The Prospects for Asian Monetary Cooperation:
Drawing Lessons from Europe

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Abstract

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Monetary cooperation in Asia has been discussed for quite some time now. One perspective used to analyze the prospect of Asian monetary cooperation includes lessons from the European experience. Close examination of the history of European monetary integration can help outline what the conditions for regional integration are as well as provide strategies to pursue it. Lessons from the European experience pre and post crisis can also be drawn, but they must be cautiously transferred to Asia since vast differences between the two regions exist. A critical analysis of these lessons, some of which are right, wrong, or questionable, is therefore essential.

Greater understanding of major regional integration theories can also further identify and explain some lessons. Specifically, neofunctionalism is one of the international relations theories where more insight can be gained. This approach, developed by Ernst Haas, emphasizes the notion of spillover or how integration in one sector leads to pressures to integrate in other sectors. There have been many examples of important spillovers in Europe like the formation of the European Coal and Steel Community, the development of the Single European Act, as well as the creation of the Common Agricultural Policy. However, the mechanisms and channels through which

spillovers occurred remain fuzzy. Therefore, this study also sheds light on the concept of spillover and provides a critical analysis. In addition, looking at the concept of spillover and its applicability to Europe can also help us to draw lessons for Asia as well.

After careful examination of these areas, this study will then attempt to determine what is the prospect for Asian integration. The course for Asia will not replicate that of Europe's, but this study shows that lessons the Europe provide a better understanding to the integration process. A monetary union may not be in the near future for Asia, however, alternative strategies such as creating regional institutions and other short and medium term goals are recommended in order to promote monetary cooperation in the region.

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I. Introduction

This dissertation gives a critical analysis of the European integration process as well as determines what lessons it can provide for Asia. First, by looking at several different international relations and economic theories, a better understanding of the Europe Monetary Union has been garnered. A major framework that will be closely examined is neofunctionalism as well as its core notion of spillover. In addition, it is important to also identify what has happened historically in Europe both in the early aspects of cooperation as well as after the 2009 crisis. The dissertation draws upon the different theories as well as the historical events that have occurred to determine some of the lessons that the European integration process has provided. Some of these lessons are more applicable to Asia than others, but important nonetheless.

The dissertation is organized as follows. The first chapter examines several different theories used to explain the European integration process. Both economic and political theories have been examined in order to gain a better understanding of the integration process. The second chapter focuses principally on the neofunctionalism, a major framework that has been applied to Europe. Critical analyses of neofunctionalism as well as its idea of spillover are discussed. The third chapter gives a historical overview of the events that led up to the European Monetary Union. The fourth chapter draws on the lessons from Europe, specifically looking at the lessons that were before the crisis of 2009. The fifth chapter then analyzes the Euro crisis and in turn draws lessons post crisis. The sixth chapter looks at what the implications of the lessons from Europe are for Asia as well as if there are prospects of monetary integration in that region.

Chapter 1. Theories Used to Explain European Monetary Integration

There are several international political economy theories that attempt to explain the process of regional integration. All of these different theories have wide applications in understanding European monetary union development. There are various notions as to what contributed to the development of the EMU. While some concepts are more controversial than others, the ultimate goal is to garner an understanding of the environment in which integration occurred within Europe. This chapter thus looks at the key determinants in the progression of the EU to fully comprehend the process of regional integration and the problems that it has run into the current financial crisis.

Realism, Neorealism, and Geopolitics

Realist theory often has been used to explain the creation of international monetary systems. There are several key assumptions. First, it assumes that international politics is anarchic and treats the state as a rational, unitary actor. The main objective of the state is the search of power and security. It also dismisses the importance of international institutions like the EU, which are considered epiphenomenal reflections of the underlying distribution of material power in the international system. (Pollack, 2001) An arguable idea for the case of European integration lies in this international relations theory of realism. For some realists, the multi-polar world after the collapse of the Soviet Union was believed to have spurred further steps in integration. According to this view, increased security and concerns with relative gains were the primary causes to why Europe wanted to integrate.

An additional viewpoint of EU development is that it was a direct result of war, and that only through this type of turmoil could integration be reinforced. Granted, the start of the EU and integration could be attributed as a reaction to the negative effects war had on the area, the real question lies whether it was the chief component of European regional development. For instance, the reminder of World War II has been said to create the needed community for EU progress. It is true that the European community banded together to make future war unthinkable. However, was war the only factor needed to generate this society? Some continue to question the role of war in European integration. Cohen argues that in the case of Europe, the trigger happened to be war, but it does not have to be. War is not necessary, but is a trigger.

Part of the realist theory argues that hegemony has a major influence on the success of a monetary union. Two central propositions of the hegemonic theory are that order is created by a single and dominant power, and maintenance of order requires continued hegemony. A hegemon must have control over capital, markets, raw materials and competitive advantages in production of highly valued goods. (Keohane, 1984) Its duty is to maintain the stability of a monetary regime by supporting short-term stabilization and long run growth. It can either coerce states into cooperation or resolve fears of exploitation. Proponents of the hegemonic stability theory believe that the presence of a powerful state such as a locally dominant country is necessary for integration to be successful. (Cohen, 2001)

Although the influence of hegemony is widely accepted as an important factor in regional integration, one controversial viewpoint holds that EMU success was exclusively dependent on the presence of a main dominating economy. Without this influence, monetary integration could not thrive in Europe. According to proponents of hegemonic theory, Germany's economic stature provided the driving force for EMU development. Its large economy, low inflation levels, and independent central bank made Germany attractive for becoming the home of the anchor currency. The Bundesbank had also become the most credible inflation fighter. For those reasons, Germany was seen as the most influential contributor to the economic and political stability of the European region. However, many scholars have attested that having a hegemon is neither sufficient nor necessary.

