

Langhammer, Rolf J.; Schweickert, Rainer

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## EU integration and its implications for Asian economies: What we know and what not

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**Kiel Institute for World Economics**  
Duesternbrooker Weg 120  
24105 Kiel (Germany)

**Kiel Working Paper No. 1264**

**EU Integration and its Implications for Asian Economies**  
**– What We Know and What Not**

by  
**Rolf J. Langhammer**  
and  
**Rainer Schweickert**

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# **EU Integration and its Implications for Asian Economies**

## **– What We Know and What Not**

### **Abstract**

In this paper, we analyse effects of EU integration on Asian countries. Since the early 1990s, it is especially the trade creation effect of monetary integration (so-called Rose effect) which is heavily debated in the literature. Recent papers seem to indicate that the Rose effect seems to be significant especially for countries like the old EU members which are already highly integrated in terms of trade and factor mobility. The potential discrimination effect against trade with third countries tends to increase with new member states entering EMU and could also affect Asian economies' exports to Europe. At the same time, so-called overlap or similarity indices for trade patterns show an increasing similarity between EU, US, and Japanese exports to Asia on the one hand and Asian and European exports to industrialized countries on the other hand. These observations are consistent with recent policy responses, i.e., the focus of European contingent protection on Asian competitors, the desire of Asian countries to negotiate free trade agreements (FTA) with the US and Japan, and the EU's response by probably entering into FTA negotiations with Asian countries, including ASEAN.

Keywords: Trade, Monetary Integration, Protection, FTA, Overlap Index, Europe, Asia

JEL-Classification: F13, F15, F31, O52, O53

### **Rolf J. Langhammer**

Kiel Institute for World Economics  
24100 Kiel, Germany  
Phone: +49/431/8814-203  
Fax: +49/431/8814-500  
Email: [rolf.langhammer@ifw-kiel.de](mailto:rolf.langhammer@ifw-kiel.de)

### **Rainer Schweickert**

Kiel Institute for World Economics  
24100 Kiel, Germany  
Phone: +49/431/8814-494  
Fax: +49/431/8814-502  
E-mail: [rainer.schweickert@ifw-kiel.de](mailto:rainer.schweickert@ifw-kiel.de)

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## I. Introduction

The process of EU integration has been a unique and unprecedented endeavour in both political and economic history to create domestic market-like conditions for a number of politically independent states. The literature on this process is endless. So are efforts to mimic various stages of European integration in other parts of the world, especially in developing economies, and so are failures. The large number of failures suggests special conditions to exist in Europe which cannot be duplicated elsewhere even after almost half a century of training field preparation.

In this paper, we are rather concerned with external effects of EU integration on Asian countries. The question is whether EU integration stimulated third countries' economic growth and trade more than what individual EU member states could have achieved without integration only by adhering to MFN-driven multilateral liberalization. This search for the counterfactual to EU integration has stimulated both theoretical and empirical research for long time. It concentrated on assessing and comparing the magnitude of the internal welfare-enhancing efficiency effect of integration deepening for a widening group of countries on the one hand and the welfare-decreasing discrimination effect of treating non-member countries less favorably than member countries on the other hand. Substantial welfare effects for the rest of the world can be expected as long as internal and external liberalization are interconnected<sup>1</sup> as was the case with the manufacturing but not in the agricultural sector. Additionally, monetary integration has to be taken into consideration. By lowering transaction costs within the Eurozone trade may have been created on the expense of countries outside the Eurozone. Finally, external effects of European regional integration arguably depend on trade policies towards specific countries or regions.

In order to collect the empirical evidence on EU integration effects on Asian countries, we proceed in two steps. In a first step, we survey the literature on growth and trade creation effects of EU integration in Europe (Section II). To the extent that real sector and monetary integration have increased economic growth and intra-EU trade this should have had an impact on Asian countries. In a second step, we look into the more direct impact of EU integration on Asian trade patterns. In Section III.1 we calculate the overlap of EU vs. other-OECD exports to Asian markets and of Asian vs. South European exports to EU and US markets. We argue that increasing similarity of trade patterns can explain recent trends in trade policies, i.e. mushrooming FTAs in Asia and EU contingent protection (Section III.2). Section IV has the conclusions.

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<sup>1</sup> See for example for older literature Jacquemin, Sapir (1990, 1991) or more recently the conclusion of "new regionalism" (Ethier 1998) that successful regional integration requires preceding multilateral liberalization.

## II. Growth and Trade Creation in Europe – in Search of the EU Effect

Since its foundation in the fifties, EU members have discontinuously reduced their internal barriers to trade and factor movements parallel to lowering external barriers to trade. The start of the European integration project is ineradicably intertwined with the legacy of post-war political reconciliation with Germany as the former enemy on the one hand but a leading economy in Europe already in the mid-fifties on the other hand. As political integration at that time was still far beyond any realistic chance of implementation, economics served as a vehicle to further political reconciliation and later on political cooperation and integration. In short, the old colonial phrase saying that “trade follows the flag” was reversed in the sense that the flag followed trade. Preconditions were favourable in the post-war period with rapid economic growth driven by factor accumulation (reconstruction), traditionally strong trade ties between the founding member states of the European Economic Community (EEC), and a clear road map of stages of integration.

The latter aspect was particularly important (Langhammer 2002). Sectorally limited integration (the European Community for Coal and Steel) was widened towards a process of complete industrial goods market integration and gave agriculture a special status from the very beginning. The classical stages of integration in four steps (free trade area, customs union, common market and economic union) were made public and credible as medium-term target with a logical sequence of goods market integration and common policies against third countries (customs unions) to be initiated first and replicated for agriculture, services, capital flows and free circulation of labour later. In each of these stages a removal of barriers to transactions (integration) was supported and made irreversible by cooperation, that is by agreeing on common policies.<sup>2</sup> In economic terms, this can be called the move towards the law of one price which usually is violated in transactions between economies due to policy-induced barriers (tariff and nontariff barriers, restrictions against factor flows) as well as due to market-based transaction costs such as high costs of information, market exploration and uncertainty. Common policies in their final stage are instrumental to reduce the risk premium on cross-border transactions.

According to Pelkmans (2002), the European treaties marked milestones in the development towards a full-fledged internal market. The most important step remains clearly the Treaty of Rome after which the simultaneous implementation of the free trade area and the customs union for industrial goods between 1958 and 1968 was achieved in five sub-stages. This process resulted in a robust decline of price divergence between member states, and thus indicated the successful move towards the law of one price signalling integration deepening.

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<sup>2</sup> It is important to keep in mind the different meaning of integration (removal of barriers to transactions) vs cooperation (common actions against third parties).

Individual European countries implemented this process from different initial levels of trade costs and at different starting points due to adding new members to the six founding member states. One should expect this process to be growth enhancing as it reduced discrimination against third countries through external liberalization and at the same time exploited the potential of a widening market.

