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LOWY INSTITUTE PERSPECTIVES

INTEGRATION:
"THINK GLOBAL, ACT REGIONAL"

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Integration: “Think Global, Act Regional”

Stephen Grenville

While some may talk of “The End of Globalism” (Saul 2004), increasing international integration seems largely inevitable and on balance desirable. This does not mean that integration can be left to “just happen”, without much policy involvement. For all its potential, globalisation has brought both pluses and minuses, and transitional problems which are painful in themselves and which threaten the benefits. The pace and nature of integration are both amenable to influence. If the net benefits are to be maximised, international relationships need the same sort of complex set of rules and norms which exist within individual countries, but which are much less well developed internationally. Douglass North (North 1994) called this set of rules and norms “institutions” – “humanly devised constraints that structure human interaction”. It is in this sense that the case is made here that international relationships are seriously short of “institutions”, and that it should be an important part of policy to augment the sparse structure that is in place.

For the most part, these institutions will be developed within a multilateral framework, and Australia should continue to attempt to influence this universal regime process. Realistically, however, our lone voice carries only a modest influence. There may be two ways we could draw on the region (by this is meant mainly East Asia) to help overcome the institution shortage. First, there may be an opportunity to amplify our voice by joining a common cause with our regional neighbours – who are similarly under-represented in the rule-making forums. Second, there will be opportunities to develop rules specific to our regional groupings. Just as there are rule-making processes at national, state and local level, the international rule-set will be made up of a mix - or layering - of multilateral and regional arrangements – and, for that matter, bilateral. There is stronger motivation to act and a bigger pay-off for neighbours than there is for the international community as a whole: the self-interest is more prominent and the quid-pro-quo (and mutual benefit) more clearly defined.

There is a side benefit from these regional endeavours which is more indirect but may, in the longer term, prove to be more important. It draws on the experience of the European Community, where the formation of narrowly specialised technical institutions created a network of connections and a skeleton of institutional framework on which more far-reaching co-operation was built. This integration does not, of course, have to go as far as has occurred in Europe, where the economic institutions facilitated the growing degree of political integration (here we only have to look at the deep relationship Australia has with New Zealand to see the degree of economic integration that can be achieved without loss of sovereignty). It is enough if the economic institutions facilitate the same sorts of benefits that we get through getting along with our neighbours over the fence, without giving up much of our own autonomy of action. Just as society’s institutional framework brings us into close contact with our neighbours in order to sort out all kinds of issues, and in doing so we get to know each other and get along better, so too it can be with our regional neighbours. This sort of regional integration needs to be pursued more actively[1].

The point that is relevant to us in Australia is that, even if some of the economic issues currently under discussion in East Asia - common currency, optimal trade area, and pooling of reserves - do not seem to be priority issues in our narrow national interest, the institutional framework which builds up around those issues will be the forum and structure on which deeper regional integration will be built. We may not think these issues are of pressing importance to us, but if we let them "go through to the keeper", then we will miss out on the other more nebulous benefits of regional integration – learning to get along with each other. We need to recognise that there is already a very active network of co-operation, built largely around ASEAN (and increasingly, ASEAN + 3), and the importance of this goes beyond the often technical nature of the specific links. We may decide, as a nation, that "high fences make good neighbours", but in the view of this author, that would be a serious mistake. Of course, even if we are keen to take part, our Asian counterparts may take some persuading that we should be there. This may be difficult, but we should "give it a go": in fact, we should "give it our best shot".

Inevitable and Desirable?

Economic integration happens with the inevitability of water flowing downhill. The narrow economic case for international trade is long-standing (think of Hume's eighteenth century examples of cloth-for-wine trade) and intuitively clear: self-sufficiency is inefficient. Efficiencies of scale and scope seem very powerful, and these effects don't seem to have any obvious limits. A city like New York has the opportunity for a high degree of specialisation. Centres of specialisation seem to develop naturally, driven by their own efficiencies and synergies – e.g. Hollywood for films, Houston for oil. With this specialisation comes extra expertise and refinement of technique (think of Adam Smith's pin makers), in turn leading to greater efficiency (and the high incomes that go with this).