The realist theory is quite controversial. First, there is little empirical support for it in the European integration context. Security concerns and balance of power have weak explanatory in the case of European monetary unification. While it is correct to say that there was initial concern about avoiding another world war that prompted ideas toward uniting European countries, this was certainly not the only reason for deep integration. The disregard of institutions is also incorrect. Furthermore, the hegemonic stability theory has been the subject of considerable debate. The question remains, can cooperation occur in the absence of a hegemon? A study of six actual and proposed regional arrangements by Joseph Grieco (1997) points out that when looking at the relative share of GDP as a measure for hegemony, the success of a monetary union is not dependent on a single dominating state. He further argues that in the case of the European Community "the presence of an overall regional hegemon appears to be neither a necessary nor a sufficient condition for the emergence of regional economic institutions."

In the case of the EMU, the role of Germany was undoubtedly important. Its place in EMU development, as Charles Wyplosz (2002) notes, was unplanned and unforeseen. It took many years before the deutschemark evolved as the center currency, in large part due to the lack of adequate monetary policy coordination among other larger countries. Although the role of a central figure is definitely helpful for the development of a successful monetary union, it is debatable whether or not hegemony is necessary for integration.

Neofunctionalism

One of the more prominent theories used to explain the process of EMU development often is neofunctionalism. Neofunctionalists, such as Haas, Lindberg, and Schmitter, are concerned with why states voluntarily interact with its neighbors, even at the cost of national sovereignty. The neofunctionalism theory assumes a pluralistic European society and rational political actors that include social elites, and that the transfer of sovereignty is based on policymaking effectiveness.

The neofunctionalism theory considers integration as an inevitable process when deeper cooperation stems from the effects of spillover. It rejects the importance of nationalism and emphasizes that through a resourceful secretariat and organized interests, national governments can learn and agree to change their positions on certain policies. The neofunctionalism theory has some roots in David Mitrany's version of functionalism, which focused on common interests and needs shared among states.[1] Mitrany argued that "collective governance and material interdependence" was what led states to integrate. International organizations would help foster integration by addressing and meeting

[1] Mitrany, David. 1946.

human needs, and it would be these transnational ties that would lead to increased collaboration among states and eventually deeper integration. Benefits received from these agencies would lead to increased cooperation, and ultimately attract loyalty from the people.

Starting from these basic assumptions, neofunctionalism was quite similar to its predecessor but extended it in different ways such as attempting to answer why states would voluntarily interact with its neighbors, even at the cost of national sovereignty. Neofunctionalism theory assumes the importance of social elites and their self-interest, which is viewed as the primary driver of European regional integration. Elites can become capable of persuading sub-national actors to shift their loyalties toward new centers. For instance, the strategies of the founding architects of the European Community had a strong influence in the integration process. Haas strongly believed that integration was driven by the interest oriented behavior of the political elites and his theory was primarily derived from Jean Monnet or it was also known as the Monnet Method, which saw increased integration as an important precursor to peace in Europe. Monnet famously stated at the Schuman declaration that "Europe… will be built through concrete achievements which first create a de facto solidarity."[2] This meant that the integration process would be supported primarily by concrete projects rather than the declarations of basic principles. This idea revolved around getting members to agree and discuss technical issues, as well as creating institutions that would garner positive reactions from political and economic elites.

In turn, this would influence the behavior of other societal groups and bring citizens of different nations together, which would eventually lead to a transfer of loyalty

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[2] Monnet's declaration May 9, 1950.

and sovereignty at the European level. Haas (1958) explains, "... interests will be redefined in terms of regional rather than purely national orientation and that the erstwhile set of separate national group values will gradually be superseded by a new and geographically larger set of beliefs." (13) Although there is a consensus that the beginning stages of integration in the Monnet Method implied a limited but real transfer of sovereignty, the final stages of integration were not so explicit. The final stages were left unclear and intentionally open.

Developing from the Monnet Method, neofunctionalism also focused on how political elites and concrete projects would promote integration and how the transfer of sovereignty would spillover into policy-making effectiveness. It is argued by Haas (1964) that interest oriented elites and the impact of epistemic communities were what drove the process of integration. He described this type of spillover as how "integrative lessons learned in one functional context will be applied in others, thus eventually supplanting international politics." (48) Haas argues that this process is based on the clarity of purpose on the actors, since they will adapt to a new situation in order for integration to occur.

The theory of neofunctionalism describes integration as an open and dynamic process typified by spillovers from one area to another. The idea of spillovers constitutes a major part of the theory of neofunctionalism since it attempts to explain the dynamics of integration. For example, according to Eichengreen (2004), the European Payments Union can be seen as an example of spillover. The creation of EPU encouraged the reconstruction of intra-European trade, expanded the economic constituency for a common market in goods and services. More examples of spillovers will be discussed in further detail in the following section.