In a recent paper, Badinger (2005) tries to assess the growth effects. He scales reductions in protection indicators for each of the EU-15 member states and yields for the EU-15 aggregate group a level of tariff-based integration (remaining level of tariff protectionism) of about 87 percent (13 percent) of its 1950 level in year 2000 (ibid: 59). While the indicator fails to include non-tariff barriers (NTBs), the Common Agricultural Policy (CAP) and transfers from the Structural Fund and thus probably overrates the dismantling of access barriers, it nevertheless seems to provide a reliable proxy for the process of integration. Remaining barriers comprise the average common external tariff level in industrial products being the proxy of trade costs in EU-external trade. These trade costs were internally scrapped through implementation of the four freedoms (trade, labor, capital, establishment) in the single market program.. Panel estimates which Badinger introduced with data on growth rates of per worker capital stock, human capital proxies, the integration proxy and openness lead him to conclude that growth effects of EU integration had been of temporary and not of permanent nature. Yet, he concludes that GDP per capita of the EU had been about one-fifth lower in year 2000 if integration had not been proceeded since 1950 (ibid: 74). The “no integration” counterfactual is most likely too extreme as some sort of integration had certainly come anyway through market forces and technological progress as in all other parts of the world. Nonetheless, it is safe to argue that EU integration both widened and deepened markets and thus facilitated investment in Europe much beyond what had been achieved in other areas of the world except for the US.

Such effects, however, have been threatened by erosion. Patterns of income convergence of EU countries relative to the US benchmark suggest that over four decades (1960–2000) the speed of convergence slowed down decade by decade in spite of the most ambitious integration program implemented by the EU during the last decade, the 1992 completion of the single market (see e.g. Cotis 2004). Put it differently, there is much evidence that either EU-inherent obstacles such as high regulation in product and labor markets or US-inherent advantages in better exploiting the technological leapfrog of the “new economy” prevented EU countries from collecting a larger growth dividend from institutionalized integration than they could actually gain.

To sum up, given that EU 15 annual per capita growth rate of EU between 1950 and 2000 (at 1990 PPP) was about 2.9 percent (Maddison 2001: 185), the EU effect accounts for about 0.5 percent. From that we can derive four major implications for the effects of EU integration for Asia.

First, one can put these estimates into the perspective of similar endeavors in the past to assess EU additional economic growth due to the completion of the single market in 1992 (Catinat et al. 1988). Dynamic simulations based on the HERMES model of the EU Commission and the INTERLINK model of the OECD yielded an average increase in annual GDP growth of the EU of 3.1 percent over six years (measured as a percentage change from the baseline run of EU growth without the single market), i.e., six times as much as EU-induced growth over 50 years. Verbiest and Tang from the Asian Development Bank used these estimates to assess the impact on Asian countries' growth. The maximum (average) impact of EU-1992 on Asian countries was estimated to be one third of a percent of baseline GDP at the end of the six years period (Verbiest and Tang 1991: Table 4.2.) for the most open and most strongly EU-oriented economies of Hong Kong and Rep. of Korea. The lowest effect was found for the large relatively closed South Asian economies (India, Pakistan) with only one twentieth of a percent.

The EU single market program was an unprecedented period of accelerated integration embedded into longer periods of standstill before and after. Against this background, the 0.5 percent EU-induced additional growth for the entire period of post-war European integration compared to about 3 percent for the period of accelerated integration seems commensurable. It can be translated into a back-on-the-envelope-calculation of one twentieth of one percent growth of GDP for the most open Asian economies and to a "quantité négligeable" for the closed economies. On aggregate for all Asian countries, direct effects of EU integration are closer to the lower bound given the weight of the large inward-oriented economies.

Second, these direct effects must be complemented by important indirect second-round effects. To mention few of them, EU integration has contributed to real income gains through price and income effects. EU integration deepening enhanced competition supported by an increase of external imports in apparent domestic consumption and pushed world market prices downward in which EU suppliers were active. Typically, these were sophisticated capital products imported by Asian economies. Net importers of these products collected terms of trade gains. For instance, the EU single market program has been estimated to reduce the price level (measured by the EU GDP deflator) by 1.7 percent in the first year with a maximum of 6.5 percent at the end of the six years period (Catinat et al. 1988). Income effects through higher EU-induced demand were transmitted to EU trading partners such as the US and emerging markets, which triggered higher demand for Asia-originating products.

Third, the interaction between EU integration and multilateral trade liberalization is important. While advocates of "new regionalism" argue that multilateral trade liberalization has made regional integration efficient and therefore successful (Ethier 1998), it is likely that in the EU case (but probably in other integration schemes as well) causation has run two ways. On the one hand, EU participation in multilateral rounds parallel to the removal of EU

internal barriers raised EU competitiveness through speeding up factor allocation towards sectors in which the EU enjoyed comparative advantages. It thus paved the ground for further integration deepening without running the risk that integration would be income-diverging within the union. On the other hand, the growth impulses originating from EU integration deepening may have mitigated both domestic opposition against multilateral trade liberalization and external opposition against an allegedly inward-looking “fortress”. In total, this might have been especially helpful for Asian economies as they do not (yet) maintain privileged reciprocal trade relations with the EU but instead are subject to MFN treatment (apart from the unilateral concessions of the Generalized System of Preferences (GSP)).

Fourth, as growth effects of EU integration seem to have faded in recent years, it is likely that the speed of sectoral structural change in Europe has diminished. Asian countries might then see themselves curbed in their output expansion not only by weak demand but also by defensive policies of EU economies to lower the adjustment burden following supply pressure from Asia.

To sum up, growth effects of EU integration are on average rather modest. Hence, direct effects on Asian countries are low or even negligible. More important seem to be trade effects in the earlier stages of post-war European integration. EU trade effects were mainly determined by policies to dismantle internal barriers to trade parallel to harmonizing and removing trade barriers against non-member countries. Therefore, the discussion on trade effects of EU integration on third countries centre around the issue of discrimination. Discrimination of third country suppliers against member states is the *raison d’être* of regional integration, or – more precisely in order to deal with open regionalism APEC-style – of institutionalized regionalism. To assess whether trade between the EU and Asia would have developed differently without EU trade policy discrimination requires information about the counterfactual, i.e., the effects of MFN treatment by the EU.

Gravity model type of analyses of trade patterns yield that trade integration led to diminishing growth rates of trade between the EEC countries and non-member states over the 1957–73 period. Such trade diversion peaked after the beginning of implementing the free trade area and customs union programmes at the end of the fifties (Bayoumi and Eichengreen 1997). Similar analyses confirm trade diversion to be effective in the early eighties albeit from a high level but, surprisingly, extra-EU trade recovered just during the period of 1986–87 when the single market programme was implemented (Soloaga and Winters 1999a, 1999b).

In recent past, measuring the discrimination effect became an issue when the Eastern enlargement of the EU was implemented and its effects on East Asian trade were assessed (Plummer 1994, Horne and Huang 1996). Their findings confirmed some trade diversion to be likely but with small magnitudes. So were overall macroeconomic effects (Lee and van der Mensbrugge 2004). Similar lessons can be drawn from the analysis of EU integration deepening on EU trade with ASEAN (Plummer 2003) and from the trade effects of



completing the EU single market for Asian countries (Verbiest and Tang 1981). Overall, import market penetration ratios of advanced suppliers of manufactured goods many of them were from Asia rose in the EU similar to those in the US except for agriculture where such rise was much smaller and occurred but recently.

This underlines the relevance of EU external trade policies which in the aftermath of the Uruguay Round received increasingly favourable ratings from the WTO Trade Policy Reviews, except for the CAP which “modified ‘natural’ trade patterns and resulted in trade diversion” (Jacquemin and Sapir 1991: 169). Moving from shallow to deep integration and incorporating other engines of EU trade effects such as policy harmonization seem to have complemented trade policy instruments.

