

Sequencing and Depth of Regional Economic Integration: Lessons for the Americas from Europe

Richard E. Baldwin

Graduate Institute of International Studies

August 2005

The paper first reviews Europe's experience with regional integration, stressing the political economy forces that have speeded, slowed and guided the process. It argues that the geographic spread of economic integration in Europe is driven by a domino effect process by which each successive integration increases the pressure on non-participants to join the integration effort. On the depth of integration, the paper argues that the path of European integration – from completion of the customs union, to the Single Market programme, to the Maastricht Treaty and monetary union – was dictated by a political economy dynamo set in motion by the unique institutional features established by the 1957 Treaty of Rome. Consequently, the lessons for other regions must be considered with great care. The paper concludes by considering the lessons that the European experience provides for the Americas.

1. INTRODUCTION

Trade blocs, in Europe, turned out to be building blocs to continental wide free trade. Today, about one third of world trade is conducted under the rules of European regional trade arrangements. These rules ensure that trade is about as free as trade can be between independent nations. The degree of integration discussed in multilateral trade institutions is today at the stage Europe was at three decades ago.

Europe did not start this way. In the late 1940s, most of European trade was conducted by governments, subject to strict bilateral quotas, and hindered by exchange controls. Mutual suspicion and outright hostility among recent enemies was rife. By 1960, two competing free trade arrangements had emerged – the European Economic Community (EEC) and the European Free Trade Association (EFTA). Free trade between the blocs was established in the early 1970s and eventually the larger bloc all but absorbed the smaller bloc. War among Western European nations in the 21st century is inconceivable despite the fact that France and Germany had fought two increasingly terrible wars in the 20th century. Despite this rapid regional integration, European nations have always been leaders in the push for multilateral liberalisation.

Given this amazing history, it is natural to look to Europe for lessons. Readers may thus be disenchanted to find that the main thesis in this paper is that the world has relatively little to learn from the European Union as far as the deepening of economic integration is concerned. The EU's supranationality is the key to its deepening and this degree of supranationality would be unacceptable to most nations in today's world. Indeed, if EU members could redesign the Union from scratch, I suspect that all but a handful of the current EU members would choose a much shallower level of supranationality.

On the widening question, however, I believe that the lessons of Europe are very important. European leaders have always viewed economic integration as part of a much more important process of maintaining Continent wide peace. Even today, the EU is considering Turkish members for geopolitical reason rather than economic reason. This led the founders of European integration to establish rules that fostered a harmonious expansion of free trade. In short, the fact that European trade blocs became building blocs is a direct consequence of their institutional choices in the post-war period. The EU's institutions, as usual, are fascinating but so idiosyncratic as to hold no lessons for the rest of the world. EFTA, on the other hand, is an organisation that bears close study.

Plan of the paper

The paper's plan is simple. It starts with a review of the deepening and widening of European integration and then moves on to drawing lessons and concluding remarks.

2. THE DEEPENING OF EUROPEAN INTEGRATION: A NARRATED HISTORY¹

History is one damned thing after another, according to the Henry Ford school of thought. While there is definitely something to this cynical view, history is not bunk, especially not when considering the lessons of European integration for the rest of the world. The European Union is a truly unique endeavour. No where else in the world have a group of former mortal enemies come to be so integrated by peaceful means. For the most part, the means and motives that brought about this happy state are unique both to the nations involved and the moment in time when the process started. This section covers the essential history.

Understanding European economic integration today requires one to connect emotionally with the misery and hardship that was commonplace on the Continent circa 1945. This shared misery was critical to the adoption of institutional elements that continue to make European integration an irreproducible experiment even today.² For this reason, the early post-war period is the place to start.

2.1. *A climate for radical change*

In 1945, a man standing almost anywhere in Europe found himself in a nation which was, or had recently been: (a) ruled by a brutal fascist dictator, (b) occupied by a foreign army or (c) both. Such a man could not help but doubt his nation's ability to govern. Tens of millions of Europeans were dead. Hundreds of millions of the survivors were homeless,

¹ For more detail see Baldwin and Wyplosz (2003), Chapter 1.

² The web allows access to photos, videos, original documents and speeches from the time. One of the best sites for all European documents is the Luxembourg-based Centre Virtuel de la Connaissance sur l'Europe. Its excellent and well-organised website is at <http://www.ena.lu>. Also at <http://www.dhm.de/lemo/html/Nachkriegsjahre/DasEndeAlsAnfang/> the Germany History Museum's site provides some powerful photos and videos focusing mainly on Germany's experience.

hungry or jobless. And WWII was not freak of history. It came just two decades after the disaster of WWI, which was itself preceded by two early wars in which France and Germany played the key roles.

It was plain to all in 1945. Something was desperately wrong with the way Europe governed itself. Minds were open to radical changes.

War experiences and attitudes towards supra-nationality

The war had a very uneven effect on European nations. Even today, this goes a very long way to explaining the very uneven attitudes of European towards the supranationality that is the heart of the uniqueness of European integration. During WWII, about 8 million people died in Western Europe, with Germans accounting for three-quarters of this total. The Germans who survived experienced 10 years of occupation by foreign armies. Not coincidentally, Germany is the staunchest supporter of embedding national sovereignty in a supranational structure.

In the Benelux nations, the Krieg was such a blitz that the death and destruction was relative moderate, although still massive as a share of the population (especially for the Dutch). The impact of the war on the psyches of Benelux citizens was profound nevertheless. Helplessness in the face of Nazi occupation and the fact that liberation only came because it suited foreign powers led most citizens to question the viability of their own nation-states – at least in the context of the European system of nation-states that had existed in the first half of the 20th century. Likewise, Italy suffered fairly modest losses in WWII, but apart from a few glory years after the 1870 national unification, Italy had veered from chaos and depression to Fascism and eventual military occupation (first by the Nazi army and then by Allied forces). Like the Germans, many Italians were happy to see their government's freedom of action constrained by a supranational body like the EU.

These desires for supranationality did not really bear fruit until 1957 with the European Economic Community, but they showed up almost immediately in governmental and constitutional crises. General de Gaulle resigned as President of the provisional government in 1946 over a disagreement on France's new constitution. Italy and Belgium saw bitter internal conflicts over their monarchy. Italy abolished its monarch in a referendum in which the communists were accused on manipulation. In Belgium, the return of the king sparked riots. Citizens of these nations were not ready to return to the business-as-usual governments of the pre-war era.

On the other end of the spectrum, Switzerland, Sweden and Britain actually grew economically during the war years. Almost no Swedes or Swiss died due to hostile action and the death toll in Britain was fairly low as a percent of its population. More importantly, the lessons of the war were exactly the opposite for these nations. In all three nations, voters were firmly convinced that their system of government was exactly what saved them from the worst ravages of the war. In these nations, the sacrifice of national sovereignty implied by EU membership was not then and is not now viewed as a 'plus.' In these nations, political integration is at best viewed as a necessary evil.

2.1.1 Avoiding future wars

The horror and revulsion arising from this devastation pushed one question to the forefront in the mid-1940s: ‘How can Europe avoid another war?’ The solutions offered depended on beliefs about the causes of the war. There were three main lines of thinking on the causes and thus three main types of solutions:

- School #1 blamed the war on the loser, Germany. Neutering Germany was the solution (see the 1944 Morgenthau Plan).
- School #2 was Marxism–Leninism which blamed capitalism both world wars. The solution was Communism.
- School #3 blamed destructive nationalism for the war, the solution being tighter integration of all European nations – as Winston Churchill called it, a United States of Europe.

The third solution prevailed, but this was not obvious in the 1940s. Most European nations were either struggling to re-establish their governments and economies, or were under direct military occupation. West European governments’ limited governance capacities were overloaded by the dismal humanitarian situation. By contrast, things moved swiftly in Central and Eastern Europe.

The Soviet Union began to implement its war-avoidance solution vision during the war by imposing Communism on the previously independent nations of Estonia, Latvia and Lithuania. By 1948, communist parties had been pushed to power in every Soviet-occupied country. They took power in Albania and Yugoslavia, and were gaining strength in Greece. The Communist point of view was also shared by many in Western Europe. In the parliamentary elections of 1946, communists won a fifth of the vote in Italy and a third in France.

2.1.2 From hot to cold war: narrowing Western Europe’s options

Schools #1 and #2 both had many adherents throughout Western Europe, but School #3 eliminated the feasibility of School #1. The US and Britain concluded by 1947 that an economically strong Germany would be essential to the defence of liberal democracy in Western Europe. They merged the UK and US zones into ‘Bizonia’ (September 1947), and France, which had originally favoured the Morgenthau Plan, added its zone in 1948. Germany drew up a constitution in 1948. In short, the Soviets’ aggressive implementation of their solution triggered a Western reaction that narrowed the competing ideologies into two schools with an ‘iron curtain’ between them.