Liberal Intergovernmentalism

The theory of liberal intergovernmentalism introduced by Andrew Moravscik (1998) also takes a political approach in explaining the process of monetary cooperation. Moravscik hypothesizes a two-step approach towards European integration, beginning with preference formation followed by interstate bargaining. In the first stage, national interest groups dictate domestic policy and their views on integration. The second stage then describes the outcomes of state preference and bargaining power.

According Moravscik, the Single European Act and Maastricht Treaty both exemplify major intergovernmental bargaining as a result of preference convergence by the largest states within the Union. In a divergence from neofunctionalism, he argues that although institutions adopted in such bargains do provide members with information and reduced transaction costs, they do not result in a transfer of loyalty. But Pollack (2001) disagrees and believes that Moravscik's model actually does represent a large number of views of rational-choice institutionalists. He notes that there are similarities in basic assumptions such as the state acting rationally on behalf of aggregate interests to advance the preferences at the EU level and institutions are designed to maximize utility.

Ideas and Mental Models

Another important, yet less emphasized, concept in the study of European monetary integration is the evolution of ideas and mental models. Thomas Willett (2000) argues that rather than critically analyzing the costs and benefits of a monetary arrangement, the EMU was more motivated by abstract political idealisms. First, the establishment of a single European market was seen as continuation of Jean Monnet's idea to increase linkages within Europe, therefore making war unthinkable. Leaders then became more enamored with the "fuzzy vision" of a politically unified Europe than careful consideration of the economic costs and benefits discussed in the optimum currency area (OCA) theory.

The prevailing motivation for the EMU mainly came from political elites, such as Chancellor Helmut Kohl, who wanted to eliminate any possibility of war within Europe in the future. Willett (2000) also emphasizes that "in essence, the primary promoters of EMU failed to understand the difference between marginal and total benefits and the difference in patterns of economic effects between trade liberalization and the formation of a common currency." (382) Perceptions of national macroeconomic sovereignty were ultimately cast aside and replaced with new mental models. Moreover, it is fairly easy to explain the motivation of some countries joining the union. For example, France had already decided on giving up monetary policy independence due to the instability of an adjustable pegged exchange rate in a world of high capital mobility. Once this was done it was better from their standpoint to have monetary policy determined by the group than by Germany alone. For smaller countries joining the union was based mainly on OCA criteria. For countries like Italy, Spain, and Portugal, regional integration was desired in order to not be seen as second-class citizens and also as a way of borrowing macroeconomic credibility. On the other hand, it is harder to see why Germany would change its monetary policies. Willett argues that timing played a major role in Germany's decision. Particularly, Chancellor Helmut Kohl's goal for Germany was political integration with other European nations. Therefore, ideas proved to be helpful in understanding both leaders' visions and reasons why countries would be willing to give up monetary policy independence.

Kathleen McNamara (1998) also emphasizes the connection between ideas and interests in the evolution of European monetary cooperation. Ideas, or "shared causal beliefs" generated from experiences and interactions of actors, are implemented into monetary cooperation and policy strategies. According to her, the success of the European Monetary System (EMS) was due to the development of a 1980s neoliberal policy consensus based on a variety of aspects. First of all, the failure of macroeconomic policies after the first oil crisis led to changes in paradigms of policy choice. Another factor was the ideological shift towards lowering inflation levels that took precedent over economic principles such as growth or employment. Therefore, countries were more willing to give up independent monetary policy to achieve this goal. In Europe, an adjustment in thought "…redefined state interests in cooperation, underpinned stability in the EMS, and induced political leaders to accept the domestic policy adjustments needed to stay within the system." Furthermore, the movement toward neoliberal consensus allowed for the acceptance of Germany as a stable economic model, and the Deutschemark as an anchor currency. In this case, neoliberal ideologies helped to shape the major movements in European integration.

Constructivism

Constructivism is one of the newer approaches used to study international relations. Broadly defined, it is "the view that the manner in which the material world shapes and is shaped by human action and interaction depend on dynamic norms and epistemic interpretation of the material world."[3] It attempts to provide a theoretical and empirical explanation of the social and material environment in which agents take action and the settings that provide agents with the understanding of their interests. One of its core propositions is that governmental elites choose specific policies because it is deeply rooted in their ideas and interests. These ideas have structural characteristics, which are generally collective knowledge institutionalized in practices. Moreover, these ideas and interests are formulated from specific historical incidents that occur. Most of the time, ideas stem from a 'critical juncture,' like in response to a political crisis. The constructivist approach has been used to understand international relations, specifically in this case, European integration.

There are three major schools of constructivism, according to Haas (2001). The first is systemic which emphasizes the actors and their roles in the global system. The second is the norms and culture school, which states that interests are derived from a cultural matrix. It particularly looks at the role of norms in shaping foreign policy. And lastly, there are soft rationalists who examine political causality, particularly in terms of interests and how the world works. He argues that neofunctionalism is most similar to soft rationalists. This is because an actor's perceived interests change when there is an

[3] Adler, Emanuel, 1997, p. 322.

"inspiring... alteration" (27) and they become learners. Ideas become interests in this case.