But integration brings opportunities beyond trade in goods and services – it brings ideas and new insights which are the drivers of economic improvement. At the policy level, integration can drive the wider reform agenda. Sometimes this is simply a case of learning by seeing how someone else does the job: Newton saw further than others because he stood on the shoulders of those who came before, and similarly, countries can get a leg-up from seeing how other people do things. We often see examples of ideas which have been brought home from overseas and applied successfully, without this leading in any direct way to more international trade. While it is true that competition from foreign products and techniques provides a powerful incentive for improvement, we should not think of integration simply in terms of opening up markets for trade. Perhaps the most compelling example of this is the impact of

[1] There is a huge literature on the economics of integration. It covers such issues as Optimal Currency Areas and the benefits of a single currency (see Mundell (1961), McKinnon (1963), Kenen (1969) and Rose (2000)). The need for international rules and the relationship between globalisation and sovereignty have been addressed by Rodrik (2000 and 2002), Grenville (2000) and Weiss (2003). Integration within the East Asian region and the role of regional union in reducing the impact of financial crises has its own huge literature (see Henning (2002), Thirlwell (2003), Adams and Semblat (2003), Asian Development Bank (2002), Agrawal and Prakash (2002) and Clarele, Edmonds and Walleck (2002), Bergsten and Park (2003)).

Admiral Perry's black ships in Yokohama in 1851. They may have opened up Japan for trade, but much more importantly, they opened it up for new ideas. The benefits of this "learning by doing" (or quietly borrowing other people's good ideas) are potentially huge and largely "non-rivalrous" – the originator of the idea often suffers no loss from sharing it. Drawing again on North: "adaptive efficiency is more important than allocative efficiency".

The Countercurrents

If this high degree of integration is such a good idea, why doesn't it just happen by itself? Against the compelling logic of integration, there are counter-currents which have inhibited implementation of the degree of integration that economic theory would suggest.

First, comparative advantage may be one of the few issues on which economists agree, but it is counter-intuitive, and has never really been accepted by the public at large, who by and large still see merit in self-sufficiency, and a desire to give available work to their fellow-countrymen.

Secondly, the benefits of integration are at an aggregate level – the economy as a whole is better off. But economic theory doesn't promise that every individual will be better off – only that there would be enough benefit to allow the losers to be compensated, and still leave a surplus.

These are familiar narrowly economic arguments, associated with trade in goods. More recently, the resistance to globalisation is on more general grounds. One of the effects of globalisation is a tendency for the homogenisation of cultures, and a trend for some of the interesting aspects of society (including the best jobs) to gravitate to the centre – the "winner takes all" phenomenon (so that local stars of sport and culture have to play second fiddle to the world-best performers). The judgement of the market says that we are better off, but we have to ask if this provides the stimulus and variety in our society to encourage and accommodate diversity, necessary for a tolerant and well-adjusted community. Are we comfortable when the best jobs shift overseas (the "branch economy" effect)? Is the narrow economic case for openness missing the dynamic aspects, which mean that the global winners will increase their advantage over time, attracting the smartest resources to the centre, and leaving the periphery with the lame and the losers? Relevant here are the arguments about "first mover advantage": once a country has established its position in a complex industry, it is hard for other countries to compete. At the same time, globalisation may make it harder to compensate the losers of economic change: high-taxing countries may be less attractive to investors (even domestic investors), causing capital to flow to those countries with less concern for redistribution. Globalisation sharpens the edge of capitalism – comparative advantage finds it harder to absorb the diversity found in countries and sharpens social divisions. There is a groundswell which resists integration, or at very least is yet to be persuaded. Globalisation is perceived as a *threat*, not an opportunity.

None of these counter-arguments takes away the powerful case for a high degree of integration, but they draw attention to the paucity of rules and institutions which can ensure that the full benefits of international integration are achieved, and that these benefits are equitably divided so as to make them politically sustainable. Just as domestic rules and institutions assist transacting parties to reach equitable outcomes and politically negotiated redistribution rubs the sharp edges off the free operation of market forces in our domestic economies, so too we need to rewrite and enhance the international rules to make the system work better, to address equity issues without doing too much harm to the undisputed efficiency gains from integration, and to reinforce the political compact which makes this degree of international integration consistent with national sovereignty.[2]

There are, of course, serious difficulties in writing these international rules. Most prominently, there is an apparent loss of sovereignty involved. But it would be easy to exaggerate the intractability of this issue. Many rules are in everyone's interests to adopt, just as it makes sense for us all to play soccer with eleven players. Standardisation makes international transactions easier and cheaper. Even when the rules serve to divide up the benefits of integration, the right response is to attempt to get the rules written equitably, rather than to say that we won't play the game at all. Being a sovereign autarky isn't the answer.

Why has the question of rule-making been glossed over in the debate on economic integration? The answer is partly in the sheer difficulty of getting sovereign nations to agree on anything (even something ultimately in their own interests): but it is also partly for doctrinal reasons. Most of the debate on globalisation has taken place between old-fashioned state-interventionists versus those who promote the fiction that today's "free-enterprise" economies somehow operate solely according to Adam Smith's "invisible hand", and joining the globalised world meant signing up to the free market model. As a representation or model of a modern economy such as the United States or Australia, this free market atomistic-player model is about as remote from reality as the pre-Copernican views of the universe. Once there is a recognition that the textbook free market model has application only to spot markets where goods and money are exchanges in the simplest way, and that any more complex (i.e. realistic) market has issues of time and geography to cope with, we understand why our domestic economies operate with such complex and ubiquitous rules. We might recognise, at the same time, that international markets (growing twice as fast as domestic markets) are further removed still from this "hands-off" free market model and have an even greater need for rules to facilitate relationships.