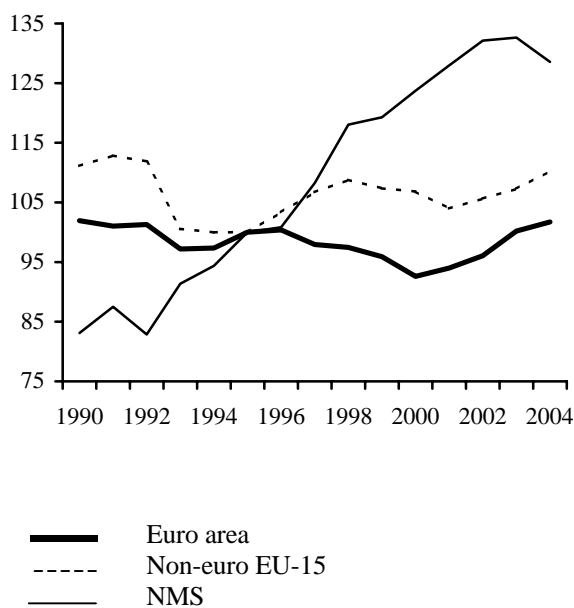
While most of the real sector integration effects are already priced in to a large extent, monetary integration effects are not and, therefore, figure prominently in the recent discussions.

Concerning potential trade gains of monetary union, Rose (2000) found that the trade effects of using a common currency are positive, statistically significant and very high: he estimated that countries with a common currency trade over three times more than countries using different currencies. Frankel and Rose (2000) found the same and also that this additional trade has substantial positive effects on growth. On the other hand, subsequent studies came up with results that indicate either small, negative or non-significant trade effects from a monetary union (Nitsch 2002, 2004; Pakko and Wall 2001; Persson 2001). Looking specifically at the early euro area experience, Vinhas de Souza (2002) and De Sousa and Disdier (2002), find negative or non-significant trade effects, while Micco et al. (2003) find small but significant positive effects. Some of those results may suggest that participation in a monetary union could hold some potential trade (and, eventually, growth) enhancing effects, although there is limited knowledge concerning to what extent these effects may be distributed among the countries participating in a monetary union and also concerning the time profile of these eventual gains, i.e., how quickly these effects would take to eventually materialize.

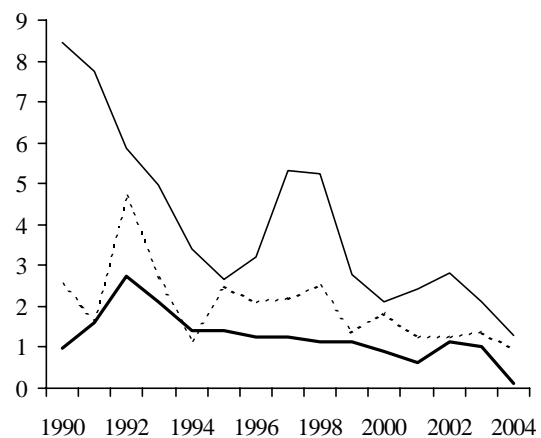
A reason why positive trade effects from monetary union may be low in Europe, providing a lower-benchmark for the effect generally to be expected becomes evident if one looks at the underlying transmission mechanism. The trade gains expected from a monetary union can be assumed to be related to the lower trading costs which, in turn, are imposed by declining real exchange rate instability. Figure 1 shows that real effective exchange rate changes have been rather small in EU-15 and became rather more synchronized between EMU and non-EMU after 1999. The changes for the New Member States (NMS) are clearly larger and dominated by an increasing trend, related to (a) the long-run catch-up process, and (b) the recovery from their substantial “entry” devaluations in the early 1990s. Hence, real exchange rate changes were significant but rather predictable.

Figure 2 shows the yearly standard deviation of the real exchange rates as a measure of uncertainty related to the development of real exchange rates. According to this proxy, uncertainty should have been lowest in EMU countries but, again, there is no significant effect of monetary union.<sup>3</sup> The volatility observed among the NMS is still somewhat above the one observed for the euro area members, but has already fallen to values quite similar to the ones observed among the non-EMU countries, and that from much higher average starting values.

*Figure 1:*  
Real Effective Exchange Rate (unweighted averages)<sup>a</sup>



*Figure 2:*  
Standard Deviation of Real Effective Exchange Rate (unweighted averages)<sup>a</sup>



<sup>a</sup>Annual real effective exchange rate is based on the trade weighted nominal exchange rate divided by a price deflator.

Source: Datastream; own calculations.

Nevertheless, recent empirical studies seem to reconfirm the Rose effect especially for the group of EU-15 with relatively low volatility of the real exchange rate. These are based on the results produced by Micco et al. (2003) showing that the Rose effect depends on the time horizon, the control variables, and the country sample, i.e., that estimations of the Rose effect are sensible to the specification of the regression equation.

<sup>3</sup> The difference between the two groups has actually become smaller after 1999. This effect, however, is essentially due to the high volatility of the non-EMU countries in 1992, the year of the ERM I crisis.

Berger and Nitsch (BN; 2005) show that the Rose effect shrinks if one looks at European integration since the early 1990s as in Micco et al. (2003) and substitutes the usual control variables in the gravity equation by country-pair fixed effects. As argued by BN allowing for country-pair fixed effects accounts for any tendency toward bilateral trade, i.e., also effects which are not fully captured by the gravity equation.

Table 1 shows the elasticities calculated on the basis of the BN regressions for the EMU dummy (=1 for all pairs of EMU members). In a short run horizon (1992–2003), the Rose effect shrinks to about 15 percent, i.e., membership in EMU increases bilateral trade by only 15 percent compared to more than 40 percent in a full gravity specification for the European countries' sample. However, adopting a long-run view by looking at European integration since the late 1940s and early 1950s respectively increases the impact of monetary union on trade to more than 50 percent. This number stays fairly constant even if variables for volatility and (time varying) real integration are included as control variables. However, the different estimates for the OECD compared to the European sample indicate that trade among the Europeans is different. Actually, integrating a time-trend for the whole post war period which may catch the – with hindsight – continuous integration process renders the Rose effect insignificant. BN interpret this result as an indication that the introduction of the euro was an extension of a long-term trend in European integration which is (statistically) difficult to separate from other aspects of integration. Nevertheless, even this result implies that monetary union was an important element in this continuing trend.

*Table 1:*

Impact of EMU on Bilateral Trade Between Member States (Elasticities, percent)

	Country Sample	
	Europe	OECD
Micco et al. (1992–2002)	44	36
Berger/Nitsch		
Short-Run (1992–2003)	15	15
Long-Run (1998–2003)	55	41
incl Volatility (1957–2003)	49	38
incl. Integration (1950–2003)	45	32

*Source:* Berger and Nitsch (2005 : Tables 1–6) ; own calculations.

The results from BN also allow to compare real and monetary integration effects. Table 2 shows the elasticities calculated for the free trade and EU-membership dummies as well as for a time-varying component measured by an integration index. For the European sample, the figures are again larger especially for the integration index. However, one has to keep in mind that the index starts after World War II, i.e., with European countries still in autarky. Hence, some (world market) driven integration could have been expected independent of European

integration schemes. Looking at the development since 1985, i.e., after the movement towards the Single Market, the impact of integration is much smaller.

Taking the Single Market impact as a conservative estimate of real integration over time and adding the impact of EMU, FTA, and EU leads to a total estimate of 0.73–0.85 percent increase in bilateral trade due to European integration. At least more than half of this impact seems to be related to monetary integration. With respect to monetary integration the total effect is only marginally different to the effect measured by the dummy. Volatility of the real exchange rate became lower since 1992 but – as shown above – has already been quite low.