Ideology and narrow national interest converge

The merger of the French, US and UK zones was a defining moment in Europe. Ideologically support for European integration was crucially reinforced by the pursuit of national interest. It was a standard ‘politics makes strange bedfellows’ situation.

French leaders saw the Franco-German integration as a way of counter-balancing US–UK influence on the Continent while at the same time assuring that a reindustrialized Germany would become an economic partner rather than a military adversary. The UK

and the US supported European integration as the best way to counter the spread of communism in Europe. German leaders embraced European integration as the surest route to re-establishing Germany as a ‘normal’ nation (Germany was recognized as an independent nation only in 1955). Italian leaders also welcomed European integration, which provided them with an ideological counterbalance to Communism and held the door shut on Italy’s fascist past. The Benelux nations were happy about anything that reduced the chances of another Franco-Germany war.

2.2. *First steps and calls for deeper integration: A fork in the road*

The Marshall Fund’s Organisation for European Economic Cooperation (OEEC) was the first concrete step towards solution #3. The OEEC is but a footnote in our story, but is it important since it changed attitudes towards economic integration. Under the OEEC, trade barriers throughout Western Europe fell massively from levels that were very little short of autarky. Simultaneously, trade, output and incomes grew two or three times faster than they ever had in the past.

The thinking of policy makers was profoundly affected by the fact that industrial output grew at historically unprecedented rates even as European trade was being liberalized. In the decades following WWI, especially during the 1930s, economic growth had been viewed as a competition between nations – a competition in which trade barriers played the central role. Things seemed just the reverse in the late 1940 and 1950s.

2.2.1 The drive for deeper integration: Two camps

By the early 1950s, almost all European leaders (apart from Communists) agreed that economic integration was a critical pillar in Europe’s post-war architecture. Opinions differed on whether this one pillar would be enough. The Six, led by France and Germany, believed that Europe’s former enemies needed political as well as economic integration. And their citizens, having lived through such spectacular governmental failures, thought it was a good idea to bind their national sovereignty in supra-national organisations such as the European Coal and Steel Community (1950) and the European Economic Community (EEC, 1958). For other European – like Britain, the Scandinavians, and the Swiss – the sharing sovereignty with nations as prone to war as the Six was a very bad idea. (Other West European nations were either still under Fascist dictators, the Iberians, or constrained by Soviet strictures, Austria and Finland.)

The Cold War lent urgency to this drive. With East–West tensions rising steadily, Germany would not only have to be allowed to regain its industrial might, it would have to rearm in order to counter the ‘Soviet menace.’ Many Europeans, including many Germans, were uncomfortable with the idea of a Germany that was both economically and militarily strong, so integrating Germany into a supranational Europe seemed a natural way forward.

This “Federalist versus Intergovernmentalist” schism, which first appeared in concrete terms in the late 1950s, continues to divide Europe and continues to affect the course of European integration. The main progeny of the schism were the EEC and EFTA.

2.2.2 The Treaty of Rome and the EEC

The first big federalist step came only in 1952 with the implementation of the Schuman Plan. This proposed that France and Germany should place their coal and steel sectors under the control of a supranational authority – a radical federalist move since coal and steel were viewed as the ‘commanding heights’ of an industrial economy at the time and crucial to a nation’s military and industrial strength. While all party certainly had *arrière-pensées*, Schuman explicitly justified his Plan as a means of rendering future Franco-German wars materially impossible. Other European nations were invited to join this European Coal and Steel Community (ECSC); Italy and the Benelux nations actually did. This created ‘the Six.’

From the ‘commanding heights’ of the economy to the whole economy

By the time the ECSC was up and running in 1952, Europe was a very different place to what it had been at the war’s end. The Axis-Allied confrontation had been completely replaced by an East-West confrontation – the old friends were enemies and the old enemies were friends. It is unlikely that nations as bitter as the victims of Nazism could ever have joined with Germany had it not been for the external threat of Soviet territorial expansion. The rosy economic situation also played an important role. The Six had managed to get their economies back on track, and were experiencing growth that would make many 21st century East Asian jealous.

The event that triggered the critical first step in what is today Europe came in 1955. To counter the Soviet’s perceived threat, Germany joined Western Europe’s main defence organization, the North Atlantic Treaty Organization (NATO) and regained its national sovereignty. To ensure that another Franco-German war remained unthinkable (and to pursue the strange-bedfellow motives discussed above), leaders in the Six turned their minds to deeper integration. The economic road was not their first thought, but having failed to move directly to political or military integration via the ill-fated European Defence Community and European Political Community, the natural way forward was broader economic integration.

Foreign ministers of the Six met in 1955 to start a process that led to the Treaty of Rome – a Treaty that committed the Six to extraordinarily deep integration. In a sense, the Treaty of Rome was the bud whose leaves unfolded over 50 years into today’s European Union.

Economics of the Treaty of Rome: The Spaak Report’s race-to-the-bottom logic

The post-war architects of the Europe had radical goals in mind when they established the EEC. Indeed, the Treaty of Rome cannot be fully understood without reference to the founders’ intentions. The various elements of economics integration in the Treaty were not subject to individual cost-benefit calculations. The idea was to fuse the six national economies into a unified economic area. This fusion was expected to launch a gradual process that would draw the nations into an ever closer union. Economic integration was to be the means of achieving the ‘*finalité politique*.’

The spadework behind the Treaty’s economics was done by the so-called Spaak Committee. This group’s report, known as the Spaak Report, (“*Rapport des chefs de délégation aux ministres des affaires étrangères*,” Bruxelles, 21 avril 1956) contained the

outcome of the experts group set up by the Messina Conference. The Treaty of Rome followed the recommendation of this group very closely.

The group's task was to define the measures necessary to fuse the Six's economies. While ideology was an ever present background force, much of the Report's contents can be viewed as a 'race to the bottom.' Right from the start, all the Six agreed that tariffs and quotas would have to be eliminated. The fear, however, was that various governments would offset the trade liberalisation with state-led or private-led schemes. This fear resulted in an insistence that virtually every avenue of distorting free competition be ruled out. Since the Spaak Committee members knew that the Treaty could not possibly foresee all future distortions, they recommended that creation of an independent European Commission to ensure ongoing surveillance and enforcement of the internal market. They also recommended that an independent judiciary be set up to interpret the Treaty and settle disputes.

In the end, the Treaty of Rome followed the Spaak Report in going far, far beyond a customs union. The goal became to create a unified economic area where firms and consumers located anywhere in the area would have equal opportunities to sell or buy goods throughout the area. Where, owners of labour and capital should be free to employ their resources in any economic activity anywhere in the area.

As Europeans found out of the subsequent decades, this level of economic integration was not possible without deep political integration. As it turned out, idea of using economics as a Trojan horse for political integration worked like a charm.

2.2.3 The Stockholm Convention and EFTA

Formation of the EEC introduced an important new element into European economic integration. Hereto trade liberalization in Europe had been orchestrated by the OEEC with nations liberalizing on a non-discriminatory basis. The EEC, however, promised to go much further, removing all trade barriers, but this time on a discriminatory basis. The other OEEC members were left on the sidelines. Fearing the discrimination and marginalization that might occur if they faced the EEC bilaterally, seven of these 'outsiders' reacted by forming their own bloc in 1960, the European Free Trade Association (EFTA). This co-ordinated response was greatly facilitated by the UK's leadership. By the early 1970s, all Western European nations had forsaken bilateralism except Ireland, which was in a monetary union with its major trading partner (the UK). Greece and Turkey both applied for associate EEC membership almost as soon as the Treaty of Rome was signed, and Spain signed a preferential trade agreement with the EEC in 1970 and another with EFTA in 1979.

The key elements of EFTA were free trade in industrial goods (food trade was excluded) within the Association, but no harmonisation of third country trade policy. Decision making was strictly intergovernmental in the sense that no nation would be forced to accept something it did not vote for. (The EU's majority voting means all Member States regularly find themselves having to implement laws that they oppose.)

Importantly, EFTA contained 'docking arrangements' right from the start. That is, the Stockholm Convention describes how the Association could be enlarged. The same was true of the EEC, but such forward looking provisions have only rarely been included in

other preferential trade deals around the world. Moreover, it was much more than modern regional agreements – like NAFTA and AFTA. It had functioning institutions, common rules of origin that allowed cumulation, and at least in the beginning, a clear lead nation – the UK.