As soon as we understand that globalisation is not governed solely by Adam Smith's invisible hand and that there are countercurrents which inhibit its full development, we recognise the need for North's "institutions" – "made up of formal constraints (e.g. rules, laws and constitutions), informal constraints (e.g. norms of behaviour, conventions, self-imposed rules of conduct), and the enforcement

[2] This need for international rules (explored in more detail in Grenville (2000)) is closely related to arguments made by Rodrik (2002) that "Global markets without global governance are unsustainable" and Friedman (1999) that "as your economy grows (with globalisation), your politics shrinks". Weiss (2003) argues against the idea that globalisation diminishes the role of the state.

characteristics. Together they define the incentive structure of societies". This raises two questions. What international rules are needed? This will be examined in the next section. In the following section, we will explore the second issue: who will formulate and enforce them? The central issue that will concern us here is whether these rules and institutions should be multilateral, bilateral, or regional/collective.

Maximising the Benefits and Dividing them Equitably: the Need for More Rules and Institutions.

It would be hard to exaggerate the complexity and pervasiveness of rules, procedures and standards which govern commercial transactions within the jurisdiction of a single country. Rules lessen uncertainty and smooth transactions, governing the relationship between people and modifying the outcomes (and the sharing of the benefits) of these relationships. Think what a huge efficiency improvement comes from something as simple as everyone agreeing to drive on the same side of the road (at least within one country). Think what it does for international sport that the rules for the main games are universal: when the World Cup is held in soccer, no-one needs to learn a new set of rules to participate. There are two aspects of international rule-making. First, they need to be much more comprehensive. Second, there needs to be much wider and more effective participation in the rules-setting, not only for fairness (to overcome the current "democratic deficit" in rule-making), but to ensure that the rules take into account the legitimate needs of all the participants.

While multilateral institutions have been able to put in place a variety of purpose-built rules, many of the international rules currently in place derive, almost by accident, from history or the domestic rules in the largest countries. Some intellectual property (IP) rules date back to the colonial era and the British Empire. Any new drug or medical device has to get the US FDA approval if it is to stand a chance of selling internationally. Similarly, US patent and copyright rules will set the norms elsewhere – even when these rules have been made with US interests in mind.

Sometimes lack of consistent international rules opens up opportunities for avoidance of legitimate laws (e.g. tax evasion, or regulatory arbitrage where transactions are shifted to countries with lax laws). Society pays a price for these. In other cases there may be no intention to operate outside the rules – they just don't exist. Bankruptcy illustrates the point. Every country has its own domestic bankruptcy rules, to handle the *in extremis* cases where businesses no longer have the resources to repay their debts, and the means must be found to override legitimate contracts and either arrange delays ("Chapter 11" in the USA) or gather together the remaining assets of the enterprise and distribute them equitably among the creditors (usually, in these enlightened times, leaving room for the debtor to continue some sort of existence outside a debtors' prison). No such rules exist internationally[3]. During the Asian crisis there were examples where ad hoc arrangements were made, with universally beneficial outcomes (e.g. Korean bank debt rescheduling). But by and large such arrangements were strongly resisted by the

[3] The nearest thing to institutional arrangements is the "Paris Club" for government debt and the "London Rules" for other debts.

creditors – with frequent references to the "sanctity of contract" and warnings that capital would never flow again until debts were repaid in full.[4]

There are other sets of rules which have been written by a subset of the people who are affected, and so are unrepresentative of the overall needs. Internationalisation of finance has required that there be some uniformity of rules for prudential regulation, and these were developed by the G10 countries within the framework of the Bank for International Settlements (the central bankers' "club") in Basle. While these were developed specifically for the G10 banks, it was inevitable that they would become the international standard – no bank could participate fully in international affairs unless it met the Basle Rules. When these rules came to be reformulated a decade or so ago, in recognition of the narrow authorship of the original rules, a much fuller process of consultation took place, although it would have to be said that the new rules are tailored to the needs of the banks in the most advanced countries. So progress has been made, but there is still some distance to go.