*Table 2:*

Impact of Real and Monetary Integration on Bilateral Trade Between Member States (Elasticities, percent), 1950/57–2003

	Country Sample	
	Europe	OECD
FTA + EU (dummy)	35	33
Integration (index)	32	19
Single Market (index) <sup>a</sup>	6	4
Monetary Integration <sup>b</sup>	51	39
Total Integration <sup>c</sup>	85	73

<sup>a</sup>On the basis of the change in the integration index 1985-2003 of 5 points.—<sup>b</sup>Impact of a EMU dummy plus volatility reduction from 1992-2003 of 0.035 standard deviations for EMU member states.—<sup>c</sup>Impact of EMU, FTA, EU, and integration.

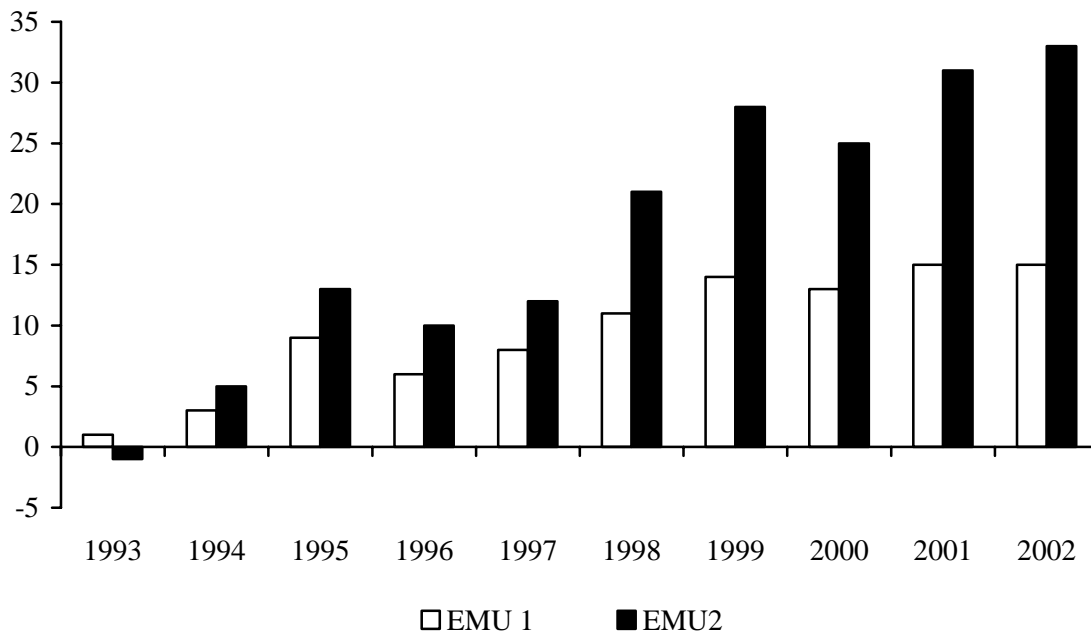
*Source:* Berger and Nitsch (2005 : Tables 1-6) ; own calculations.

Nevertheless, as also reported by BN, the Rose effect seems to be higher for countries which were already highly integrated like the countries which formerly formed the DM-bloc.<sup>4</sup> Baldwin and Taglioni (BT, 2005) try to make sense of this paradox. BT combine a “new trade” model (Helpman and Krugman 1985) with sunk costs of exporting to a new market (Baldwin 1988) and monopolistic competition that allows for heterogeneous firms (Melitz 2003) in order to show a convex relationship between trade costs and exchange rate volatility in determining bilateral trade. The intention behind their finding is that the higher (and potentially prohibitive) trade costs are the less significant will be the impact of a lower exchange rate volatility due to monetary union. For the highly integrated European countries this implies that monetary union had a significant impact although volatility was relatively low and because trade costs are so low. Actually, BT found the integration term between distance (as a proxy for trade costs) and a volatility measure to be positive.

<sup>4</sup> Apart from Germany, there were the Benelux countries, Denmark, Austria and – to some extent – France

Another interesting question related to trade effects of monetary union is to which extent a Rose effect might be trade diverting. Some insight is provided by BT in a regression with year-by-year Rose dummies for trade of EMU countries with third countries, EMU (EMU1) and intra-EMU trade (EMU2). The results are shown in Figure 3. Obviously, there is a positive trade effect for extra-EMU trade which showed a positive trend leading to trade creation for third countries of about 15 percent. At the same time, trade creation effects among members of EMU seem to have increased stepwise. Starting in 1998, the year before the beginning of the monetary union and with arguably already fixed exchange rates the gap between intra-EMU and extra-EMU trade effects increases with the Rose effect for intra-EMU trade jumping the level above 20 percent and – after the move to a currency union – above 30 percent.

*Figure 3:*  
Year by Year Estimates of the Rose Effect for intra-EMU and extra-EMU Trade (Elasticities, percent)



EMU1 (□) = 1 for pairs of EMU and other countries; EMU2 (■) = 1 for pairs of EMU countries.

Source: Baldwin and Taglioni (2005: Figure 9).

To sum up, there are some relevant conclusions from an Asian perspective:<sup>5</sup>

- The external effect of European monetary union is significant and increasing. Especially after the move to a common currency the trade diversion effect seems to be dominant. The impact on EU trade with Asia might become even larger as more and more European competitors among the new member states move into EMU.
- The effects of monetary union seem to be larger than pre-union monetary integration effects which may promote trade by reducing exchange rate volatility. But the Rose effect seems to be higher the lower the level of trade barriers, i.e., the more integrated countries are already. This does not necessarily imply that monetary union has to be preceded by top-down real sector integration schemes. What matters is de-facto regional integration like in Asia.
- There is a potential effect of the monetary union on intra-EMU bilateral trade which is difficult to measure. Empirical results seem to suggest that estimates are more robust if a more long-term perspective is adopted. In this case, the effect of monetary integration seems to be quite large even if compared with real integration. However, we only have the European experience where monetary union has been one element in a trend of increasing integration from autarky after World War II to full-fledge integration after the move to monetary union. Generally, the literature of trade effects of monetary integration is too sparse to be conclusive (Pomfret 2005). For Asia, the motivation for monetary integration is much more outward oriented like rationalizing on foreign exchange reserves, avoiding currency crises, and establishing a regional capital market (Kwack 2005, Click and Plummer 2005).

While negative direct *effects* for EMU on EU-Asian trade seems possible but uncertain, drawing any *lessons* from European experience one has to be rather careful. It has to be recognized that especially with respect to monetary union the integration process was not continuous and not driven by economic considerations in the first place (Schweickert 2002). It was, e.g. not clear in the 1970s that the Bundesbank would grow into its leading role

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<sup>5</sup> Additionally, EMU may provide some advantages in addition to pure trade effects which may strengthen the growth potential of those new EU member states which because of their resource endowment compete with Asian economies (Backé and Wójcik 2004). First, joining a monetary union can have positive credibility effects. Second, participation in monetary union reduces the risk of exchange rate crises, which is particularly relevant for cases of sudden shifts in sentiment leading to abrupt stops or reversals in capital flows, and consequently to a currency crisis. A look at the convergence of interest rates in Europe rather suggests that most of the expected gains from a monetary union are actually largely endogenous to the soundness and consistency of the overall (and, therefore, also national) economic policy-mix, and, therefore can be achieved by credible, time-consistent domestic policies (Gern et al. 2004).<sup>5</sup> The framework for entry into the EU and into monetary union should have helped significantly to formulate and sustain such policies. Hence, the effects of EU-membership and monetary integration are difficult to separate for the new member states.

providing the anchor currency of what has been known as the DM-bloc. German reunification was a necessary condition for the conclusion of the Maastricht treaty setting the agenda towards monetary union. Further, the Maastricht treaty was designed to keep EMU small and the dynamics of monetary integration especially its attractiveness for peripheral countries was largely underestimated. Finally, even countries like Ireland which hardly fit into any optimum currency area with its European neighbors seems to have profited from participation (Schweickert 2001).