2.3. Deepening of European integration

Throughout the EU's long history, many national leaders have regretted the depth of integration promised in the Treaty of Rome. Several times they have tried to ignore these commitments, but the Treaty itself does not allow them this luxury. The Treaty has the force of law in all member states and it created an independent legal system that is supreme to national court systems on Treaty matters. Since the Treaty touches on almost every aspect of economic policy, the Court has astounding powers. The Treaty also created an independent body, the European Commission, to act as 'guardian of the Treaty.' Even if a national leader would have liked to ignore the promises made in 1957, the European Commission and especially the EU Court take the Treaty as the law of the land – which indeed it is in all EU Member States.

2.3.1 De Gaulle's rejection of supranationality

After its army surrendered just two weeks into the fighting in 1938, after part of its territory was occupied by Nazis for 7 years and the rest was run by French collaborating with Nazis, La Gloire de la France was in serious disrepair in the 1940s. Indeed, when the Nazis reoccupied Vichy France in 1944, the spirit of French Revolution had been so thoroughly broken that not a single shot was fired in opposition to the invading German army.

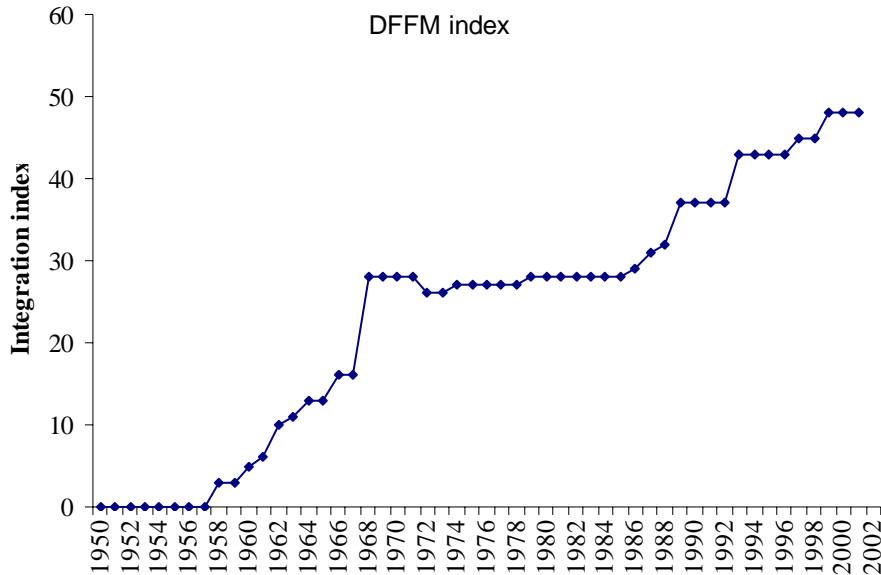
Charles de Gaulle set out to restore France to its former eminence in the post-war period and pooling national sovereignty with other Europeans was not part of his plan. The Treaty of Rome, however, was signed and ratified by France while de Gaulle was out of power. When he returned to power, the Treaty was a *fait accompli*, and he decided to use it to further his plan for France. The first thing to do was to gut the Treaty's main supranational element – majority voting.

The issue came to a head as the final stage in the Treaty of Rome's transition period approached (1 January 1966). At this stage the voting procedures in the EEC's key decision making body, the Council of Ministers, was scheduled to switch to majority voting. For de Gaulle, the objectionable part of majority voting was that France might have to accept a majority-backed policy even if France had voted against it. De Gaulle challenged the principle in 1966; France stopped attending EEC meetings and threatened to withdraw. In exchange for France's return to the table, de Gaulle won the so-called Luxembourg Compromise, a deal that *de facto* overturned most of the EEC's supranationality.

Although the Luxembourg Compromise had no legal force, it had an enormous impact. It meant that unanimity was the *de facto* rule for almost everything. Almost all progress on deeper economic integration was blocked until the majority voting was restored in the 1986 Single European Act. This can be seen in the index of European integration developed by a team of economic historians (see Figure 2-1).

Although no one can know for sure, it seems likely that the Luxembourg Compromise would have put an end to, or at least enormously slowed, deeper European integration had it not been for the supranational institutional arrangements in the Treaty of Rome. In any case, the historical fact is that deeper European integration came to a standstill for two decades after de Gaulle's bold move.

Figure 2-1: European integration stalls after de Gaulle's maneuver.



Sources: DFFM index, Dorrucci. E., S. Firpo, M. Fratzscher, and FP Mongelli (2003) "What Lessons for Latin America from European Institutional and Economic Integration?" in: P. van der Haegen and J. Viñals (eds.), *Regional Integration in Europe and Latin America - Monetary and Financial Aspects*. Ashgate, Aldershot. pp. 171-218.

2.3.2 Failed deeper integration

The only concrete integration promised in the Treaty of Rome was the implementation of the customs union and this was accomplished 18 months ahead of schedule. Yet while intra-European trade was free of the 'easy' barriers, tariffs and quotas, by 1968, the Treaty of Rome foresaw much deeper integration. The European Commission duly formulated a plan for completing the common market, but this was thwarted by protectionist instincts of Member State governments. To be concrete, consider the example of technical barriers to trade (TBTs).

The EU recognised TBTs as a barrier to the Common Market in 1957 with Article 100 of the Treaty of Rome. This requires approximation (Euro-speak for harmonisation) of national regulations for the "proper functioning of the common market".

The EU systematically took up the removal of technical barriers in 1969 with its 'General Programme', which launched what came to be called the 'old' approach to TBT liberalisation. This approach – combined with the Luxembourg Compromise – meant that TBT liberalisation was to happen via detailed technical regulations for single products or groups of products implemented by unanimously agreed 'directives' of the EU's Council of Ministers (the EU's main decision-making body).

This approach failed completely. The detailed timetable was roundly ignored and harmonisation of standards and regulations proceeded much more slowly than the development of new national TBTs. For example, ten years were required to adopt a directive on gas containers made of unalloyed steel and 9.5 years was the average delay for the 15 directives adopted en masse in 1984. Furthermore, rules on ‘standstill’ and notification were ignored. In practice, Member States had full discretion to adopt new national regulations – as long as they did not cross EU case law. The Commission received an average of only 11 notifications annually between 1975 and 1982 while thousands of new regulations sprang up in Member States.

Almost no progress was made until the 1986 Single European Act.

2.3.3 Single European Act sparked by judicial activism

The Single European Act is stunning in at least two ways. First, it was adopted with lightening speed by EU standards. The path-breaking White Paper appeared in mid-1985 and by mid-1987 the Treaty implementing it and much more (the Single European Act) had been ratified by 12 Member State parliaments. Second, it aimed to implement exactly the sort of deeper integration that EU leaders had been resisting in the Council of Ministers for a decade and a half.

One has to presume that EU leaders found it politically optimal to resist deeper integration from 1868 to 1986, so why did they find it politically optimal to embrace it in 1986? I believe there are three salient points in solving the riddle.

The first point is that the Single European Act did not initiate the process of breaking the protectionist dam of TBTs in Europe. The EU Court put the first large hole in the dam with its *Dassonville* and *Cassis de Dijon* findings – a hole that was large enough to eventually provoke the collapse of TBTs as protectionist devices (see Box 1).

Before explaining the political economy logic of the collapse, it is necessary to review a critical element of the EU's institutional structure – a feature that is so unusual that most non-European (and many EU citizens) find it hard to believe. In some nations it would be considered treasonous to suggest that the nation's constitution should become second tier legislation compared to an international treaty, or that an international Court should be supreme to national courts, but this is exactly what all EU members have accepted (see Box 1: The Dassonville and Cassis de Dijon Cases

In the 1974 “Procureur du Roi v. Dassonville” decision, the EU Court reminded EU members that they had agreed to eliminate TBTs by signing the 1957 Treaty of Rome. It opined that “all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade are to be considered as measures having an equivalent effect to quantitative restrictions,” and are, therefore, to be prohibited. According to this ruling, virtually any regulation or standard that might hinder or substantially raise the cost of imports seemed to be prohibited. Of course, this decision did not automatically remove all TBTs. Each of the thousands of barriers would have to be challenged in court.

In its 1979 “Cassis de Dijon” case, the EU Court explicitly allowed for some trade-inhibiting national regulations and standards. However, it set the permissibility bar very high. In fact, the Cassis de Dijon case is an example of where the Court rejected the Member State's assertion that the measure was necessary, thus serving notice that the Court would scrutinise all such justifications in a very critical light.