Constructivism has been used to explain the process of European integration by examining the role of institutions and how they help to construct arenas for communication. Institutions are viewed quite differently between rational institutionalists and constructivists. Rational instituitonalists believe that it is the self-interest of agents that drive the strategic choices made and institutions can provide a constraint for this behavior. Constructivists, on the other hand, see institutions in a broader sense and look at the effects it has on identities and interests of agents. They are conceptualized as social norms and are not only based on formal rules, but rather on collective understanding and also include informal norms as well. Institutions can help shape incentives, identities, and preferences. According to constructivists, EU institutions can identify what factors have caused states' identities to change. For example, it can be through mediating, constructing a social reality, persuasion, and/or role-playing. Constructivists believe that their view of institutions has helped to bridge the gap between rationalist and sociological work. [4]

Constructivism has often been criticized, however, as not being a good approach to understanding European integration. For instance, Moravscik (1999) believes that constructivism does not provide a 'distinctive testable hypothesis' and even if it does, it does not employ methods that distinguish the predicted outcome from those predicted by an alternative hypothesis. He believes there are no causal mechanisms identified in its core proposition. He argues that it is unclear which ideas influence which policies and

[4] For more on this, please see Caporaso, Checkel, Jupille (2003), Lewis (2003), and Diez and Wiener (2003).

under which circumstances. The second part of the constructivist proposition is the political crises that occur that lead to changes in ideas and interests is also not specified, he adds. Therefore, the constructivist approach is not testable.

In order to address this issue Jeffrey Checkel (1999) gives more of a theoretical analysis by drawing from social constructivism. He finds that an individual's policy ideas are most likely to change when there is an institutional hierarchy that can impose conformity on an individual. Social learning as well as normative diffusion is key here. He argues, "social learning involves a process whereby actors, through interaction with broader institutional contexts… acquire new interests and preferences – in the absence of obvious material incentives. Put differently, agent interests and identities are shaped through interaction." (Checkel, 53) The empirical work here shows that social learning is more likely in groups 1) with shared common backgrounds, 2) that feel it is in crisis, 3) with high and repeated interaction, and 4) when it is insulated from direct political pressure. Moravscik agrees that this study gives a clearer direction, but more elaboration is required.

This dissertation sees that despite some of the shortcomings of constructivism, it can give insight into the study of international relations as well as to the notion of ideas and institutions in the European integration context.

The Interaction of Neoliberal and Europeanist Ideas

Craig Parsons (2006) takes a different view from both Moravscik and from McNamara's notion that the EU progressed solely from a neoliberalist consensus. Rather, Parsons argues that the intersection between neoliberal ideas and an Europeanist agenda was in fact what led to policy convergence. He argues that, "neoliberal ideas have gone as far as they have in Europe largely because they benefited from a fortuitous political connection to the distinct project of Europeanist institution-building." (Parsons, 26) Therefore, according to this author, it is essential to examine Europeanism whenever discussing institutional frameworks such as the Single European Act (SEA) or the EMU. In addition, the ideas of shared mental models by Denzau and North help to explain the actions of European elites such as Mitterrand and Kohl, whose influence played a major part in driving the Europeanist agenda forward.

Craig Parsons uses the interaction of the neoliberal consensus with ideas and mental models to identify the process of integration in Europe. He finds that there are linkages between the two schools of thought in European political economy. The first is a structural rationalist approach that focuses on how increasing international capital flows and foreign competition led businessmen and policymakers to rethink their preferences for monetary policies. The key period of change was the late 1980s and this timeframe led to the growth of institutions and convergence of national level economic policies.

The second school of thought derives from the connection between ideas and interests to influence economic policymaking. Ideas, or "shared causal beliefs" generated from experiences and interactions of actors, are implemented into monetary cooperation and policy strategies. Therefore, Parsons believes that neither of the approaches alone fully explains the European Union. Rather, the intersection of these schools of thought is necessary in order to understand the development of the European monetary cooperation. He believed the convergence of neoliberal ideas and an Europeanist agenda led to policy agreements. He argues that, "neoliberal ideas have gone as far as they have in Europe largely because they benefited from a fortuitous political connection to the distinct project of Europeanist institution-building." (34) Therefore, Parsons says to understand neoliberal policies, it is essential to discuss institutional frameworks such as the Single European Act (SEA) or the EMU as well as Europeanist ideas along with it. The Europeanist agenda which can be explained by the actions of European elites such as Mitterrand and Kohl, had influence on driving integration forward. And for this reason, the use of mental models as developed by Denzau and North is helpful in explaining the course of integration in the EU.

Parsons discusses how the linkages between neoliberal ideas and the sense of Europeanism can be clearly seen in the Single European Act (SEA). The SEA had goals of liberalization and increasing competitiveness among member countries. During this period of the late 1980s, there was rising economic interdependence amongst the European Economic Community (EEC). This created pressures for countries to cooperate economically by increasing intra-Community trade, international banking, and capital flows in order to liberalize the economy.

According to Parsons, the structural rationalist approach would explain the SEA by looking at the changes in national level liberalization. The French especially had a significant role in making negotiations and bargaining possible. On the other hand, there is the thought of using ideas to explain the SEA focuses on the French Socialists to conform to new consensus of the Single Market Program. Also, the Commission had made an impact on the neoliberal consensus in the EEC, especially through Jacques Delors who was a prominent advocate of regional integration. Delors pushed hard for monetary cooperation and increased industrial and social policies, and wanted institutional reform in the EEC. It was not until 1984 and French President Mitterrand's ideas of moving forward with integration that institutional reforms were possible. The EEC was about to be "re-launched," in more concrete terms and plans, making it become supranational.