For Asia, this implies that one should not be overly ambitious concerning first steps towards monetary integration. Clearly, the Chiang Mai initiative is a large step forward in a region not used to implement top-down approaches of regional integration. To talk about coordination of macroeconomic policies, to discuss best-practice policies, and to make better use of the vast foreign exchange reserves in the region directly benefits the less advanced countries but may also provide the ground for next steps which depend on political incentives. Any attempt to accelerate monetary integration without political backing or will may induce macroeconomic instability and would impede Asia's competitive advantage of providing rather stable real exchange rates as a guide for export-led development.

### **III. Changing EU Trade Structures and Policies**

#### *1. The Impact of EU Integration on Asian Trade Patterns*

So far, an EU effect on Asian countries seems to be rather moderate in the case of growth effects, is already priced in to a large extent in the case of real sector integration, and are still uncertain concerning discrimination effects of monetary integration. However, structures may matter more than size. A first question in this respect is whether the Asian export supply structure on EU markets matches or overlaps with its supply structure in a fully integrated "benchmark" market, the US market, and how the extent of matching has developed over time. An increasing similarity of Asian export structures on both markets over time would signal that demand conditions in the EU have become increasingly comparable to conditions in the reference market of the US, possibly by removing internal transaction costs. A suitable tool to address this question is the well-known Finger-Kreinin export similarity index, which measures the percentage of a country's (scaled) total exports, which is matched by another country's exports.<sup>6</sup> This argument rests solely on the similarity of demand conditions in two markets, which are differently integrated. To check whether supply conditions also have an

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<sup>6</sup> This index has been primarily used to assess the potential of trade diversion once two trading partners, one privileged, one non-privileged, export to the same market. The higher the similarity or overlap, for instance, the more scope would arise for trade diversion. Hence, the index has a long tradition in studies on trade effects of integration. It was introduced by Finger and Kreinin (1979), refined and interpreted for integration effects by Pomfret (1981) and tested, for instance, for aggregation biases and stability over time by Kellman and Schroder (1983).

impact we take as a reference region for developing Asia (excluding Japan) the structure of Latin American exports to both the EU and the US.

The results shown in Table 3 compiled at the highest level of disaggregation (5-digit SITC categories) for both total trade and manufactured trade (SITC 5-8) yield two conclusions.<sup>7</sup>

Table 3:

Indices of Similarity<sup>a</sup> between the Asian Export Supply (excl. Japan)<sup>b</sup> on the EU-15 and the US Market<sup>c</sup>, 1993–2003

Year	Exporting region			
	Asia (excl. Japan)		Latin America	
	Total trade	Manufacturing SITC 5-8	Total trade	Manufacturing SITC 5-8
1993	45.8	62.6	46.6	39.6
1994	48.0	63.0	42.9	39.6
1995	52.8	61.7	32.6	36.3
1996	51.8	63.4	36.8	35.8
1997	52.5	63.5	36.0	38.1
1998	56.4	65.2	33.9	39.4
1999	51.8	66.3	42.2	42.5
2000	53.0	67.7	40.7	40.5
2001	50.3	67.8	33.9	38.0
2002	52.0	69.0	24.5	39.1
2003	55.5	70.1	32.3	39.1

<sup>a</sup>Finger-Kreinin trade similarity index. The index of export similarity is defined by the formula

$$S(ab,c) = \left\{ \sum_i \text{Minimum}[Xi(ac), Xi(bc)] \right\} 100,$$

which measures the similarity of the export patterns of countries (or country groups) 'a' and 'b' to market 'c'.  $Xi(ac)$  is the share of commodity  $i$  in  $a$ 's exports to  $c$ . If the commodity distribution of  $a$ 's and  $b$ 's exports are identical ( $Xi(ac) = Xi(bc)$  for each  $i$ ), the index will take on a value of 100. If  $a$ 's and  $b$ 's export patterns are totally dissimilar (for each  $Xi(ac) > 0$ ,  $Xi(bc) = 0$ , and vice versa) the index will take on a value of zero.

<sup>b</sup>5-digit SITC categories.

Source: Own calculations from Datastream.

First, in fact, Asian total exports and manufactured exports to the EU and the USA have become more similar since 1993, which was the first year of observation. Second, the comparison to Latin America reveals a striking difference. Not only does the Latin American structure of exports to the EU differ significantly from the Latin American structure of

<sup>7</sup> Understandably, the index figures are subject to an aggregation bias. They decline with increasing levels of disaggregation since intra-commodity trade will tend to be netted out once the level of aggregation rises. As Kellman and Schroder (1983) have shown the comparison of country ranks in the level of export similarity is also sensitive to the aggregation level chosen probably depending on the relative importance of inter-commodity vs intra-commodity trade and the general level of a country's export diversification. Additionally, using bootstrap tests we have so far not been able to reject the center hypothesis of no change on a significance level of 10 percent.



exports to the US. Even more, differences have increased for total trade and remained unchanged for manufactured trade. This suggests that supply conditions mix with demand conditions as explanatory factors of export structures. Unlike Asia, Latin America has been much more a raw commodity exporter (including raw commodity intensive-products) on the EU market than on the US market. This is probably due to Latin America's closer foreign direct investment links with US than with EU companies which seem to have helped to diversify exports towards manufactures. Such discrepancy between the Latin American and the Asian findings for export similarity invite two conclusions. Differences in the degree of integration between the completed internal US market and the not-yet-completed EU market are likely to be much larger in the primary goods markets than in the manufacturing sector. Put it differently, national agricultural markets within the EU influenced by the CAP are still much more segmented than in the US apart from different levels of entry barriers. Asian countries whose export supply is dominated by manufactures do not only enjoy increasingly desegmented markets within Europe like in the US but also benefit from their more advanced supply structure which is less vulnerable to policy-induced barriers to trade than that of Latin America.

The second application of the export similarity index is to ask whether the process of EU integration deepening has contributed to make the EU supply on Asian markets more or less substitutable to the supply of competing trading nations, such as the US and Japan. The argument is that the completion of the single market does not only bring the EU closer to fully integrated markets like Japan and the US on the demand side but also changes its supply structure in the direction of these two other high-income trading partners. Common elements of the so-called home bias in the three areas may condition the export supply on factors prevailing domestically like scale economies, a uniform regulatory system, and the decline of distance costs. Such overlap calculations (again performed for total trade and manufactured trade) are presented in Table 4 in which the EU export structure is matched with that of Japan and the US on the entire Asian market (excluding Japan) and on the sub-market of ASEAN. As concerns the Asian market, results are somewhat ambiguous. During the nineties and early this decade, the EU export supply in Asia became more similar to that of the US, albeit from a lower initial overlap level than in comparison to the Japanese supply. On the entire Asian market, the EU/Japan overlap remained fairly stable. On the ASEAN market, there has been a clearer tendency of an increasing similarity of the EU supply with both the US and Japanese supply. Obviously, demand patterns on the three big domestic markets of China, Rep. of Korea and India considerably differ from the market of ASEAN economies. It is important to note that increasing overlaps have to be evaluated against the background of losses of EU trade shares in Asian manufacturing markets from about 18 percent in 1990 to 14 percent in 2003 mainly against intra-Asian competitors but also against OECD countries.