The particular measure under fire was a German import prohibition on certain low-alcohol spirits (to wit Cassis de Dijon which is the essential ingredient in the famous cocktail ‘kir’). When challenged, the German government argued that the prohibition was necessary to protect public health (since weak spirits more easily promote alcohol-tolerance) and to protect consumers (since consumers might buy weak spirits, thinking they were strong). The Court ruled that the measure was not necessary since widespread availability of beer in Germany made the prohibition ineffective in furthering public health. It also found that putting the alcohol content on the label was sufficient to protect consumers, so the import ban was not “necessary”.

The upshot of these rulings (and a knock-on Commission Directive interpreting the Cassis de Dijon case) was to make mutual recognition of other Member States' standards, regulations and conformity assessments the ‘standard operating procedure’. Any deviation required clear and compelling justification and had to pass the test of being the least trade-restrictive-means of accomplishing a “mandatory” requirement. In short, the presumption in the EU is now that any product that is lawfully made or sold in any Member State can be sold in any other member state.

Box 2). In short, the EU Court's rulings are the supreme authority in the EU on areas in which the Court has jurisdiction (basically all Single Market issues). Of course, the logical necessity of this situation is clear if deep integration is to survive, but it nonetheless highly specific to the EU. Indeed, the only recourse national politicians have to a Court ruling they do not like is amending the Treaties.

Box 1: The Dassonville and Cassis de Dijon Cases

In the 1974 “Procureur du Roi v. Dassonville” decision, the EU Court reminded EU members that they had agreed to eliminate TBTs by signing the 1957 Treaty of Rome. It opined that “all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade are to be considered as measures having an equivalent effect to quantitative restrictions,” and are, therefore, to be prohibited. According to this ruling, virtually any regulation or standard that might hinder or substantially raise the cost of imports seemed to be prohibited. Of course, this decision did not automatically remove all TBTs. Each of the thousands of barriers would have to be challenged in court.

In its 1979 “Cassis de Dijon” case, the EU Court explicitly allowed for some trade-inhibiting national regulations and standards. However, it set the permissibility bar very high. In fact, the Cassis de Dijon case is an example of where the Court rejected the Member State’s assertion that the measure was necessary, thus serving notice that the Court would scrutinise all such justifications in a very critical light.

The particular measure under fire was a German import prohibition on certain low-alcohol spirits (to wit Cassis de Dijon which is the essential ingredient in the famous cocktail ‘kir’). When challenged, the German government argued that the prohibition was necessary to protect public health (since weak spirits more easily promote alcohol-tolerance) and to protect consumers (since consumers might buy weak spirits, thinking they were strong). The Court ruled that the measure was not necessary since widespread availability of beer in Germany made the prohibition ineffective in furthering public health. It also found that putting the alcohol content on the label was sufficient to protect consumers, so the import ban was not “necessary”.

The upshot of these rulings (and a knock-on Commission Directive interpreting the Cassis de Dijon case) was to make mutual recognition of other Member States’ standards, regulations and conformity assessments the ‘standard operating procedure’. Any deviation required clear and compelling justification and had to pass the test of being the least trade-restrictive-means of accomplishing a “mandatory” requirement. In short, the presumption in the EU is now that any product that is lawfully made or sold in any Member State can be sold in any other member state.

Box 2: EU law versus national law

One classic example of the supremacy of EU law is the 1991 Factortame case which confirmed the supremacy of EC law over UK law. The UK’s Merchant Shipping Act of 1988 had the effect of forbidding a Spanish fishing company called Factortame from fishing in UK waters. Factortame asserted in UK courts that this violated EC law, and asked the UK court to suspend the Merchant Shipping Act until the EC Court could rule on the matter (this often takes a couple of years). Under traditional UK law, no British court can suspend an Act of Parliament. The EC Court, however, ruled that under EC law, which is supreme to UK law, a national court could suspend laws which contravened EC law. Subsequently, the highest UK court did strike down the Merchant Fishing Act. In essence, the EU Court (one which there is only one Brit) gave the UK Courts power over the UK Parliament – a power that was not in the UK’s unwritten constitution.

2.3.4 The Court remembers the Treaty of Rome promises

In the 1970s, the Court expressed the view that most TBTs contradicted the Treaty of Rome and were therefore illegal (see Box 1 on the two famous cases). This meant that most TBTs could be challenged in, and probably overturned in court. Of course, the Court could not feasibly eliminate each TBTs one-by-one. The ruling, nevertheless, subtly rearranged the political economy forces supporting the entire TBT protectionist system in all Member States.

National firms push for idiosyncratic standards in order to hobble their competitors and thus create rents for themselves. Such political efforts are subject to a cost-benefit analysis by firms. The Court's rulings shifted this analysis in a way that made pro-protection efforts much less profitable to national firms. The point is that although not all TBTs could be repealed by the Court, the ones that would be challenged would be those that created the most rents since such barriers are the ones that created the greatest losses for foreign competitors (under EU law, individual firms can bring cases before the Court, even against their own government).

In essence, the Court's decisions capped the maximum rents obtainable from TBTs and this drained the incentive to lobby for regulatory protection. One can wonder how the Court got so far out in front of EU politician, but having destroyed the non-cooperative status quo, EU industry had little to gain from opposing the further liberalisation. The Single European Act sailed through without major opposition from EU business, and this despite that fact that it was pressure from EU businesses that had so effectively hindered EU TBT liberalisation for decades.

Finally, it is important to note that EU governments accepted the Single European Act for a different reason. Mutual recognition driven by the Court would have fostered regulatory competition, maybe even a race to the bottom. The rapid embrace of the 'new approach' by EU national governments was a means of regaining control over the regulation/liberalisation process. Of course, the governments' acceptance of the Act was driven by many other complex motives as well, but the Single European Act was not a reduction in national sovereignty once the Court had established mutual recognition as the principle.

To summarise, the deepening of Europe's economic integration was stalled in the late 1960s by classic nationalistic stances adopted by some member states. European integration would today be very little deeper than a customs union had it not been for the relaunch of EU's deeper integration in the Single Market Act. But this relaunch was brought about by highly idiosyncratic features of the Treaty of Rome.

2.3.5 From Single Market to Monetary Union

One of the remarkable aspects of the 1986 Single European Act was its emphasis on the free mobility of capital. The idea was clearly in the Treaty of Rome (it states that all restrictions on capital flows should be abolished), but very little capital-market liberalization was undertaken since the Treaty provided an important loophole. It allowed capital market restrictions when capital movements create disturbances in the functioning

of a Member State's capital market. Moreover, it did not set a timetable for this liberalization.

The Single European Act did allow very free flows of capital, and this, as all students of open macroeconomics know, changes the viability of a fixed exchange rate system. As the European Monetary System (EMS) hardened in the late 1980s and early 1990s, the free flow of capital meant that Europe ran into the tri-lemma. The exchange rate crisis of 1992 and 1994 were the result. European leaders decided to fix the problem by hardening the EMS into the Economic and Monetary Union (EMU).

The political economy of this is interesting to reflect upon. Why would so many sovereign governments decide to give up so much power over their economy?

Monetary autonomy in a very integrated market

Devereaux and Lane (2002), inter alia, showed that nations tend to stabilise their bilateral exchange rates against nations with whom they trade a lot. There are many sophisticated reasons for this, but my favourite is a political economy story. If a nation's currency depreciates against its major trade partner, cheers arise from exporting firms but screams are heard from firms that import components and materials. The roles are reversed for appreciations. Since losers lobby harder, Central Banks in nations that are thoroughly integrated with their trade partners face strong political pressure to keep the exchange rate steady against the currency of its major trading partner, especially in very small nations where the importers and exporters dominate local politics.

Europe in the late 1980s and early 1990s, saw this political logic (which operates in most small open nations) combined with the strong belief that an independent Central Bank was the best way to achieve a favourable inflation-growth trade-off. Thus, as part of the 1992 Maastricht Treaty, EU governments agreed to make their Central Banks independent. This changed the whole political landscape.

Central Bank independence means the elected governments – the ones who make the currency union decision – have almost nothing more to lose in terms of policy levers by abandoning the currency. Indeed, if the independent Central Bank has become addicted to following the leader nation (Germany in this case), the nation as a whole may gain greater control by joining the monetary union. In a sense, the formation of the Eurozone meant putting a Frenchman on the board to the Bundesbank.

2.4. *Reaction of European 'outsiders' to the Single Market*

The European Union decision to radically deepen its goods and factor market integration via the Single European Act posed the threat of new discrimination for seven EFTA members (four Nordics and three Alpines). This episode contains critical lessons for deeper integration among non-European nations, so it is worth exploring.