Institutional reform stemming from the SEA was imperative for greater European cooperation. Parsons argues that "… institutional reforms did not flow from a substantive neoliberal agenda. The pushes for liberalization and a stronger EEC had distinct political roots, and were only bound together in the SEA by the political logic of bargaining, not the functional logic of instrumental institutions. Without the separate push for institutional reform, the EEC in the mid 1980s would have only achieved a weak, erratically-supported rhetorical commitment to a list of liberalizing goals…" (25) Therefore, we discover that he does not assume spillovers will automatically lead to institutional reforms or increased cooperation. Instead, Parsons emphasizes that ideas and intergovernmental bargaining led to the changes in the EEC, not solely spillovers as neofunctionalists have believed.

In addition to the SEA, Parsons also discusses the creation of the single currency and how it was also again strongly based both on structural factors and the ideas of political elites. Monetary integration and the formation of the euro could have stemmed from reasons such as increasing capital mobility and geopolitical considerations such as the end of the Cold War. However, the ideational account he uses is Kathleen McNamara's notion of "currency of ideas."[5] She discusses the convergence of ideas among leaders such as Delors and Kohl in wanting the similar economic policies and

[5] McNamara, Kathleen R. 1998.

collective institutions. There were several different ideas advocated by the various potential members of the European Union. Parsons discusses the various views from Germany, France, and Britain.

The British had ill feelings toward monetary union. The Germans on the other hand, while having little to gain from monetary union in economic terms, had more of an idealized Europeanist belief in the need to integrate. This likely stemmed from the negative reputation it had from the war. On the other hand, the French had a more disjointed view on integration. While President Mitterrand was a strong promoter of integration, others felt that having a single currency would mean loss of sovereignty and accepting German leadership. However in the end, it was the idealistic views of the French and German leaders that made monetary integration possible. Parsons argues that "Kohl and Mitterrand were representative in favoring neoliberal policies ... but much less directly representative in favoring supranational projects." (33) In this case, there was more Europeanism than neoliberalism, Parsons would argue. But he does not trivialize the importance of supranational institutions in the development of the European Monetary Union (EMU). Similar to neofunctionalists in this case, Parsons believes that supranational institutions were crucial to the development of monetary cooperation. The European Central Bank and other new institutions were necessary because authority needed to be removed from national control in order to make future policy choices. Finally Parsons concludes with the view that attention must be put on the "ideational agenda of supranational Europeanism." (35)

Institutions

James Caporaso (1998) takes an institutional analysis of European integration. He examines North's work and identifies institutions as important because they "define the rules of the game in a society, or, more formally, are the humanly devised constraints that shape human interaction."(North ,1990:3) He identifies the growing institutionalization of the European Community and emphasizes the importance of Haas' approach in understanding how the theory of institutions applies to the integration process. Institutions, or rules they define, are significant because they influence the outcomes of policy. The rules derived from the institutions in this case come from the European Economic Community (EEC) in the Commission, European Parliament, and European Court of Justice to name a few. These institutions while important do not make the European Community a strong state economically, but rather they provide a regulatory framework for its member countries. They are supranational entities and defined as "the competence of the EC to make binding rules in any given political sector."[6] (Caporaso, 1998:339)

Wayne Sandholtz and Alex Sweet (1998) also emphasize the importance of institutionalization. They contend that "because of institutionalization, EC policy domains can become more supranational without some, or at times a majority of, governments want it or being able to reverse it." Rules are the key to institutions because it identifies the actors involved and the strategies they establish for the game. They believe that when a supranational identity occurs, rules will create its own momentum and the actors in this case are self-motivated and the institutions provide as

[6] Caporaso, J. 1998.

rules to govern them. Sandholtz and Sweet consider institutions to be dynamic, constantly changing to adapt to situations presented. They can serve to be regulatory, but at the same time create new rules when existing ones are not adequate. This idea is prevalent in the EC, because it is a supranational institution that provides a venue for negotiations and disputes to be settled. In order to correctly understand the dynamics of institutionalization, they propose beginning with the Treaty of Rome since it was the start of the development of rule enforcement. Since the establishment of the Treaty, there is constant evolution of rules. With new changes and amendments to the Treaty, actors that are involved also change and adapt to the new rules of the game.[7] Therefore, they conclude that since institutions come with defined rules, it makes the supranational governance sticky and often times irreversible.

Neoliberal Institutionalism

According to the theory of neoliberal institutionalism, international cooperation stems from institutions and ideas.[8] States are focused on absolute gains and prospects of cooperation. Proponents of this theory such as identify how epistemic communities describe the process of integration. Epistemic communities include members who agree on certain ideas and collectively create solutions for resolving issues. Peter Haas (1997) looks at the role of ideas focuses on transnational epistemic communities that are the "networks of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy relevant knowledge within that domain or

[7] They argue that this is absent in the intergovernmentalist approach. Governments, not actors (that could include private bodies), are the driver of change.
[8] Robert Keohane (1984) is most associated with neoliberal institutionalism.

issue area." (3) Shared beliefs and common policy practices are the reason why epistemic communities can encourage cooperation.

Neoliberalists identify that institutions help long-term cooperation. Institutions can help to shape outcomes and decisions, and help to resolve conflicts. Individual states relinquish national sovereignty to supranational institutions, which minimizes uncertainty with other states cheating, and thus cooperation can increase. In order to keep motivating states to cooperate, there needs to be overall increased cooperation which can be done with the repeated interaction of working together. The repeated action is in fact what leads to cooperation, not the potential of war like realists tend to assume.