Table 4:

Overlaps between the EU/Japan and EU/US Export Supply on Asian and ASEAN Markets, 1993–2003

Year	Matching export regions on							
	Asian (excl. Japan) market <sup>a</sup>				ASEAN market <sup>a</sup>			
	EU/Japan	EU/US	EU/Japan	EU/US	EU/Japan	EU/US	EU/Japan	EU/US
	Total trade		Manufacturing SITC 5-8		Total trade		Manufacturing SITC 5-8	
1993	49.1	34.3	50.7	35.8	49.0	44.1	50.4	45.4
1994	48.6	34.9	50.4	36.5	49.9	44.2	51.0	45.7
1995	47.8	36.0	49.6	37.2	50.0	45.2	51.2	46.3
1996	48.4	35.9	50.1	37.1	49.0	46.9	49.8	47.8
1997	47.8	37.3	49.5	38.2	50.4	47.7	50.9	47.8
1998	47.4	35.3	49.5	36.6	53.0	47.8	53.7	47.8
1999	47.4	35.3	49.5	36.6	53.0	47.8	53.7	47.8
2000	47.8	34.5	50.1	35.1	54.4	52.4	57.2	53.9
2001	48.6	36.3	51.0	37.4	53.1	55.1	55.7	56.7
2002	46.9	38.3	49.2	37.9	51.5	52.8	54.6	53.8
2003	n.a.	39.1	n.a.	39.0	n.a.	51.6	n.a.	52.2

<sup>a</sup>5-digit SITC categories.

Source: See Table 3.

In an increasingly contested market, rising substitutability between EU supply and that of the two other major OECD competitors can be interpreted as the companion piece of rising intra-industry trade in non-standardized products and thus as a normal phenomenon. Yet, competing in products facing imperfect competition does not release the EU from fears of trade diversion. If an increasing share of the EU export supply to Asia “matches” Japanese supply, say in automobiles, such fears materialize in opposing bilateral free trade agreements between Asian countries and Japan which would discriminate against European supply unless they invest in Asia and jump over tariff hurdles (see below). Overall, Table 4 suggests that such fears have been more founded in 2003 than ten years ago.

A third application of the trade overlap approach refers to specialization patterns within the EU. Recent disputes among EU member states on how to deal with import increases in textiles and clothing products from China in 2005 led to the reapplication of import quotas against Chinese exports after the fading out of the quotas under the world textile agreement. Requests for quota reapplication have come from the Southern European countries, which see their industries particularly, exposed to competition from labour-abundant Asian countries, primarily from China. Hence, we can expect the supply structure of these countries (France, Greece, Italy, Portugal and Spain) to differ from those of the rest of EU-15 (Northern Europe) and we hypothesize that their export structure differs too being more similar with the export supply of Asia than does the export structure of Northern Europe.

The results in Table 5 supports such discrepancy between the Southern and the Northern European export supply for the period since 2001 when Asian exports including that of the new WTO member China expanded rapidly. On the EU-15 market, the Southern European countries' export supply has become more similar to that of the Asian supply (regardless of whether or not China is included). On the second export market for European and Asian supply, the US market, the level of overlap between the supply from the two areas is generally considerably smaller than on the EU market. This might be explained by the high degree of firm-level integration of the EU market. Unexpectedly, the export supply from Northern Europe matches more with that from Asia on the US market than does the Southern European export supply provided the Asian supply includes Chinese exports. This suggests that Northern European countries have been successful exporters in products which while being relatively close to the export supply of Asia are still far from being substitutes, for instance, industrial textiles or high-fashion home appliances. This ambiguity addresses a fundamental problem of measuring substitutability between products. Even at the highest level of

*Table 5:*

Trade Overlap Between Asian<sup>a</sup> and South European Export Supply<sup>b</sup> on EU and US Markets, 1993–2003, 5-digit SITC Categories (Manufacturing SITC 5–8)

Year	Matching export regions on							
	EU-15 market				US market			
	South Europe/Asia		North Europe/Asia		South Europe/Asia		North Europe/Asia	
	incl. China	excl. China	incl. China	excl. China	incl. China	excl. China	incl. China	excl. China
1993	36.7	36.5	36.6	36.4	20.9	18.9	24.4	22.6
1994	35.8	35.3	35.4	35.1	21.9	20.2	27.5	25.9
1995	37.0	36.2	37.2	36.6	26.3	24.8	29.9	28.6
1996	36.7	36.1	37.1	36.6	25.3	22.6	29.6	28.0
1997	36.5	35.5	37.4	36.6	25.1	22.2	30.1	27.2
1998	38.7	37.5	39.6	38.5	25.6	22.8	29.0	25.8
1999	39.4	38.7	40.5	39.7	23.0	19.8	28.8	25.3
2000	38.9	37.8	40.9	39.3	24.3	20.9	29.9	26.6
2001	54.5	54.6	51.7	51.9	30.2	25.5	34.9	30.1
2002	54.5	54.6	51.7	51.9	30.2	25.4	34.8	30.1
2003	54.5	54.7	51.7	51.9	30.3	25.5	34.8	30.1

<sup>a</sup>Excluding Japan.—<sup>b</sup>North European export supply (EU-15 minus South European countries) is taken a reference case.

Source: See Table 3.

disaggregation it cannot be taken for granted that manufactured products from two different origins compete in the same market. The issue of intra- vs inter-industrial trade cannot be ultimately decided by referring to different levels of disaggregation.

This is not to belittle the merits of these trade overlap analyses nor to ignore their shortcomings. Their main findings consist in confirming the hypothesis that in recent years the European export supply in Asia has indeed become more similar with that of their two other large OECD competitors, the US and Japan, just during the period after the completion of the single market.

Overall, the overlap indices report increasing similarities of trade patterns in to respects. Exports from Asia seem to face stronger competition from South Europe especially on the EU market and exports from Europe seem to face stronger competition from Japan and the US on Asian markets. At least, this observation is in line with recent trends in trade policies in Europe and Asia.

## 2. *Our Policy, Your Problem: Mushrooming Regionalism in Asia and EU Contingent Protection*

Unlike Latin America and Africa, Asia still maintains trade relations with the EU based on the MFN non-discrimination principle.<sup>8</sup> There is not a single FTA between the EU and an Asian country while the EU has already concluded or negotiates such agreements with a number of countries (including pending negotiations with the regional scheme of MERCOSUR from the western hemisphere). A standstill of entering into such negotiations with Asian countries before the end of the Doha Round was announced by the EU based on level-playing-field expectations: no such agreement of the US with Asian countries nor agreements among Asian countries meanwhile. These expectations have not materialized. The “competitive regionalism” strategy in US trade diplomacy has led the US into bilateral negotiations with Asian countries and at the same time ASEAN economies are on the way of negotiating FTAs with Japan and China. While it is too early to assess the actual third country implications of these bilateral endeavors, especially in trade with Europe, it is possible to depart from apriori reasoning and stylized product-level facts and derive three hypotheses.