To redress the impending discrimination, the EFTA nations negotiated the European Economic Area (EEA) agreement. This arrangement had the effect of extending the Single Market to the EFTA nations excluding political integration and agriculture.

The EEA negotiations were long and difficult, since the depth of the economic integration was unprecedented in the world of commercial diplomacy. When the talks were launched, tariffs and quota between the EU and EFTA (apart from agriculture) had

been gone for two decades. The negotiations concerned behind-the-border measures – measures that were previously viewed as purely national concerns. Moreover, given the defuse and ever-changing nature of behind-the-border barriers, extending the Single Market to EFTA would require surveillance and enforcement mechanisms akin to the European Commission and the EU Court of Justice. The first EEA deal signed involved a joint EU-EFTA Court to arbitrate EEA disputes. This solution, however, was rejected by the EU Court of Justice as contradicting basic EU law: the Court held that it must remain the supreme authority over Single Market issues. The final EEA deal gave the EU Court of Justice sole authority over all EEA matters, except those involving purely intra-EFTA issues.

The lesson for the EFTA nations was crystal clear. Truly deep economic integration was impossible without some form of political integration. The real options facing the EFTA nations were either to accept hegemonic authority from Brussels on Single Market matters (some called this “regulation without representation” at the time), or to join the European Union.

This realization, in conjunction with the end of the Cold War in the early 1990s, convinced many EFTA governments that joining the EU was the best way to redress the impending discrimination of the Single Market. Indeed, by the end of the EEA talks, all the EFTA nations, except Iceland and Liechtenstein, had put in membership applications. Membership talks concluded successful with four candidates. Norway’s voters, however, rejected EU members, so only Austria, Finland and Sweden joined in 1994.

3. WIDENING OF EUROPEAN INTEGRATION: DOMINOS AND JUGGERNAUTS

We now turn the history of how European integration spread geographically.

3.1. *European Dominos*

The 1960s saw rapid discriminatory liberalisation with the EEC and EFTA. This had a dramatic effect on trade patterns. The EEC’s share of trade with itself rose from 30 to 50 per cent. The share of EEC imports from other European nations stagnated or fell. This discrimination meant lost profit opportunities for exporters in both groups, but since the EEC market was more than twice the size of EFTA’s market (and growing faster), the EEC club was far more attractive to exporting firms. This generated new political economy forces within the EFTA nations – forces that pushed for EEC membership.

3.1.1 The first enlargement and EC-EFTA FTAs

The United Kingdom was the first domino to fall. Despite the UK’s lead role in creating EFTA, the British government reacted to new trade pressures by applying for EEC membership in 1961. Three more dominos fell immediately. If Britain were to jump to the EEC, exporters in the remaining EFTA nations would face discrimination in even more markets. In reaction, Ireland, Denmark and Norway – nations that had found it politically optimal to avoid EEC membership in 1958 – also applied in 1961.

When the EEC enlargement finally occurred in 1973, many more dominos fell. As the size of the EEC market expanded and the size of the EFTA market shrunk, the impact of the potential discrimination was magnified. This created new, pro-integration political economy forces in the EFTAn. Exporters in the remaining EFTA nations pushed their governments to sign bilateral free trade agreements with the EEC in 1973.

This dynamo, which Baldwin (1993, 1994) calls the ‘domino theory of regionalism’ goes a long way to explaining the seemingly endless queue of nations who wish to join the EU.

3.2. *Secondary dominos and the virtual “European FTA Union”*

The EC-EFTA FTAs set the pattern of trade relations that governs Europe right up to today. Each time the EU signs another bilateral FTA, all the non-EU West European nations rush to sign a very similar agreement with the same nation. This is what I call the ‘virtual European FTA union’ that has been in operation for 40 years.

The domino logic pushes this. For example, the 1991 EU-Poland trade deal (a so-called ‘Europe Agreement’) would have provided German firms with an edge over Swiss rivals in the Polish market. This impending discrimination generated new political economy forces in Switzerland that pushed Bern into signing an FTA with Poland. Switzerland’s list of actual and planned FTAs matches the EU’s list almost exactly. The same is true today for the only other West European players outside of the EU’s fence, Norway and Liechtenstein.

The basic force also applied to the newly freed nations Eastern and Central European Countries (CEECs) and Turkey. To avoid discrimination against their exporters, these nations followed the EU’s lead. Importantly, the circular causality of the domino theory played out in the FTA union as well. If a single European nation decided to not sign a FTA with the EU’s new partner, its firms would severe discrimination since firms based in almost every European country would have free trade access.

3.2.1 *Second, third and fourth enlargements*

The force for inclusion in the EU has always been strong, and the EU has basically open to new European members since its first enlargement. It was thus clear that Greece, Portugal and Spain would apply once they had rid themselves of their authoritarian governments (democracy is a criteria for EU membership). For Greece accession came in 1981. For the Iberians, it occurred in 1986.

The fourth enlargement occurred in 1994 as a result to the process surrounding the EEA. As mentioned above, the deepening of the Single Market created a domino effect that was so strong, it overcame the long lasting opposition of EFTAns to EU supranationality. A closer look at the 1994 enlargement serves to strengthen the argument. Two of the EFTAns – Austria and Finland – had stayed out of the EU due to Soviet pressure. Once the threat of Soviet intervention evaporated, these nations put in EU applications (just as in the Greek, Portuguese and Spanish cases). For Sweden and Switzerland, on the other hand, joining the EU was viewed as a great cost. These nations came through the two world wars in fine shape due to their independence of Great Power struggles in Europe. The peaceful end of the Cold War, and the rapid off-shoring of Swiss and Swedish

companies to the EU put great pressure on their governments to join. Eventually Swedish voters accepted members in a referendum, but the Swiss said no (via a referendum on the EEA in 1992). The Norwegians also said no after their government completed accession talks. On one hand, Norway exports relative few manufactured goods that were heavily affected by potential Single Market issues, so the gains of membership were modest. On the other hand, the costs were viewed as very high by voters since Norway had won its independence from Sweden only in 1905. Having so recent left one ‘union’, the Norwegians were reluctant to join another, especially since their abundance of oil made them feel secure outside the fence.

3.2.2 The 2004 Enlargement

The most recent EU enlargement, the largest ever by some measures, was also driven by the domino logic, but the real motor – at least in the early 1990s – was geo-strategic.

One of the first policies adopted by the post velvet-revolution CEECs was to announce their intention to join the EU. The EU was initially reluctant since the CEECs were (and still are) so poor, agrarian and populous. It was only in 1994 that EU leaders agreed that the CEECs that wanted could join, provide only they met some fairly straightforward criteria.

Given that EU membership is so widespread, almost all the remaining outsiders want to join. Or using domino terminology, the size of the bloc means that the discrimination faced by outsiders is so important that it over rides any potential opposition to the trade liberalisation inherent in EU membership. Croatia, Serbia, Albania, Montenegro, Bosnian, Macedonia, and Ukraine are all looking to join. Indeed, since the EU stretched its definition of European with the Cyprus accession (Cyprus is south of Tunis and east of Cairo) some nations that are not European by classical definitions are thinking about applying.

3.3. *Juggernauts and Dominos*

The evolution of the European spaghetti bowl of FTA was greatly facilitated by what I call the juggernaut theory of liberalisation. To set the stage, we turn first to the simple version of the theory and then its application to the problem at hand.³

3.3.1 The Juggernaut theory of multilateral liberalisation

The Juggernaut theory asserts that liberalisation begets liberalisation, so once the liberalisation ball starts rolling, it is difficult or impossible to stop.⁴ Here is the logic. Wind back the clock to 1947 when the GATT became active. At that moment, tariffs started at levels that were politically optimal. That is, tariff levels – like prices in a competitive market – balance the supply and demand for protection in the political market. The main demanders of import protection are import-competing firms and

³ The theory was first posited informally by Baldwin (1994) and Baldwin and Baldwin (1996) and formalised by Baldwin and Robert-Nicoud (2005).

⁴ The word ‘juggernaut’ – defined as “any massive inexorable force that advances crushing whatever is in the path” – stems from a British mispronunciation of the Hindu diety of the Puri shrine, Jagannath. A festival is held in Puri involving the ‘chariot of Jagannath’, an enormous and unwieldy construction that requires thousands of people to get it rolling. Once started, however, it rolls over anything in its path.

workers they employed. The government was the supplier of protection, but was reluctant to raise tariffs to autarkic levels since this would harm the general economic health of the nation.