Multilateral versus Regional; with Illustrations from our Region

The arguments so far make a strong case for integration, but *global* in scope, with global rules. The post WWII international infrastructure was multilateral in vision, with these institutions set up as guardians of the multilateral mode of integration: the International Monetary Fund, and the GATT, with its emphasis on 'Most Favoured Nation" i.e. some guarantee that all would be treated the same, with no special deals on tariffs.[5]

The mindset of received economic wisdom was also predominantly multilateral. By the 1970s, there was a universal model of how economies should be run – the 'Washington Consensus" [6]- with its multilaterist free trade market-based deregulated hands-off approach. Much was achieved with this multilateral emphasis (including in this region: Singapore may be best example of a beneficiary of openness). But the low-hanging fruit - the easy benefits - has largely been picked, and the system is up against the deeply entrenched recalcitrants – European, US and Japanese farmers, and the US shipbuilders to mention just a few. Multilateralism is not in retreat (a modest victory was notched up recently when the US rolled back its emergency steel tariffs) but, if not stalled, it is at least facing diminishing returns.

[4] At the time, the IMF was part of this process of resisting debt settlements. In part this can be explained by the lobbying of Wall Street (the efforts of the New York based IFI were notable), but the more important issue may have been the mindset of the time. As late as September 1997 (i.e. when the Asian Crisis was well under way) the Fund (at its Annual Meeting in Hong Kong) was attempting to have free capital movements embodied into the Fund charter, in the same way that free trade was. In this mindset, the "invisible hand" would work out solutions, and anything that smacked of "capital controls" was anathema. The Fund recognised that its position needed to be changed (see Krueger (2001), but even now, despite strenuous efforts to put in place measures which would cover only a part of the problem (i.e. sovereign debt), even this partial solution has not found agreement. One problem is that one of the lessons coming from the Mexican crisis of 1994/5 is that some countries and creditors will be rescued from a repayment (i.e. the Mexican Crisis left a "moral hazard" legacy), and this legacy had encouraged influential creditors *and* debtors to resist ex ante bankruptcy arrangements which borrowers feel will discourage lending to them and lenders feel might encourage easy reneging on debt (and close off the opportunities to do more resolutions of the Mexico and Korean variety, where they got full repayment, with no "haircut").

[5] Implicit but just as important, tariffs could only go one way – down. Where political realities forced recognition of regional trade arrangements, these were discouraged through Article XXIV, which required special dispensations.

[6] Although that terminology was not invented until later.

If further progress is to be made, it may be with a different and smaller number of participants around the table - participants who can identify their common interests more clearly, and who may be readier to trade off some elements of benefit (and perhaps some degree of sovereignty) in order to move to an overall improvement. There will be more opportunities for give-and-take trade-offs, so that rule-making becomes a true negotiation, rather than an imposed process. For all the importance of the multilateral rule-making framework, it can take us only so far: for example, wide-spread agreement on anything except trivia and platitudes among the nearly 200 members of the IMF is next to impossible. It is no accident that many of the existing international rules are either "principles" that didn't require a lot of thrashing out, or are imposed by a small group of big countries (again, not requiring much thrashing out).

Even where the rule-making is still at multilateral level, regional groups can learn to sing in unison to help the smaller and medium-size countries have their voices heard (one of the functions of the G10 is to co-ordinate their views in other forums). A more powerful regional institutional infrastructure could give the region a louder voice in international rule-making and, over time redress the under-representation of Asia (see Henning (2002) p73-4) in the councils of the world. Regional arrangements can be some counterweight to the power of the big nations in drawing up the rules and administering the multilateral institutions.

In any case, there is no presumption that international uniformity is always best. We don't need the same building codes in Sydney that they have in quake-prone San Francisco. It will not be appropriate to impose uniform labour standards on everyone. In fact one of the dangers is that inappropriate rules and standards will be imposed (as the Basle II Rules are doing??). This might be a case where subsidiarity is appropriate – devolve the power of rule-making to the lowest level at which it can be effectively made. In some cases, there are advantages in having a degree of competition in regulatory regimes (provided that this results in a "race for the top" – where the best regulatory regime is favoured by the market forces - rather than for the bottom, where market forces seek out the most lenient regimes)[7]. There will be many opportunities to develop regional rules which will have enough coverage and uniformity to be a major advance on the current feeble rule structure. The East Asian countries could, for example, agree to include collective action clauses in all the international bonds they issue (to help resolution in case of repayment problems). They could have their own foreign investment dispute resolution, with enough international authority to enforce outcomes[8]. One pertinent way of addressing the volatility of international capital flows would be to create a region-wide register of flows (co-ordinated with the BIS/IMF work in this area) to ensure that governments know what is going on and can respond to excessive inflows, rather than waiting for the damaging reversals of capital. They could have their own Basle Rules for prudential supervision, sufficiently tailored to their

[7] See Rubin Lee (2003)
[8] Such dispute-resolution is under active development in ASEAN.

own needs to make them more relevant to the financial sector of the region, while having enough uniformity and substance to re-assure the international financial community.