Keohane (1988) also examines the importance of institutions and how they affect patterns of transaction costs. First he identifies the term institution as a "persistent and connected set of rules that prescribe behavioral roles, constrain activity, and shape expectations." (386) He finds that these institutions help to reduce uncertainty and change transaction costs through their information or monitoring as well as through stabilizing expectations. In addition, he looks at the relationship between transaction costs and institutions and finds that when transactions costs are small, there will be no need to create new institutions and when they are high it is not feasible to create new institutions. But transaction costs are seldom small, so he sees that institutions should remain when incentives are there to create them. He argues that "rules of any institution will reflect the relative power positions of its actual and potential members which constrain the feasible bargaining space and affect transaction costs." (389)

Interest groups and Domestic Politics

Monetary cooperation can be seen at the core of a larger process of European integration. Barry Eichengreen and Jeffrey Frieden (2000) discuss the political constraints have influenced the advancement of cooperation, while economic changes brought about by monetary integration continue to affect EU policies. The role of interest groups and linkage politics, for instance, can help us to understand EMU development. Jeffry Frieden (1993) also discusses how France and Italy's acceptance of the European Monetary System (EMS) exemplifies the role of these political factors. Preferences of economic interest groups helped to identify their commitment towards the EMS. Even though groups such as the import-competing manufacturing sectors had less interest in fixing exchange rates, they accepted these monetary policies because of the linkage between EMS commitment and broader European integration. Therefore, Frieden's analysis gives us insight into the distributional effects of France and Italy's commitment as well as the linkage process between the EMS and European integration.

It is often argued that the role of interest groups did not have a big role in the European monetary union development. The EMU was seen to be more elite-driven, but it was supported by large business and banking firms. Helen Milner (1997) challenges the theory of realism and states how domestic politics matter when cooperation occurs. The realist assumptions that international politics is anarchic, domestic politics is hierarchic, and states are unitary actors are non-relevant in her model. Instead, she identifies how the interrelationship between domestic politics and international relations is the reason why nations cooperate with each other. Most of the international relations theories that define reasons behind cooperation tend to depict the state as a unitary actor. States tend to make different decisions based on these various preferences of domestic groups. There are major differences in internal preferences of states and therefore one cannot assume that a state is the unitary actor. Domestic politics is often neglected, but she states that a country's international position does impact its internal politics and economics. Her main argument is that cooperation among countries like in Europe, are affected by its domestic distributional consequences, not its fear of others' relative gains or potential cheating. In addition, she finds that international politics is not anarchic, but both international and domestic politics lie in polyarchy. Polyarchy essentially describes the realm of international politics as being without a single group at the top. Here, decision-making is shared between groups, but often unequally.

Theory of Optimum Currency Area

The theory of optimum currency areas (OCA) is an economic framework that examines the costs and benefits of entering a currency union. There are several criteria in which determine whether a region should have a single currency. Some of them include degree of openness, nature of shocks and business cycles, international factor mobility, wage and price flexibility, fiscal transfers, and product diversification. There can be damaging implications of joining a monetary union when member countries have not met OCA criteria and have not converged prior to forming a single currency. With different economies among member countries and no homogeneity, the prospect of a successful monetary union is challenged.

There have been many studies that looked at the European Monetary Union to determine whether member countries have met the OCA criteria and if the region is a suitable currency union or not. Empirical studies have examined the degree of openness and commodity diversification to which most of the member countries did seem to fulfill these criteria. However, some criteria have not been met either. Eichengreen (1991) for instance, looks at labor mobility and nature of shocks in Europe and compares it with the U.S. and Canada. He finds that labor mobility is lower and real exchange rates are more variable in Europe compared to the US. He concluded in his paper that Europe was farther to an ideal optimum currency area compared to the currency unions in North America.

This dissertation finds that the EU members did not satisfy all OCA criteria before joining the monetary union. Smaller countries have failed to converge with the larger member countries, and the great disparity among the economies did not prove favorable to joining a union. There has been no sustainable process of convergence among members even after the adoption of a common currency.

Chapter 2. A Critical Analysis of Neofunctionalism and the Notion of Spillover in the European Integration Process

As discussed earlier, there are numerous theories used to identify the European integration process. This chapter will look more closely at the framework of neofunctionalism and its application to Europe, particularly the dynamics of the integration process. This chapter will also look at spillovers, the core of neofunctionalism. It will examine the types of spillover, and give a documentation of how spillovers have been identified, as well as present case studies. It will also identify the various criticisms against neofunctionalism and spillover and finally look at how the framework can be extended.