First, the trade diversion potential of inter-Asian countries’ FTAs or FTAs with USA is not a *quantité négligeable*. A view on average applied and bound MFN tariff rates (Table 6) of Asian emerging economies in product groups of export interest to the EU shows that they are often in the double-digit range (if Japan is excluded) and much above respective rates of the

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<sup>8</sup> The GSP is a non-negotiable unilateral concession and thus not an integral part of trade policy.

EU, the US or Japan. The binding overhang measured as the difference between the higher WTO-bound rates and the much lower applied rates signals that in some cases Asian tariffs could be lowered by 30 per cent in the multilateral trade negotiations without affecting the applied rate and therefore without having price effects. Hence, both types of FTAs would create preference margins, which visibly discriminate against third country suppliers such as the EU and trigger trade diversion effects. A CGE-model presented by Saygili and Wong (2005) designed to portray likely effects of a FTA between China and ASEAN yields a decline of the rest of the world's (ROW) exports (which includes the EU) to these two trading partners by 5 percent for manufacturing and 4 percent for agriculture, respectively. Declines are much sharper for ASEAN manufacturing imports from the ROW (–19 percent) than for the Chinese imports (–2 percent). A CGE-model applied by Chirativat (2004, 2002) comes to a similar conclusion with respect to the magnitude of the decline of Chinese imports from the EU (–1.5 percent).

*Table 6:*

Applied and Bound Average MFN Import Duties in Asian Economies, 2003 for Selected Manufactured Products

	Chemicals and photographic supplies		Transport equipment		Non-electric machinery		Electric machinery	
	Applied	Bound	Applied	Bound	Applied	Bound	Applied	Bound
South Asia								
India	29.2	39.6	36.9	35.8	25.2	28.3	24.8	26.8
Pakistan	13.6	48.4	31.3	33.8	12.7	50.0	16.5	50.0
Southeast Asia								
ASEAN								
Indonesia	5.4	38.1	12.2	38.9	2.2	34.9	6.0	30.3
Cambodia	10.1	n.a.	19.4	n.a.	14.5	n.a.	25.1	n.a.
Lao PDR	6.8	–	13.7	–	6.0	–	6.7	–
Malaysia	3.6	11.9	18.5	14.2	3.7	9.1	6.7	13.8
Philippines	3.5	19.6	8.0	19.1	2.1	19.0	2.9	18.1
Singapore	0.0	5.1	0.0	6.0	0.0	6.3	0.0	5.4
Thailand	7.3	29.4	28.3	48.3	8.4	20.2	13.1	18.2
Vietnam	4.8	–	22.2	–	4.9	–	13.4	–
East Asia								
Japan	2.5	2.0	0.0	0.0	0.0	0.0	0.2	0.2
China	7.5	6.7	15.9	11.5	9.9	8.4	10.4	8.8
Korea, Rep. of	6.9	5.8	5.4	13.4	6.1	9.5	6.0	9.0
Average weighted by GDP (without Japan)	10.8	16.6	18.0	19.9	10.8	15.4	11.6	14.9

Source: WTO (2004: Appendix Table 4); own calculations.

As always in FTA agreements, it is the car-manufacturing sector, which politically matters most because of its assembly characteristics and the effect of tariff escalation between high peak tariffs on direct car imports and lower tariffs on CKD (completely knocked down)-package imports to be assembled in the importing country. This is confirmed by recent concerns of European car manufacturers and their CKD-plants in Southeast Asian countries to lose against duty-free imports car imports from Japan (not yet against China) should the countries conclude a FTA with Japan. It is self-evident that the Japanese side has a keen interest just in this sector to penetrate into Asian markets of premium cars still mostly dominated by European brands.<sup>9</sup>

Second, while negative static trade effects of intra-Asian FTAs affecting non-member states may be higher than in other FTAs they are nevertheless likely to be small relative to the dynamic effects. Given that the Asian countries are very differently endowed with physical and human resources they are highly complementary in their production structures. Removing barriers to intra-Asian trade and facilitating trade through an improved infrastructure network will therefore be very instrumental to trigger productivity effects and higher growth beyond what individual countries have already achieved on their own. Third countries like the EU may benefit from such a growth impulse, which we witnessed for many years already as a result of market-driven rationalization in Asia. Of course, growth effects would be larger if a multilateral approach would be chosen and/or if intra-Asian liberalization would automatically be coupled to reducing barriers to Asian markets against non-member countries.

Apart from the FTAs currently negotiated in Asia, the emergence of China in recent years may cause a policy response from the EU although, CGE-trade analyses support the view that China can become the victim of its own trade expansion either due to its regional or multilateral trade liberalization. On the one hand, its demand for commodities rises and causes commodity prices (including energy and agricultural products) to rise leading to terms of trade deterioration (Saygili and Wong, *ibid*). On the other hand, Chinese manufacturing prices export prices are expected to fall, again leading to terms of trade deterioration for China (Francois et al. 2003) and respective gains for net importers of such products, for instance the EU. The ultimate net terms of trade position for the EU remains subject to further assessments as the EU as a net exporter of some highly protected agricultural commodities might also

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<sup>9</sup> In the Japanese-Thai FTA negotiations an agreement was reached to dismantle Thai tariffs against Japanese 3-litre engine cars stepwise over a longer period in order to allow European CKD-plants in Thailand to amortize their equity capital.

benefit from rising agricultural prices in its terms of trade. Furthermore, a higher price level for those agricultural products subsidized by the EU would narrow the gap between EU internal and international prices and thus reduce the base for export subsidies. Put differently, rising Asian demand for agricultural products can be instrumental to overcome the EU vested interests against liberalizing the CAP.

So far, however, EU trade policies towards Asia contain a considerable amount of protectionism. As in trade with many trading partners in recent years, tariffs and quotas have lost in importance as border barriers for the EU also against Asian manufactured exports. For instance, industrial tariffs were cut in implementing the Uruguay Round results with some peak tariffs remaining in consumer industries, quotas against Japanese cars were phased out and textile quotas were gradually dismantled. Simultaneously, however, “gray area” measures or contingent protection rose in importance ranging from the enforcement of so-called precautionary measures against food imports to protect consumers by stricter sanitary standards to the key tool of contingent protection, that is anti-dumping (AD) measures. The latter measures have been a more widely applied tool of US trade policies than in Europe but also in Europe at least in terms of initiations there has been a three-digit number of investigations since the start of the WTO in 1995 over ten years with more than 60 per cent of initiated investigations leading to measures, that is anti-dumping duties. Unlike in the past, also Asian countries have resorted to AD procedures against WTO members, notably against neighboring Asian countries.