How is the East Asian region going in the integration stakes? There are many facets to this, but here we will concentrate on the economic linkages. There is quite a long history – most notably ASEAN, where substantial work and progress has been made across a variety of topics of the type suggested here[9] and, more recently, APEC. The Asian crisis of 1997-8 was a watershed and catalyst for exploring regional mechanisms which would make countries less vulnerable. "The reluctance of Asian Governments to leave all their stabilisation eggs in the IMF basket is understandable. The organisation is dominated by the United States and European governments and it demonstrated it fallibility during the 1997-8 crisis" (Henning (2002) p76). The crisis gave a great fillip to regional arrangements, because it was generally judged (rightly or wrongly) that the International Financial Institutions (representing the multilateral mode) had failed.[10]

The Chiang Mai Initiative (CMI) was one response, with the central objective of pooling some foreign exchange reserves. It was built on earlier currency swap arrangements between the ASEAN countries, but the size of the facility is much larger and the country coverage wider. This wider grouping ("ASEAN + 3" – i.e. ASEAN plus China, South Korea and Japan) seems to be the key emerging regional cohort[11]. Some see it as developing into an Asian Monetary Union (AMU) on the model of the EU (see Bergsten (2001) and Henning (2002)), while others see little gain and much difficulty in this direction (Wyplosz (2001)[12]).

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[9] See www.aseansec.org

[10] "The formation of the regional dialogue and co-operation was driven by the deep dissatisfaction with the IMF's performance in 1997 and 1998 and the perception that the US support was unreliable" (de Brouwer (2004(a))

[11] Just how the different groups will emerge (and how quickly) is still under debate – see Chalermpalanupap (2003)

[12] Certainly, when the differences in terms-of-trade shocks between, say, Japan and Indonesia are considered, the region does not seem to be an obvious candidate for an AMU, judged on the usual economic criteria of Optimal Currency Areas. Wyplosz sees the search for regional currency linkages as a premature reaction to the failure of soft pegs. In his view, it is far too early to conclude that regional currency arrangements will have an endurance significantly exceeding previous peg arrangements. He is sceptical of rigidly fixed arrangements – the cost is high ("macroeconomic stability function is precious, especially when it is recognised that the fiscal policy instrument is blunter and more politically sensitive"). Wyplosz argues that "Europe is unique" and contrasts this experience with that in East Asia:

- Exchange rate stability was pursued as an encouragement to trade, not as mechanism for reducing vulnerability. Stability among the members was the priority, not stability vis-a-vis the major external currencies. "A hard peg implies the same loss of sovereignty." "Monetary union requires the deep abandonment of sovereignty and the setting up of a common central bank." "It carries to distinct disadvantage of tying the Asian countries to far-away economies. It would be a very roundabout way of mimicking a monetary union, with most of its drawbacks and few of its advantages."
- There was an emphasis on institution-building. "Collective institutions become the advocates of integration. They move the debate from the purely political sphere to the technical level, allowing for professional assessment and avoiding costly mistakes. They can prepare the blueprints that can readily be put to use when the occasion arises, often unexpectedly."
- Optimal currency area arguments were unimportant – trade integration was the key issue, driven by politics of intertwining the economies
- Trade arrangements within Asia are common, but are numerous and fragmented rather than collective "For the task at hand, bilateral agreements are highly cumbersome. Bilateral bargaining is unlikely to foster a collective framework i.e. establish rules and arbitration processes"
- Real convergence (as measured by the stage of development) is much wider in Asia than in "old" Europe, or even New Europe.
- "the only feasible path for Asia must be to combine confidence-building steps and limited ambitions"
- There is a risk that CMI will be "both a beginning and an end".

Whether the bilateral currency swaps are important[13] and whether this will lead to AMU will be resolved over time. But Henning (2002 p30-31) is surely right in saying: "With the CMI arrangements, ASEAN+3 has created for itself an option that it did not possess a few years ago: to build upon these arrangements if governments of the region are dissatisfied with their treatment outside the region and multilateral institutions in future crises". Perhaps most importantly, it has created a forum for the discussion of regional issues at a technical level, and there is no need for this to be confined to the narrow agenda currently on the table.