From this situation, announcement of multilateral tariff-cutting talks based on the principle of reciprocity alters the array of political forces inside each and every nation participating in the talks on the basis of reciprocity. And reciprocity is the key. Reciprocity turns each nation's exporters from bystanders in the tariff debate to fervent opponents of protection within their own nation. Reciprocity means exporters win better access to foreign markets only if home tariffs are lowered. Thus lobbying against domestic tariffs becomes a way of lowering foreign tariffs.

Since this rearrangement of political forces goes on inside every nation involved in the talks, a new political equilibrium emerges. Tariffs are cut because now the supply of protection shifts in (exporters increase the marginal political cost to their government of maintaining any given level of tariffs), but the demand for protection is unchanged. Note that tariffs do not go to zero, but they are cut in all participating nations and these tariff cuts are phased in over a 5 to 10 year period.

The phase in of tariff cuts at home and abroad alters the economic landscape and this generates a sort of political economy momentum. In all participating nations, export sectors expand output and employment as foreign tariffs come down, and import-competing sectors reduce production and employment as home tariffs are lowered. In economic terms, the long-run supply responses in the export and import-competing sector are greater than the short-run responses. Why does this matter?

Although many factors affect a sector's political influence in tariff-setting, size always matters. That is, other things equal, a sector with lots of workers, lots of capital and lots of profit will have more influence. Since the export sectors in all nations have expanded while all of the import-competing sectors have shrunk, the next GATT/WTO Round leads to a different outcome. A few years down the road, when another multilateral Round is launched, reciprocity again re-aligns the tariff-setting balance by turning exporters into anti-protectionists. But this time, the pro-tariff camp is systematically weaker in every nation and the pro-liberalisation camp is systematically stronger in every nation. The result is that all participating governments find it politically optimal to cut tariffs, but again not to zero. As these fresh tariff cuts are phased in the cycle is repeated.

This process means that any sector in any nation that is included in the reciprocal trade talks will eventually get liberalised.

Exceptions that prove the rule

Oversimplifying to make a point, tariffs in the world can be summarised in three points: they are zero on industrial goods imported into rich nations, they are high on food imported into rich nations and they are high on industrial goods imported into poor nations. How does the theory account for these 'facts'? Until the 1990s, GATT Rounds focused on manufactured goods, so it is no surprise that food was not liberalised. More specifically, the import competitors in the EU, US and Japan were so strong that they managed to take food tariffs off the bargaining table, so no one inside the EU, US and

Japan gained from lobbying against food tariffs. In this way, food tariffs were shielded from the relentless crushing force of the Juggernaut effect.

Developing nations have participated in GATT/WTO Rounds, but not on the basis of reciprocity. Until the 1970s, the GATT was a rich-man's club. Most poor nations were colonies or newly independent states, few of which wanted to join. When the merit of membership did become to be appreciated by some developing nations in the 1970s, the GATT adopted its "Enabling Clause" – which should have been called the 'disabling clause' since it disables most of the GATT's discipline poor nations. The Enabling Clause meant that developing nations did not have to make tariff concessions in order to gain better market access. Or, more to the point, GATT Rounds did not turn developing country exporters from bystanders to free traders. Under these rules, the multilateral talks had no impact on the array of pro-trade and anti-trade political forces within developing nations. Little wonder, then, that they decided to stay with the initial level of their tariffs, which were after all politically optimal to begin with.

3.4. *Juggernauts and Dominos: Political economy momentum from FTAs*

The juggernaut theory stresses how reciprocal tariff cutting alters the political economy environment in ways that fosters further liberalisation. We turn now to explaining how this dynamic facilitated the widening of European integration, but we use the example of Mexico to illustrate the point.

Juggernaut effects and Mexico's FTA strategy

Up until it asked the US for a bilateral free trade agreement in 1990, Mexico followed a classic import-substitution policy – a policy explicitly aimed at preventing US industry from crushing nascent Mexican industry. Mexican tariffs were high and Mexico stayed out of the GATT until 1986. The Mexico-US free trade agreement (FTA) changed all this. The FTA was announced under the GATT's Article 24, so Mexican tariffs had to go to zero on substantially all trade in about 10 years.

Once NAFTA had been implemented, Mexico had zero tariffs on three-quarters of all of its imports. Moreover, because the US and Canada have very low MFN tariffs on their non-food, non-clothing imports, free trade with NAFTA is not much different than free trade with the world (with a few spectacular, but low-volume exceptions). Or, more to the point, Mexico's regional liberalisation forced out or downsized all the import competing industries that would have otherwise resisted multilateral liberalisation. Basically, the NAFTA-launched juggernaut crushed in 10 years the sort of protectionist forces that took the GATT 40 years to crush in the US and Canada.

What all this meant was that Mexico had little to gain from keeping its MFN tariffs on industrial goods. Why not, then, go all the way for unilateral free trade? Or, better yet, why not get something in exchange by signing FTAs with anyone and everyone? The result of this logic has been impressive. While most Mexican exports go to NAFTA, Mexico sought FTAs with the EU and Japan. Additionally, Mexico signed free trade agreements with its poor and economically small neighbours, including Honduras, Costa Rica, Columbia, Venezuela and many more.

Juggernaut effects in Europe

The same sort of thing operated in Europe since the mid-1970s. Once the first EU enlargement was completed and the complementary EC-EFTA FTAs in place, Western Europe was a great big free trade zone for industrial goods. The nexus of the Treaty of Rome, EFTA's Stockholm Convention and the EC- FTAs had eliminated tariffs on at least two-thirds of imports of all West European nations. As in the Mexican case, any potential opposition to further FTAs had already been crushed by EFTA or the EC-EFTA FTAs. This is why it was so easy for the virtual European FTA union to develop. All non-EU the governments in nations like Austria and Norway needed was a sizable reason to sign a new FTA; there was no serious opposition left.

4. LESSONS FOR THE REST OF THE WORLD

A while back, macroeconomists switched from arguing over what level of inflation a Central Bank should choose to arguing over the institutional structure in which the Central Bank would make its inflation decision. While the pendulum has swung back on the rate issue, the result of the institutional argument was historic. Since most Central Banks are now independent of politicians, worldwide inflation has been tamed.

In game theory terms, the macroeconomists switched from arguing about strategies (taking the game setup as given) to arguing about mechanism design – i.e. how to choose the rules in which agents will play in order to guide the likely outcome in a favourable direction.

Trade economists are only starting to think in these terms about trade institutions. Trade diplomats, on the other hand, have always viewed trade arrangements from the mechanism design perspective. The GATT was a master piece of mechanism design. It set the juggernaut of liberalisation rolling in a way that has by now crushed most tariffs on industrial goods. Likewise, the post-war European trade arrangements were created by diplomats who understood mechanism design issues. The EU was explicitly designed to lead self-interested nations into ever deeper and ever broader integration. The founders of EFTA had more modest goals – they wanted a Continent wide free trade zone without political integration – but they clearly thought about the impact of institutions on future integration.

This section extracts a handful of lessons from the European experience, separating the lessons into widening and deepening. Before turning to these, we start with a general proviso on how unique is the European experience.

The cataclysm of the two world wars convinced the Six to sign a document establishing a structure that contains a degree of supra-nationality that is almost unthinkable from today's perspective. These peculiar aspects of the EU are responsible for a large measure of the integration we see today, a fact one must keep in mind when drawing lessons for other regions. Most the EU's features are irreproducible in other regions of the world. In general, this points us to study the lessons of EFTA much more carefully than the lessons of the EU. After all, most nations in the world today count a loss of national sovereignty as a negative aspect of regional integration, as did the EFTAs. The founders of the EU, by contrast, viewed it as a plus.

4.1. *How Europe widened*

The domino effects of discriminatory integration were the main reason European integration spread so thoroughly. Political factors are what knocked over the first domino in 1957, and various political barriers (mainly the Soviet Union) stopped the domino process for a while, but it is simple, reproducible commercial factors that drove the widening forward in Europe. The same logic is driving regional integration across the world, including the Americas. The big difference is that no one seems to be in charge of the integration in the Americas. Here is where the lessons from Europe are important.

What has Europe done to allow regional integration to widen so smoothly?

Most regional trade arrangements started without a vision and turned into a loose collection of bilateral arrangements (e.g. NAFTA). Others started with high-minded vision, but no basis in commercial realities (e.g. AFTA). EFTA and the EU combined both vision and commercial realities, but with an important difference. The founding document of the EU was primed to create an ever-closer union. EFTA, on the other hand, was primed to create a pan-European free trade area. Since it is unlikely that any other group of nations is willing to embrace the EU's supra-nationality, the real lessons come from the Stockholm Convention and EFTA.