Neofunctionalism, developed by Ernst Haas, emphasized the importance of supranational institutions and spillovers in explaining the progress of European integration. He believed regional integration stemmed from elites who wanted to switch functions from national control to supranational institutions. A shift in loyalties toward a new supranational institution would occur when actors believed integration to be fruitful, providing a stimulus for spillover. The notion of spillover was the core of the neofunctionalism theory, which Haas argues best explains the dynamic and course of the integration process. For example, he believed that integration in the economic sector would eventually spillover into political areas, thus leading to the creation of a political community. He sees spillovers as an 'expansive logic of sector integration' meaning that integration in one sector would create pressures for integration in other sectors. The notion of spillover seemed to have relevancy in explaining the earlier periods of European integration.[9]

However, the theory and its implications have not been without controversy. Many scholars were skeptical of the neofunctionalism theory. For instance, they realized that the pace of integration was not steady as neofunctionalists predicted, especially during the 1970s with De Gaulle. Also, the idea of spillovers was also subject to criticism because the term was considered ambiguous and the channels through which spillovers occurred were not clearly identified. Therefore this section aims to better understand the course of European integration through the two major components of neofunctionalism. First, it will identify the importance of supranational institutions on European monetary

[9] Neofunctionalism went out of favor after the late 1950s but then came back in vogue after 1985.

integration. Additionally, it will critically analyze the various meanings of the term 'spillover' as well as how scholars have documented it. It will also provide examples and evidence of spillover as well as the channels through which they have occurred. Finally, it will give address some of the limitations of the neofunctionalism theory.

The early works on spillover by Haas were later extended to include greater political and institutional roles in the European integration process.[10] The political dimension is essential in order to understand how the pace of integration was maintained over time and how it achieves progress towards continued integration. Political loyalty and commitment as well as the ability to relinquish state sovereignty were believed to have contributed to making monetary integration possible.

Spillovers also described how economic integration could eventually lead to political integration. The strategy for building European communities, for instance, would be integration in areas of 'low politics' at first but ensure that they are key strategic economic sectors like the coal and steel industry. Also, a high authority such as a supranational institution would be created in order to oversee the integration process as well as promote further integration. Starting from economic integration of the key sectors has led to more integration politically. This is seen in the development of a European Community, for instance.

Neofunctionalism also differed from functionalism by emphasizing the importance of a supranational system of governance. For Haas, two things were required for integration to be successful which included a central government that stands apart from those of the member states, i.e., supranational institutions, and a development of a

[10] Some authors added to the idea of neofunctionalism. Please see Schmitter (2003), Neiman (1998), and Sandholtz and Sweet (1998).

European consciousness. Supranational institutions were integral to regional integration in Europe because it was a part of the ideal type of political community because these types of institutions would become the agents for integration. The nation states would transfer its power and sovereignty to a new European level in political, sectoral, and geographic terms. Neofunctionalists firmly believed that supranational institutions were necessary to create a committed bound group of European countries. Supranational institutions such as the European Community (EC) were the force in creating pressures for increased integration in the area, which could be seen through the concept of spillover.

Supranational institutions were found to have a profound impact on European monetary integration. First, Caporaso (1998) identifies the growing institutionalization of the European Community and emphasizes the importance of Haas' approach in using institutions to identify the integration process. Institutions, or rules they define, are significant because they influence the outcomes of policy. The rules derived from the institutions in this case come from the European Economic Community (EEC) in the Commission, European Parliament, and European Court of Justice to name a few. These institutions, while important, do not make the European Community a strong state economically, but rather they provide a regulatory framework for its member countries. They are supranational entities defined as "the competence of the EC to make binding rules in any given political sector." (339)

Sandholtz and Sweet (1998) also emphasize the importance of institutionalization, by depicting when a supranational identity occurs and also how the rules that come from this supranational entity will create their own momentum. They contend that "because of institutionalization, EC policy domains can become more supranational without some, or at times a majority of, governments want it or being able to reverse it." Rules are defined here as the key to institutions because it identifies the actors involved and the strategies they establish for the game. The actors in this case are self-motivated and the institutions provide rules to govern them. Sandholtz and Sweet consider institutions to be dynamic, constantly changing to adapt to new situations. They can be regulatory but at the same time create new rules when existing ones are not adequate. This idea is prevalent in the EC, because it is a supranational institution that provides a venue for negotiations and disputes to be settled. In order to correctly understand the dynamics of institutionalization, they propose beginning with the Treaty of Rome since it was the start of the development of rule enforcement. Since the establishment of the Treaty, there has been a continued evolution of rules. With new changes and amendments to the Treaty, actors that are involved also change and adapt to the new rules of the game.[11] Therefore, they conclude that since institutions come with defined rules, it makes the supranational governance sticky and often times irreversible.

Spillover Types

Spillover effects were the main component of the theory of neofunctionalism. It describes integration as an open and dynamic process. Spillover can be commonly broken down into three major types – functional, cultivated, and political. Functional spillover assumes that different sectors of the economy are highly interdependent and describes how cooperation in one area leads to cooperation to other areas. Integration of the coal

[11] They argue that this is absent in the intergovernmentalist approach. Governments, not actors (that could include private bodies), are the driver of change.

and steel sectors, for instance, is considered to be an example of functional spillover. Monnet envisioned these two sectors integrating and putting pressure for other sectors to integrate.

There are several interpretations of the term functional spillover. One interpretation is that there is a growing interdependence among countries which is described as an 'expansive logic of sector integration' because "… the initial decisions of governments to delegate policymaking powers in a certain sector to a supranational institution inevitably create pressures to expand the authority of that institution into neighbouring policy areas."[12] This is drawn from Haas' notion that policies to promote cooperation can be made real only if compromises are made among the states. Hence, there is a reliance of an institutionalized mediator, as well as intergovernmental negotiations with interest groups and political parties. Majone also identifies the importance of members giving up policy making powers for the better of the group in order for the expansion of supranational institutions to occur.