In trade, there is still plenty to discuss. There are numerous trade oriented regional groups and the fact that trade integration is already very high (higher than Europe, even after the latter has had 40 years of integration) may suggest that these benefits have already been reaped. Is the way forward FTAs, which are the current vogue? There is a much stronger theoretical case for the sort of "open regionalism" practised within APEC (and set down as a work in progress at Bogor in 1993), and envisaged within ASEAN in the "ASEAN Vision 2020" than for bilateral FTAs.[14] The objective should be trade creation rather than trade diversion. To pick up the terminology of Lawrence (1996), agreements should be building blocks rather than stumbling blocks. The strongest justification for the FTAs now in vogue may be that "everyone is doing it": in the face of others setting up these kinds of trading arrangements, it may be better to follow suit rather than to be isolated. Of course, there is some hope that these FTAs not only expose countries to the benefits of foreign trade, but might also become so ubiquitous that they are not too far removed from multilateral free trade. But hub-and-spoke arrangements will never have the uniformity of approach that comes with wider agreements, and make the rules complex (what is "domestically produced"? – see Garnaut (2003)). It certainly seems to be a third-best world, whereas patience and persistence with regional arrangements would seem to offer larger benefits[15] [16]. This suggests one further specific area where regional co-ordination might have a big pay-off. If a template for FTAs could be established (covering, for example, common rules of origin) there might be a better chance, at least, that the hub-and-spoke approach might merge eventually into the "most favoured nation" (i.e. nondiscriminatory) paradigm.

These specific and detailed negotiations might open opportunities for wider discussions. The sort of deal-making and reciprocal trade-offs may now have more potential than in the past. China is now receiving 80 percent of the foreign investment flow to the region, and growing not only at a speed which has no match in the region, but in a way that (casting economic purity aside for a moment) might be typified as having "comparative advantage in everything". There is a danger that South East Asian

[13] Curiously, these are a series of bilateral agreements rather than an omnibus agreement. Exploring why this is so might reveal where regional arrangements are still striking problems.

[14] Lloyd and MacLaren (2003) make the case for free trade. See Schott (2003) for some of the pressures which have shifted countries away from the multilateral forum.

[15] The danger is, of course, "trade diversion", where the bilateral deal results in a country switching its imports from the cheapest source, to import from the bilateral partner. Those of us with long memories remember the cost we paid for the trade-distorting effects of the Commonwealth Preferences – was it Clive James who observed that the main question when purchasing a British-built Standard Vanguard car was whether the chrome bumper-bar would rust through before the muffler fell off? Even if bilateral deals result in a chain of further bilateral agreements, there will still be inefficiencies. Schott (2003) suggests that if Japan and Korea reach a bilateral agreement, this will give rise to a Korean-US agreement as US manufacturers redress the balance, which will require the Koreans to give US preferences in agriculture. This might well leave Australian agriculture disadvantaged.

[16] Wyplosz (2001) sees the East Asian trade institutions as very underdeveloped compared with the bureaucratic arrangements that supported the EU integration.

industry may be hollowed out and some countries may become "hewers of wood and drawers of water" to fuel China's growth. Whatever the immediate comparative advantage of some of East Asia's resource-rich countries, Indonesia and the Philippines (at least) both need to attract a good share of industrial development to cope with their population growth. Perhaps a regional trade arrangement could address this issue in the same way that ASEAN has tried to "allocate" industry specialisation among its members (the "Priority Integration Sectors"). This could, in time, become the forum for addressing the specific drawbacks and division of the benefits of integration. Similarly, small groups (rather than some global institution) are likely to be best at redistributing the benefits of integration. Intellectual property rights are another area where the region might find many common interests – particularly as net technology users rather than creators.

There is doubtless much more benefit to be reaped from these trade-enhancing activities, but the main benefits may lie in the swapping of ideas. "Idea-swapping" institutions should have the intimacy of a club[17]. Australia benefited greatly during the reforms of the 1980s from the peer pressure exerted by the OECD framework. One of the obligations of OECD membership is to submit to an annual "examination", at which a country's policies are subjected to detailed analysis by the OECD secretariat and members. Just as this pressure kept reform on the public agenda, East Asian countries can benefit from the peer pressures exerted by policy-oriented interaction at a regional level. Of course surveillance exists at the moment, but it is too nuanced, soft, forgiving, and less intrusive than is needed if it is to be a catalyst for reform.

One area where there is still a lot of work to be done (and where mutual support would be useful) is in the strengthening of financial sectors. It was the collapse of the financial sectors, rather than the exchange rate fall, which proved so damaging (and costly to fix) in the 1997-8 crisis. This was a lost opportunity: if a forum had existed to bring together and co-ordinate the views of the East Asian countries, the mistakes made by the IMF (see Grenville (2004)) might have been much reduced, and the domestic policy response might have been better. As well, better regional co-ordination might have allowed the region to tap the very considerable resources which Japan was offering through the Asian Monetary Fund, while providing a forum to correct its deficiencies.

