenstein (1998) and Katzenstein and Shirashi (1998) argue that common norms arise from "the distinctive character of Asian state institutions," where the state is embedded in society and constituted by elaborate networks, to which reciprocity is critical to political consensus and legitimacy.

With such state systems, state sovereignty cannot be pooled in international organizations constituted by public international law – which presupposes European historical experience and concepts of sovereignty – and gives rise to the distinctively informal character of Asian institutions. Networks of public and private officials, corporations and organizations are thus critical to the formation of regionalism, though different network models (Japanese and Chinese).

Comparison of regions

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

NAFTA has a well-defined set of rules regarding trade and investment that, while incorporating agreement on labor and the environment, is considerably narrower in scope. A free trade agreement rather than a customs union, its penetration of national regulatory matters is relatively weak. Weakness of the few organizations created by NAFTA leaves the region without robust supranational or intergovernmental bodies or a regional capacity for secondary legislation. Some of the functional spillover from trade and financial integration has been handled on a bilateral or multilateral basis, such as the 1994-95 peso crisis. Despite proposals to develop NAFTA along the lines of the EU model (Pastor 2001), with regular summit meetings and institutions and a capacity for fiscal transfers similar to the EU structural funds, there is so far little political impetus in the United States for doing so. Rising economic integration of the region has not yet produced self-reinforcing iterations of liberalization and institution building, but could eventually do so. East Asia now appears to be coalescing around the ASEAN+3 group, although other configurations remain relevant to regional cooperation. The Chiang Mai Initiative represents the most advanced cooperative agreement as a region thus defined. A number of sub-regional trade agreements have been struck, the most important of which could be the China-ASEAN agreement, or are under negotiation. A region-wide trade agreement, distinct from APEC, is discussed but does not appear imminent. Formal institutions within East Asia and the Asia Pacific are numerous but their degree of legalization, as defined above, has always been quite low. Policy dialogue among members of the region has recently intensified and is now quite robust, the ASEAN+3 meetings are institutionalized and broad in scope, and further initiatives are being considered. The considerable degree of economic integration could thus lead to further institution building, but this is not by any means clear.

Generalizability of the EU model

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

Rules and institutions

Kahler (1995, 85) urges careful interpretation of the role of European institutions. The importance of the supranational bodies of the EU stems not from their formal roles but from other, more subtle processes that revolve around them: The nomenclature of the EU institutions (Parliament, Court) may obscure as much as it clarifies... The three institutional dimensions that set the EU apart from other regional groups lie instead in the degree of institutional delegation..., the scope of European bargains, and perhaps most important, the domestic political linkages constructed between European and national institutions. If there is a 'European model' for the future of other regional arrangements, it lies in these characteristics. First, EU member states delegated more important and extensive functions to the EU institutions than have regions elsewhere. Second, bargains across functionally linked issues cumulated into an increasingly dense network of interdependent agreements.

Crucially, argues Kahler, Community enforcement of rules and law has been less important than "national reputational considerations that serve as a central binding device". Reneging in one issue area would have negative consequences for the government concerned in others. The Stability and Growth Pact offers an object lesson in the role of hard rules in the European Union. These rules were designed to constrain governments' fiscal deficits and were given teeth in the form of painful sanctions. When they conflicted with the preferences of the large member states, however, the rules were effectively suspended and a broad discussion was launched on how to reform them. It is notable that reforms discussed as of this writing would place less emphasis on the hardness of the rule (and sanctions) and more emphasis on early sharing of information, analysis, consultation, debate and publicity - prior to, rather than subsequent to, governments' committing themselves to a fiscal path. Breaching the limits under the SGP has had substantial political consequences within the EU for relations between large and small states, providing the large with an incentive to conclude an agreement on SGP reform. The hard rule has been important not because it was enforced - to the contrary, it was violated - but because it altered the context in which member states bargained over economic policies and institutional reform. Third, European institutions have developed deep connections to domestic political institutions and interest groups. "Those links, far more than the capabilities of European Institutions alone for monitoring and enforcement, provide a basis for ensuring that European bargains are implemented" (Kahler 1995, 86). Tacit collaboration between the Court of Justice, on the one hand, and lower national courts and private groups and firms, on the other, generated forward movement in cases such as Cassis de Dijon, which established the principle of mutual recognition underpinning the single market (See Burley and Mattli 1993, Alter and Meunier 1994, Slaughter and Mattli 1998). This general analysis is widely, though not universally shared, among analysts of European integration in political science.