Britain, which was the driving force behind EFTA, viewed EFTA as the means of achieving a pan-European free trade zone for industrial goods. For this reason, EFTA contains a number of elements that proved useful when the organisation expanded. First, EFTA is not a matrix of bilateral deals. It is essentially a duty-free market pool. When one joins EFTA, one automatically grants and gains free trade access to all existing members. This all-or-nothing proposition reinforces the domino effect and ultimately makes enlargement easier. As an important part of this, EFTA foresaw a common set of rules of origin and cumulation. This allowed, in principle, a degree of integration that is deeper than one might otherwise expect. It also reduced the difficulty of negotiating the entry of new members. Moreover, there has always been an EFTA Secretariat and regular political and technical meetings among the members.

Once Britain left EFTA, the nature of the organisation changed radically, but in a way that holds many more lessons for the rest of the world, especially Latin America. From 1973, EFTAs were small nations who were all very highly dependent on the EU market. Thus EFTA became an important forum for coordinating responses to what the European hegemon – the EU – was doing. In essence, EFTA became part of the 'anti-spoke' strategy of the European nations that otherwise would have become spokes in the EU's hub and spoke system. Note that this was true even though intra-EFTA trade flows are fairly modest compared to EU-EFTA flows.

4.2. *How Europe deepened*

The deepening of European integration holds very few lessons for the rest of the world. In the EU, it was driven forward by the idiosyncratic supra-nationality agreed in the Treaty of Rome. In my opinion, had it not been for the EU Court's supremacy of Member State laws on matters of the internal market, the EU would be no more integrated than Australia and New Zealand are today. The deeper integration of EFTA markets via the EEA would not have happened were it not for the deepening in the EU.

Drawing more broadly, however, on Europe's experience, one can suppose that the juggernaut effect will work eventually in promoting deeper integration. There is, however, a subtly involved. As Baldwin (2000) points out, reciprocal liberalisation helps large efficient firms at the expense of small inefficient firms. This opens the door to a juggernaut effect at the firm-size level. The removal of tariffs leads to a restructuring in which small firms grow or disappear while large firms flourish. Since small, import-competing firms are often opponents of further liberalisation, liberalisation of some barriers changes the political economy landscape in ways that makes future liberalisation more likely. Melitz (2003) present a very amenable model of trade with heterogeneous firms in which this sort of effect is possible (see Baldwin and Robert-Nicoud 2005). The lesson therefore is that it is more important to get the regional integration started than it is to agree in advance all the integration steps that will follow. The integration itself will change the political economy forces in each nation in a way that will make deeper integration easier.

5. CONCLUDING REMARKS

European integration is most successful in regional integration experience by far. It is natural to look for Europe for lessons. The main thesis in this paper, however, is that the world has relatively little to learn from the European Union as far as the deepening of economic integration is concerned.

The EU started its life in circumstances that are almost unimaginable in today's world. The irreproducible circumstances lead to the creation of supranational institutions that prevented European integration from stalling at the level of free trade. Since it is impractical to propose that the Americas adopt this degree of supranationality, there is little to be learned from the EU's deepening experience.

On the widening question, however, Europe has much to offer. The EU's supranationality again prevents one from drawing many lessons from its history, but Europe's other trade arrangement – the European Free Trade Association, EFTA – does hold promise. EFTA was set up by nations that wanted to foster regional free trade with as little political integration as possible. EFTA set up a minimum of institutions and established the practice of a duty-free 'pool' rather than a matrix of bilateral arrangements. This greatly simplified its enlargement and its ability to deal with the 700 pound gorilla of European trade, the EU. This involved clear rules on how to expand the club and allowed for common rules of origin and cumulation.

REFERENCES

- Artis, M. and Nixson, F. (2001). *The Economics of the European Union*, Oxford University Press.
- Balassa, B. (1974), "Trade creation and trade diversion to the European Common Market" in B. Balassa, *European Economic Integration*, North-Holland, Amsterdam.
- Baldwin, Forsild, Martin, Ottaviano and Robert-Nicoud (2003) *Economic Geography and Public Policy*, Princeton University Press, London.

Baldwin, R.E. (1994), *Towards an integrated Europe*, CEPR, London. Manuscript freely downloadable from <http://heiwww.unige.ch/~baldwin/>

Baldwin, R.E. (2002), "Asian Regionalism: Promises and Pitfalls," paper presented at KIEP Seminar on East Asia Free Trade Agreement, held in Seoul Korea, 27 September 2002.

Baldwin, R.E. and C. Wyplosz (2003), *The Economics of European Integration*, McGraw-Hill, London.

Baldwin, R.E., R. Forslid and J. Haaland (1996). "Investment Creation and Diversion in Europe," *The World Economy*, Vol. 19, No. 6, pp 635-659.

Baldwin, Richard and A. Venables, (1995), 'Regional economic integration,' in Grossman and Rogoff (eds), *Handbook of international economics*: (Amsterdam: North Holland)

Baldwin, Richard E (1997). "The causes of regionalism," *The World Economy*, Vol. 20, No, 7, pp 865-888.

Baldwin, Richard E. (1987). "Politically Realistic Objective Functions and Trade Policy: PROFs and Tariffs", *Economic Letters*, 24, pp 287-290, 1987.

Baldwin, Richard E. (1993), 'A domino theory of regionalism', NBER WP 4465 (Cambridge). Published as: Baldwin, Richard E. (1995), 'The domino theory of regionalism', in Baldwin, Haaparanta and Kiander (eds.), *Expanding membership of the European Union* (Cambridge: Cambridge University Press).

Baldwin, Richard E. (1993), 'A domino theory of regionalism', NBER WP 4465 (Cambridge).

Baldwin, Richard E. (1994). *Towards an Integrated Europe*. CEPR, London.

Baldwin, Richard E. and A. Venables (1995), "Regional Economic Integration," in *Handbook of International Economics: Volume III*, G. Grossman and K. Rogoff (eds.), North-Holland, Amsterdam.

Baldwin, Robert E., and Richard E. Baldwin (1996), 'Alternative approaches to the political economy of endogenous trade liberalisation,' *European Economic Review*, 40, 7775-782.

Barbieri, Katherine and Gerald Schneider. 1999. "Globalization and Peace: Assessing New Directions in the Study of Trade and Conflict." *Journal of Peace Research*, 36: 387-404.

Bergsten, F. (1996), 'Competitive liberalisation and global free trade: A vision for the early 21st century,' (Washington DC: Institute for International Economics).

Bergsten, F. (1996), 'Open Regionalism,' (Washington: Institute for International Economics).

Bhagwati, J (1993), 'Regionalism and multilateralism: An overview,' in Anderson, K and Blackhurst, R. (eds), *Regional integration and the global trading system*, (London: Harvester-Wheatsheaf).

Bhagwati, J and A. Krueger (1995), *The dangerous drift to preferential trade agreements*, (Washington: American Enterprise Institute).

- Blomstrom, M. and A. Kokko (1997), 'Regional integration and foreign direct investment', CEPR DP 1659 (London).
- Brander, J. and P. Krugman (1983) "A reciprocal dumping model of international trade," *Journal of International Economics* 15, 313-321.
- Brenton, Paul and M. Manchin (2002), "Making EU trade agreements work: the role of rules of origin", CEPS Working Document No. 183. www.ceps.be
- Cable, V. (1994), 'Overview', in Cable, V. and D. Henderson (1994), *Trade Blocs? The future of regional integration*, (London: Royal Institute of International Affairs).
- CEA (1991), *Economic report of the President*, (Washington: Council of Economic Advisors).
- CEPR (1992), *Is bigger better: The economics of EC enlargement*, CEPR, (London).
- Commonwealth Secretariat (1995), 'Impact of Uruguay Round and Nafta on Commonwealth Caribbean Countries,' (London).
- Cooper, C. and D. Massell (1965), "Towards a general theory of customs unions in developing countries," *Journal of Political Economy*.
- Davis, D. and D. Weinstein, 2002, "Market access, economic geography and comparative advantage: An empirical assessment," *Journal of International Economics*.
- De Melo, J. and Panagariya, A. (1993), 'Introduction,' in De Melo, J. and Panagariya, A. (eds), *New dimensions in regional integration*, (Cambridge: Cambridge University Press for CEPR).
- De Torre, A. and M. Kelly (1992), 'Regional trade arrangements,' IMF Occasional papers, No. 93 (Washington).
- Deutsch, Karl W. 1968. *The Analysis of International Relations*. Englewood Cliffs, NJ: Prentice Hall.
- Dixit, A., G. Grossman and E. Helpman (1997), 'Common agency and coordination: General theory and application to government policy making,' *Journal of Political Economy*, 105,4, 752-770.
- Either, W. (1996), 'Multilateral roads to regionalism,' CIES DP, (University of Adelaide).
- Fernandez, R. (1997), 'Returns to regionalism: An evaluation of non-traditional gains from RTAs,' CEPR DP 1634 (London).
- Freund, C. (1998) "Regionalism and permanent diversion", Board of Governors of the Federal Reserve System International Finance Discussion Papers Number 602.
- Fujita M., Krugman P. and A. Venables (1999) *The Spatial Economy: Cities, Regions and International Trade* (Cambridge (Mass.): MIT Press).
- Galal, A. and B. Hoekman (1997), *Regional partners in global markets: Limits and possibilities in the the Euro-Med agreements*, CEPR (London).
- GATT (1993c), GATT/1596, Press Communiqué, 16 September (Geneva).