Table 7 provides a breakdown of the sub-regional distribution of AD initiations and AD measures of both sides against each other, including the resort of Asian countries to AD provisions against the EU. In total, with almost 62 percent of initiated AD investigations and 58 percent of measures actually taken, Asia has been the major target region of the EU. Not unexpectedly, with about 17 percent of the total, China comprised the lion’s share of both AD investigations and measures from the EU side followed by India and Rep. of Korea with each about 8 percent. Given that China is still classified by the EU as a non-market economy, it is easier for the EU to launch AD investigations against the country than against market economies. Relatively few measures were initiated and enforced against Japan probably reflecting ongoing harmonization between the competition policies between the EU and Japan, while ASEAN member states altogether even exceeded China as target area of EU measures with an even larger share of the region in EU measures applied than initiated. This indicates a sizable gap in competition policies between the two regions, which calls for

Table 7:

Anti Dumping (AD) Initiations and Measures Applied by the EU Against Asian Economies and vice versa in Percent of Total Initiations and Measures of Reporting Countries, 1995–2004

		Reporting Countries (Initiators)																			
		AD Initiations									AD Measures										
		EU	Asia	of which:								EU	Asia	of which:							
				South Asia	ASEAN	East Asia	of which:			Other Asia	South Asia			ASEAN	East Asia	of which:			Other Asia		
China	Japan	Korea Rep. of	China				Japan	Korea Rep. of													
Affected regions and countries	Asia	61.7	62.9	60.8	72.7	59.0	57.6	100.0	59.7	75.0	58.0	62.0	61.2	64.0	62.2	61.5	100.0	60.5	100.0		
	of which:																				
	South Asia	10.2	3.1	0.7	9.8	3.4	2.0	0.0	5.2	0.0	8.8	2.9	1.0	8.0	5.1	3.8	33.3	4.7	0.0		
	ASEAN	15.2	15.1	14.3	21.7	10.1	7.1	0.0	14.3	50.0	19.2	13.8	13.5	20.0	9.2	7.7	0.0	11.6	50.0		
	East Asia	27.7	32.0	30.8	29.4	37.1	39.4	50.0	33.8	25.0	25.9	33.4	33.2	26.7	38.8	38.5	33.3	39.5	50.0		
	of which:																				
	China	17.2	13.7	18.7	7.7	7.9	–	0.0	18.2	0.0	16.6	16.1	20.1	9.3	9.2	–	0.0	20.9	0.0		
	Japan	2.6	8.0	4.9	6.3	16.9	18.2	–	15.6	0.0	3.6	7.7	5.6	5.3	16.3	15.4	–	18.6	0.0		
Korea, Rep. of	7.9	10.2	7.1	15.4	12.4	21.2	50.0	–	25.0	5.7	9.6	7.6	12.0	13.3	23.1	33.3	–	50.0			
Other Asia <sup>a</sup>	8.6	12.7	15.0	11.9	8.4	9.1	50.0	6.5	0.0	4.1	11.9	13.5	9.3	9.2	11.5	33.3	4.7	0.0			
EU	–	6.0	8.6	3.5	2.2	4.0	0.0	0.0	0.0	–	6.5	8.2	5.3	2.0	3.8	0.0	0.0	0.0			
Memo: Absolute number of cases		303	735	406	143	178	99	2	77	8	193	479	304	75	98	52	3	43	2		

<sup>a</sup>Other Asia includes Chinese Taipei.

Source: WTO website. Own calculations.



reduction in bilateral negotiations. Turning to the Asian countries as initiators of AD procedures, only 6–7 percent of all Asian countries' AD procedures against WTO member states were raised against the EU. The Asian sub-regions were close to this level. As a result, one can clearly rule out the hypothesis of using the AD as a “*do et des*” retaliation of Asian countries against EU. This disparity probably mirrors two aspects. First, the potential costs of a reciprocate application of AD are high for Asian countries which are more dependent on the EU market than vice versa. That means that Asian countries will have to seek other channels to minimize the costs of AD measures against their exports, for instance by larger compliance with EU AD rules. Second, EU competition policies are likely to impede dumping practices, especially collusion strategies of companies toward concerted dumping. Rather than against the EU and the US, Asian countries have concentrated their AD procedures against neighboring countries from the region.

Overall, contingent protection still ranks much higher on the agenda of bilateral Asia-EU trade relations than between the benchmark relationship EU-Latin America. Narrowing the observation period to a more recent period would even substantiate the focus of AD on EU-Asia relations since Central European countries like Czech Rep. and Poland which prior to their EU membership were frequently targeted by AD procedures are now jointly responsible for such measures as members of the EU customs union.

#### **IV. Conclusions**

The emphasis of our analysis in this paper was not on lessons from the European experiment in the first place but rather on its effects on Asian countries. We approached this issue by asking for

- the effects of EU integration induced growth for Asia,
- the extent of effects from EU real sector integration on trade flows from Asia,
- the probability that monetary integration in Europe (EMU) inherently discriminates against trade with non-EMU countries, including Asia, and, finally,
- the trade policy response of the EU from changing patterns of trade between Europe and Asia due to integration deepening.

With respect to the first three questions the answers are: rather moderate, already priced in to a large extent, and still uncertain. Growth effects of EU integration seem to have been modest and direct effects on Asian countries have been low, sometimes even negligible if trade links to Europe were weak. Over time, growth effects appear to have diminished further as the European growth engine began to stall.

Real sector integration in Europe caused trade to divert from extra-EU trade to intra-EU-trade in the early days of integration when both the free trade area and the customs union were implemented. Later on, these effects always gauged to be small because of being static, became even less relevant because of a external opening of EU markets parallel to the single market completion. This is not to belittle the protectionist effects of special sectoral policies in agriculture, textiles and few other industries. Yet, the general direction of EU trade policies acknowledged also by the WTO trade policy reviews during the last decade suggests a stronger parallelism between extra-area trade liberalisation and intra-area trade liberalisation than in the past.

With respect to monetary integration, it seems adequate to assume trade diversion effects from monetary integration to be a relevant issue but the jury is still out on the well known Rose effect states. Recent empirical papers emphasized the importance of adopting a long-run view when comparing real sector and monetary integration effects on bilateral trade flows between member countries and the fact that the gap between trade creation effects for intra-EMU trade and trade between EMU member and non-member countries opens up with European countries entering the currency union. However, it is premature to argue that this effect is robust. So are conclusions about its relevance for trade with Asia. This is still a blank cell in our knowledge on determinants of EU-Asia trade flows.

The final question we asked is rather concerned with structures than with trade volumes. We have computed a number of so-called similarity or overlap indices for various pairs of directions of manufactured trade between the EU and Asia. Overall, the trend points into a stronger sectoral “match” between the Asian and European export supply in Asian, EU and US markets. In other words, the competitive pressure on the EU supply has increased. However, the magnitude of the rise in similarity between the Asian and the EU export supply has not been statistically significant. Rising similarity is particularly important for the Southern European countries which have responded to stronger competitive pressure from Asia by requesting safeguard measures against Asian textiles, for instance, in particular against China.

This has led our analysis to two trade policy aspects. We argued that the EU will try to lock into bilateral and regional trade agreements among Asian economies as much as the US does. This follows from the common finding of few empirical analyses on the trade effects of such agreements yielding non-negligible trade diverting effects to the detriment of non-members. By locking in, the EU may keep such effects low. Second, the EU concentrates contingent protection measures upon Asian economies. Rising overlaps in trade suggest that such policies will be continued. In this respect, trade agreements between Asian economies and the EU while inferior to multilateral solutions may contribute to less measures in future.

It will be interesting to observe which kind of FTA the EU is willing to offer balancing the desire to match the interests of European enterprises for free or privileged trade in the Asian

markets and at protection back at home. An overly optimistic perspective is clouded by two aspects. Sluggish growth in EU does not only impede structural change and dampens import demand. It can also trigger a defensive if not protectionist tone in EU trade negotiations with trading partners both on the multilateral as well as on the bilateral or regional stage. Contingent protection measures against Asian economies may, therefore, still rank high on the policy agenda of the EU. So do non-tariff barriers often legitimized as consumer protecting devices. Next to slow EU growth, the EU Eastern enlargement poses new challenges for trade relations with Asia as the group of members with a more similar factor endowment with this region increase and seeks to influence EU trade policies along their vested interests.

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