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

Political integration

The argument that aspirations for political union underpin the evolution of the European Union is widely asserted in public commentary and some parts of the literature on the European economic integration. EMU, for example, is frequently cited as the product of widely shared political ambition for something akin to a United States of Europe (See, for example, Eichengreen 1992). The absence of such ambitions in East Asia and North America are cited as reasons for pessimism with respect to economic and institutional integration in those regions. While commitment to political integration plays a role, however, it has been substantially over-rated by some analysts. Over the course of postwar history, first of all, economic projects for European integration have consistently received greater support than projects for political and security cooperation. Proposals for European Defense Community and European Political Community failed in the 1950s, for example, while the European Economic Community succeeded (See, for example, Dinan 2004). The Constitution for Europe would go some distance toward political integration, to choose a contemporary example, but its ratification will be decidedly difficult. Second, while it is true that war in Western Europe has become "unthinkable", it has been "unthinkable" for quite some time, at least the 1960s and 1970s if not before. European integration has continued far beyond the point where interstate violence was a conceivable threat. Finally, ambitions for political union do not easily explain the successive enlargements of the membership. Britain, Ireland and Denmark did not join the European Community because they wanted to participate in an ever closer political union. Many in successive enlargements are reticent, including the ten new members from Central and Eastern Europe. Indeed, the greater number and diversity of member states spawned by enlargements have created substantial barriers to political deepening.

For these reasons among others, many political scientists conclude that the politicalunity motive is a contributing but distinctly secondary motivation for European integration (See for example Moravcsik 1998). Analysis of political motivation should carefully distinguish between (a) ambitions for political union, (b) desire to avoid security conflict and war, and (c) political agreement on economic measures and the institutions necessary to implement them. Regional integration obviously cannot take place in the face of sharp security conflict, threats or interstate violence. Ambitions for political integration and a peace community can certainly reinforce regional integration, on the other hand, but they are not necessary.

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

Diseconomies" of institutional deepening

The European case illustrates not only the benefits but also the costs of institutional elaboration and complexity. Inter-institutional competition is rife within the European Union. The supranational institutions vie for prerogatives and influence among themselves as well as with national governments and institutions, such as national legislatures. While some of these inter-institutional conflicts can be ameliorated under the proposed Constitution for Europe, other inter-institutional conflicts will be created. The proliferation of institutions thus weakens the coherence of policy within the Union, a focus of the Sapir Group Report (Sapir et al 2003). Reform of these institutions, moreover, has become exceedingly difficult as member states are unwilling to surrender their prerogatives under one institutional framework for the sake of efficiency of decision making under another. Those institutional reforms that have been ratified (Amsterdam and Nice) have been modest, widely regarded as insufficient for a Union of twenty-five countries. The Constitution for Europe was negotiated to streamline the institutional structure and settle, hopefully once and for all, distributional conflict over voting schemes and limit institutional conflict. But the Constitution, which has fallen short of the hopes of many analysts (Devuyst 2004), might well not be ratified. This experience raises the question as to whether institutional deepening within the EU has reached a point of diminishing, or even negative, returns and suggests that other regions should institutionalize selectively.

Multilateral context

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

Conclusions and Implications

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

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

Regional arrangements should nonetheless be designed with due regard for the multilateral regime and its objectives. If constructed carefully, regionalism can complement rather than undermine aspects of the multilateral regime that function effectively. International financial cooperation, for example, would benefit from a set of principles that distinguish regional financial arrangements that are compatible with members' obligations in the IMF from those that are not (Henning 2002, 77-86). When appropriate, moreover, institutional arrangements should provide for external representation of the region as an entity in negotiations at the multilateral level. Harder rules are not necessarily better rules. Rules are useful not because they are necessarily enforced - they are often violated - but rather because they alter the context in which bargaining takes place (The commonly made distinction between rules and discretion is a false dichotomy). Information, monitoring and bargaining among governments with stakes in cooperation across a number of issue areas, and therefore an interest in maintaining the confidence of their partners, is more important than enforcement of hard law to advancing integration. There is a danger that enforcement of hard legalization can produce domestic political backlash when rules conflict too strongly with domestic political imperatives (Goldstein and Martin 2000).

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

The European case underscores the importance of making side-payments and concluding cross-issue bargains to assist governments in solving domestic political problems confronted in the process of integration. Political deadlock among member states was overcome on many occasions by exchanging concessions across policy areas and institutions. Such bargaining is facilitated by multi-sector economic integration and regional institutions (For an illustrative case within the G-7 context, see Putnam and Henning 1989). Regional institution building can also reach a point of diminishing returns. Inter institutional competition, insufficient coherence of policy, and deadlock on institutional reform might suggest "diseconomies" of institutional scale within the European Union.

For this reason, institution building in South Asia should be selective, designed with a view toward supplying the specific functions needed to negotiate, conclude and monitor agreements on trade, money, finance and regulations.

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