In all of this discussion about detailed specific technical issues (such as reserve pooling) one of the important functions of these micro institutional arrangements is to provide the framework for countries to get along with each other and resolve disputes. Not surprisingly, this is most clearly recognised at the regional level - the highest priority is always to get along with our neighbours. The European Community provides something of an example, where the initial institutional building blocks were purely economics oriented arrangements (e.g. the European Coal and Steel Community), but which developed to the stage where the ties are now so strong, and the economic integration so deep, that a war among the members – or even a major falling out - is unthinkable. The co-ordination is now very

[17] It might be worth noting that effective discussion sometimes requires the dominant powers to keep a low profile. US should accept exclusion sometimes, recognising that it can sometimes be "the elephant in the canoe".

wide-ranging, covering, for example, foreign policy. Why did it work? It is worth noting that it took a long time and required an inordinate amount of persistence. Wyplosz (2001) argues that the presence of substantive bureaucratic institutions was vital to this process. The bureaucrats always had a plan in the bottom draw which could be produced, whenever the political climate was propitious, to shift the integration forward. Of particular interest is the reform dynamic of new membership: the strongest force for economic reform in Eastern Europe at present is the prospect of membership of the EU, with the obligations and rules this implies. The central lesson is that when countries get used to talking to each other, and develop bureaucratic dialogue, there will be an ongoing search for new areas of co-operation. When there are enough of these spiderweb ties between countries, political problems will be addressed in rational ways – “jaw-jaw rather than war-war”. But the benefits go far beyond preventing wars – just as talking with one’s neighbours opens up all sort of opportunities for fruitful co-operation, so too with nations.

This discussion has focused on the East Asian region, because that is where the challenges lie for Australia. For completeness, however, we need to mention two different and successful modes of integration. First there is the CER between Australia and New Zealand – bilateral arrangements which have led to the near-complete economic integration of the two countries. Two points from this experience are worth noting. Despite many similarities in the economies, this has not yet produced a currency union. Nor has it produced the slightest tendency towards political union (some would say that it has sharpened the rivalries!). The second example has been mentioned in passing already: the successful existence of international institutions which are neither multilateral nor regional. The OECD is a good example of this, and its powerful role in promoting globalisation and better policymaking within countries has already been noted. The Bank for International Settlements is another – a reminder that international co-operation will often be based on common technical issues and expertise, rather than geography.

Success will come through a layering of institutions. Multilateral, regional and bilateral arrangements each meet different purposes, providing competition, and checks and balances. We shouldn’t be surprised at this layering, or see it as superfluous. After all, most countries have three layered levels of government to handle the variety of problems which arise at different levels.

Conclusions: What is Australia’s Role?

Where does Australia fit in this argument for more regional integration?

By the mid-1990s Australia seemed quite well placed in terms of regional integration. APEC (with Australia as a prime mover) was meeting regularly at Head-of-State level and substantive content was being put into the relationship via the Bogor Agreement. While Australia was not a member of ASEAN, strong links had been formed, and it was not out of the question that these might lead to some form of associate membership. There were close working ties on all sorts of operational matters with our Asian neighbours (most notably, the Security Agreement with Indonesia). Above all, there seemed to be an altered mindset within the Australian public, which found a new balance between the old ties to Europe, the vital links to the USA, and the emerging possibilities in a rapidly growing East Asia. This seemed to promise so much.

Today, much of this regional re-orientation has been lost. With APEC weighed down with extra membership, much of the action has shifted to the more manageable ASEAN+3, and the geographic centre has shifted northward, away from us. If (as seems likely) the Asian Crisis of 1997-8 can explain much of this re-orientation, this outcome is ironic, as Australia responded well to the crisis. Australia was quick to join the support packages that were put together (Japan and Australia were the only countries that participated in all three support exercises) and we were active in lobbying with the USA and the IMF when they seemed to be misreading the seriousness of the situation in Indonesia[18]. Its own economic policies during the crisis – principally allowing the exchange rate to move a fair way, while supporting it against the most extreme movements, without tightening either monetary or fiscal policy – paid off. Of course we made mistakes as well. When the Japanese proposed an Asian Monetary Fund, we should have welcomed the idea *in principle*, and constructively suggested how the original proposal needed modification (specifically, to include IMF-type conditionality of some kind), rather than viewing the proposal through the prism of the IMF/ USA viewpoint, with their obvious chagrin at being excluded[19]. At the same time, we may have misunderstood what were the most fruitful vehicles for co-operation – the resources we put into being part of the ASEM process seems absurdly out of proportion to the potential importance of this grouping: the discussion above shows why we need to be in *regional* forums which will serve a substantive relationship building role (i.e. ASEAN+3), not a talk shop for partners widely separated by their geography and peripheral in their common interests. Similarly, the effort we have put in to the Commonwealth (whose members have no geographic links and very few common interests) [20] was a waste of our diplomatic effort (see Gyngell 2003).