Grossman and Helpman (1996), 'Rent dissipation, free riding and trade policy', *European Economic Review*, 40, 795-803.

Grossman, Gene and Elhanan Helpman, (1994) "Protection for Sale," *American Economic Review*, 84, 833—850.

Harrison, G., T. Rutherford, and D. Tarr (1996), "The economic implications for Turkey of a customs union with the EU," Policy Research Paper, 1599, World Bank.
http://econ.worldbank.org/files/589_wps1599.pdf

Hillman, A. (1982), 'Declining industries and political-support protectionist motives,' *American Economic Review*.

Hillman, A. (1989), *The political economy of protection*, (London: Harwood Academic Publishers).

Hufbauer, H and Schott, J.(1992), *North American Free Trade: Issues and Recommendations*, (Washington: Institute for International Economics).

Hufbauer, H and Schott, J.(1993), *NAFTA: An Assessemnt*, (Washington: Institute for International Economics).

Hufbauer, H, J. Schott, and D. Clark (1994), *Western Hemisphere Economic Integration*, (Washington: Institute for International Economics).

Irwin, D. (1996). *Against the tide: An intellectual history of free trade*. Princeton: Princeton University Press.

Kemp, M. and H. Wan (1976) 'An elementary proposition concerning the formation of customs unions,' *Economic Journal*.

Kowalczyz, C. and R. Wonnacott (1992). "Hubs and Spokes, and Free Trade in the Americas," NBER WP 4198.

Krishna , K. (2003), "Understanding Rules of Origin", Pennsylvania State University mimeo.

Krishna, K and A. Krueger (1995)," Implementing Free Trade Areas: Rules of Origin and Hidden Protection", NBER WP4983.

Krishna, P. (1998) "Regionalism and multilateralism: A political economy approach," *Quarterly Journal of Economics* 113(1), 227-251.

Krueger, A. (1993), 'Free trade agreements as protectionist devices: Rules of origin,' NBER WP 4352, (Cambridge MA).

Krugman, Paul (1980) Scale economies, product differentiation, and the pattern of trade, *American Economic Review* 70, 950-9.

Krugman, Paul (1993) "The Hub Effect: or Threeness in Interregional Trade," in W. Ethier, E. Helpman and J. Neary (eds), *Theory, Policy and Dynamics in International Trade*, Cambridge University Press, Cambridge.

Krugman, Paul (1993) "The Hub Effect: or Threeness in Interregional Trade," in W. Ethier, E. Helpman and J. Neary (eds), *Theory, Policy and Dynamics in International Trade*, Cambridge University Press, Cambridge.

- Krugman, Paul (1993), 'Regionalism versus multilateralism: Analytic notes', in De Melo, J. and Panagariya, A. (eds), *New dimensions in regional integration*, (Cambridge: Cambridge University Press for CEPR).
- Lawrence, R. (1996), *Regionalism, multilateralism and deeper integration*, (Washington: Brookings Institute).
- Levy, P. (1997) "A political-economic analysis of free-trade agreements," *American Economic Review* 87(4), 506-519.
- Mansfield, E. and H. Milner (1999). "The New Wave of Regionalism," *International Organization* 53, 3, pp. 589–627.
- Mansfield, Edward D. and Jon C. Pevehouse. 2000. "Trade Blocs, Trade Flows, International Conflict." *International Organization* 54: 775-808.
- Martin, P. and G. Ottaviano (1996), "The geography of multi-speed Europe," *Economie Internationale* 67, 45-65. In English: CEPR discussion paper 1292.
- McCallum, John (1995), 'National borders matter: Canada-u.s. regional trade patterns', *American Economic Review* 85, 615–23.
- Meade, James (1955), *The theory of customs unions*, Oxford.
- Milward, A. (1992). *The European rescue of the nation-state*, Cambridge University Press, Cambridge.
- Oneal, John R., Bruce Russett, and Michael L. Berbaum 2003 "Causes of Peace: Democracy, Interdependence, and International Organizations, 1885-1992" *International Studies Quarterly* 46(1), March 2003.
- Panagariya (1996), 'APEC and the United States,' CIES DP, (University of Adelaide).
- Panagariya, A (1999), "Preferential trade liberalisation: The traditional theory and new developments", University of Maryland mimeo. (download form www.bsos.umd.edu/econ/panagariya/song/surveypt.pdf).
- Puga, Diego and A. Venables (1997). "Preferential trading arrangements and industrial location," *Journal of International Economics*, 43, pp 347-368.
- Robert-Nicoud, F. (2001) "A simple model of agglomeration with vertical linkages and capital mobility", LSE (mimeo).
- Sapir, A. (1992), "Regional integration in Europe," *Economic Journal*.
- Sapir, A. (1997), 'Domino effects in Western European Trade, 1960-1992,' CEPR DP (London).
- Schiff, M. and L. Alan Winters (2003). *Regional Integration and Development*. New York: Oxford University Press for the World Bank.
- Schott, J. (1988), 'The free trade agreement: A US assessment' in J. Schott and M. Smith (eds), *The Canada-US free trade agreement: The global impact*, (Washington: Institute for International Economics).
- Schott, J. (1989), 'More free trade areas?' in J. Schott (ed.), *Free trade areas and US trade policy*, (Washington: Institute for International Economics).

- Schott, J. and G. Hufbauer (1992), 'NAFTA: Questions of form and substance,' in Waverman, L. (ed.), *Negotiating and implementing a North American free trade agreement*, (Vancouver: The Fraser Institute).
- Serra et al. (1997), *Reflections on regionalism: Report of the study group on international trade*, (New York: Carnegie Endowment for International Peace).
- Smith, M. (1988), 'The free trade agreement in context: A Canadian perspective,' in *The Canada-United States free trade agreement: The global impact* (Washington: Institute for International Economics).
- Summers, L. (1991), 'Regionalism and the world trading system,' in L. Summers (ed.) *Policy implications of trade and currency zones*, Federal Reserve Bank of Kansas City.
- USTR (1981), *North American Trade Agreements*, (Washington: Office of the US Trade Representative).
- Viner, J. (1950), *The Customs Union Issue*, Carnegie Endowment for International Peace, NY.
- Weinberg, G. (1996). *Germany, Hitler and World War II*. Cambridge University Press.
- Whalley, J. (1993), 'Regional trade arrangements in North America: CUSTA and NAFTA,' in De Melo, J. and Panagariya, A. (eds), *New dimensions in regional integration*, (Cambridge: Cambridge University Press for CEPR).
- Whalley, J. (1996), 'Why do countries seek regional trade agreements?', NBER WP 5552 (Cambridge MA).
- Whalley, J. (1996), 'Why do countries seek regional trade agreements?', NBER WP 5552 (Cambridge MA)
- Winters, A. (1996), 'Regionalism versus multilateralism,' *World Bank Policy Research Working Paper 1687*, (Washington).
- Wolf, M. (1994), *The Resistible Appeal of Fortress Europe* (Washington: American Enterprise Institute)
- Wonnacott, P. (1987), *The United States and Canada: The quest for free trade*, (Washington: Institute for International Economics).
- Wonnacott, R. (1990) "U.S. Hub-and-Spoke Bilaterals and the Multilateral Trading System," *C.D. Howe Institute Commentary*, No. 23, October 1990, pp. 1-22.
- WTO (1995), *Regionalism and the world trading system* (Geneva: WTO Secretariat)
- WTO (2003), "The changing landscape of RTAs", *Regional Trade Agreements Section of the Trade Policies Review Division*, WTO Secretariat; paper prepared for 14 November 2003 seminar in Geneva.
- Yeats, S. (1997), 'Does Mercosur's trade performance raise concerns about the effects of regional trade arrangements' *World Bank Policy Research WP 1729* (Washington).
- Yi, S. (1996), 'Endogenous formation of customs unions under imperfect competition: Open regionalism is good,' *Journal of International Economics*, 41, 151-175.