One further curious anomaly in our recent history of international involvement was the key role Australia played in widening the GAB to become the NAB[21]. When we observe how these funds are used to support countries of interest to the G3 (often of little immediate importance to us), while our experience during the Asian crisis tells us that such funds will not be readily available for crises in our region, we might conclude that our effort and contribution have been misdirected.

More ominously, it has been demonstrated that there is a vein of insularity and narrow-mindedness in Australia which can be tapped by any politician who wishes to exploit it: coming to terms with Asia is a generational process, not yet complete and easy to divert for short-term political gain.

[18] Although it would have to be acknowledged that we did not have much impact.
[19] Interestingly, Henning notes that the first reaction of the IMF MD was in favour, and that he had argued for more regional arrangements of a GAB type (Henning (2002) p68)
[20] This led to us defending the rights of Zimbabwe's white farmers whose position – whatever the judgements about "fairness" - was a historic anachronism in the post-colonial world.
[21] The General Arrangements to Borrow was a G10 agreement to facilitate mutual support in balance-of-payments crises, using the IMF as implementer. This was replaced in 1998 by the New Arrangements to Borrow, with wider membership (including Australia), increased funds and a wider geographic mandate.

What might we do? In a rather unwelcoming environment, Australia's purely diplomatic effort may be doing about all that it can. This suggests we might turn our efforts to more specific forms of co-operation. One of the recent successes has been the co-operation between the Australian police and their Indonesian counterparts following the Bali Bombing. One particularly noteworthy element of this success is the fact that it has been so low-key. It is an example of the specific spiderweb ties that, in themselves, may not seem to have a great diplomatic meaning but taken together will help the countries exchange ideas, and smooth out misunderstandings as they arise. We might speak up more loudly in favour of regional arrangements. The US is ambivalent when others are doing them (planting faint praise on CMI: see Truman, quoted by Henning (2002 p13), while using them when it suits its interests (e.g. NAFTA, NAFA).

While accepting that there may be case for Australia to spend more on defence, soldiers seem the wrong presumptive response to the issues that might arise in our region. What about more effort to get good reporting by Australian journalist on our region? What about many more links between our bureaucrats (as has happened with the police)? In business, we are being left behind by Singapore, which sees a more urgent need than we do to build business ties in countries such as Indonesia, which will help both their countries. One area of potential serious aggravation is NGOs, who want to mix their humanitarian aims with a type of intrusive politics which will often be unwelcome and unhelpful to our national interests.

What has Australia got to offer, in what must be a two-way relationship? The list is impressive enough: its eclectic multicultural "can-do" successful society; mostly "good" history; education skills and capacity; well-developed and pretty effective corporate law and governance; deep experience at local Government, in a world which is emphasising greater decentralisation; privatisation experience, where this is still high on the agenda; experienced journalism and a free press; its experience at economic reform – recent and pretty successful. This non-exhaustive list shows that there is a lot more than trade or professional diplomacy. But most of the people involved in these activities don't see themselves as the vehicle for integration and reform: they are not intrinsically insular - it's just that they have a job to do in Australia and don't feel any particular pressures to widen their horizons. The greater focus on "bottom line" and the achievement of specific objectives has taken the focus off the wider, longer-term objectives. Nowhere is this clearer than in our universities, which are happy to become outward looking and international if it helps their budget, but (for the main part) will leave the longer-term national interest issues (including the debate on Australia's place in the world) to someone else. The task is how to change this? If the argument made by Wyplosz (2001) in relation to the European Union is correct, this requires much more than the occasional get-together and chinwag: we need to build institutional ties. Twinning arrangements between like-minded institutions might be a start. But it will not happen if we just leave it to the forces of the market. We need an action agenda, and it is hard to see who can provide this, if not the government. One place to start would be to make it clear to Australian government institutions that they should actively seek out a role with our regional neighbours: when East Asians get together to discuss water, weather or worms, their Australian counterparts should have made every effort to be there, even if there is no immediate benefit to their own institution's narrowly defined objectives. This should be part of the work program and strategic plan.

Let me make one last point that links economics and politics. We have seen a lot of debate over whether Australia is part of Asia, with suggestions that this should be measured in terms of *similarities* (e.g. by percent of population of Asian origin, or similarity of mindset). In economic terms, this is the wrong perspective. One of the oldest, simplest and strongest lessons of economics is that the benefits of integration will be greatest if the partners are *different* – if they have complementary skills and resources, rather than the same. The question here is whether we are *different* enough to make a significant contribution (combining this, of course, with the sensitivity and understanding to make co-operation feasible and the energy to harness these complementarities in the sustained way that will be needed to make an impact). Do we view the world differently? Is our background different? Are our skills and resources different? The answer to these questions is obviously "yes", and it is this difference that will give us the opportunities to reap the efficiencies of complementarity, to our mutual benefit.

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