Stephen George (1991), on the other hand, identifies functional spillover differently. He states that once member states are integrated in one sector of their economy, technical pressures will push them to integrate in other sectors "because modern industrial economies were made up of interconnected parts, it was not possible to isolate one sector from the rest. The regional integration of one sector would therefore only work if other sectors were also integrated." (37) He considers external forces are what propel integration into the other sectors.

Finally, Leon Lindberg (1963) sees functional spillover in the European Economic Community (EEC). The EEC treaty exemplified measures to move toward a

[12] Majone, Giandomenico. 2001, p.266.

customs union, above anything else. The merging of six economies "will require action transcending the borders of any one state." (45) Therefore, Lindberg argued that there would be a 'negative integration' from spillovers, meaning the removal of economic agents or states would lead to a 'positive integration' that included common policies and coordination.

Another type of is political spillover and focuses on transfer of loyalties to a supranational entity. Neofunctionalists have described this spillover as due to a redefined goal or interest in the political community. The reason this occurs can be attributed to political elites and their learning process that leads them to believe that their interests are best served by seeking supranational rather than national solutions. The refocus on activities will lead to a new loyalty towards a supranational institution to promote integration, which will provide a political drive.

Political spillovers center upon the buildup of political pressures in favor for increased integration. Haas, for example, classifies the elites that put pressure for integrative measures, as the non-governmental type. They would include leaders of trade unions or political parties, to name a few. He believed that the changes that occurred in the national level will eventually lead to a change at the supranational level. But Lindberg, believed that governmental elites that control the pressure to move integration forward. He believed the EEC was a bureaucratic system that involved numerous elites in the decision making process. He argued that these elites would be engaged personally in the process of integration, which could lead to different and informal channels of cooperation, and called this process 'engrenage.' In addition to Haas and Lindberg's ideas of political spillover, other scholars view how interest groups can also create political spillover when they have benefited from integrative steps. They do this by advocating more integration in certain sectors that will not be effective unless integration in other sectors occur. This will shift the behavior and expectations of the actors involved, as well generate coalescence at the supranational level as a response to integration efforts because of the appreciation of integration efforts that arise.

Cultivated spillover is the final type of spillover. It explains how central institutions such as the Commission provide a common avenue towards increased cooperation. The Commission creates spillover by making deals as well as engaging interest groups and national officials into a partnership. It acts as a middle ground where it helps to come up with solutions toward cooperation that will be of a 'common interest.' Negotiations toward a common goal can be made by a supranational entity that will find the middle ground between the two opposing views, which is what the Commission has tried to become. The outcome will generally include redefining the conflict as well as the expansion of power of the international agency. Thus, this type of spillover will depend on the acts of the supranational institutions itself and how well they can promote integrative movements. Therefore, this spillover is not deterministic but voluntary in nature. Caporaso (1998), argues that the institutions of the EU, in particular the Commission, would provide a modicum of leadership over, as well as an arena for, a burgeoning transnational society. (9)

One version of spillover is defined as "a situation in which a given action, related to a specific goal, creates a situation in which the original goal can be assured only by taking further actions, which in turn create a further condition and a need for more action and so forth." (Lindberg, 8) In this definition, the dynamics of spillover are dependent upon the support received and must come from a convergence of goals and expectations. The similar goal during the early periods of European integration that was shared by most elites was a dedication to welfare.

Other types of spillover have also been discussed and added to neofunctionalism's original notion. Spillovers due to geography examine the benefits of being inside a group versus costs of being outside of it. An example of this can be seen as how countries are motivated by the European Free Trade Association (EFTA), because they were worried about the costs of being outside of it. Negotiations were made to assure access to the internal markets, which ultimately led to the creation of European Economic Area (EEA) comprising of the European Community (EC) and EFTA to assure freedom of goods, services, and capital. This process can be seen as externalization, which is the term coined by Schmitter to describe this type of spillover. He stresses the importance of a third party and argues that "participants will find themselves compelled – regardless of their original intentions to adopt common policies vis-à-vis non participant third parties. Members will be forced to hammer out a collective external position…" (Schmitter 1969:165).

The process will increase the reliance of members on central institutions. For instance, aversely affected countries will want to try to join the union and members of the community may even threaten non-participants, which will lead to externalization. This process of externalization can be seen as a spillover in the example of the European Community (EC), and where it decides upon common policies that will affect on non-member countries in various ways, particularly in a customs union.

Documentation of How Scholars Have Identified Spillover

Spillover is a concept of great debate within regional integration theorists, since it has not been clear how much evidence there is for spillover. Although the concept of spillover has been defined in various ways, there is still debate regarding its applicability. It is useful to identify how different scholars have used spillover to explain European integration and how careful they are in describing it.

Philippe Schmitter (1969), for instance, makes a detailed analysis of the concept of spillover. He is a proponent of neofunctionalism and believes that once spillover has occurs, there is a greater chance on the part of regionally oriented elites to do more for the promotion of integration. He describes spillover as, "process whereby members of an integration scheme – agreed on some collective goals for a variety of motives but unequally satisfied with their attainment of these goals – attempt to resolve their dissatisfaction either by resorting to collaboration in another, related sector (expanding the scope of the mutual commitment) or by intensifying their commitment to the original sector (increasing the level of mutual commitment) or both." (1969:162)

He believes that spillover could be used to explain the process of integration, but believes that the nexuses that lead to spillover have not been adequately identified in the classic neofunctionalist theory. Therefore, he deems that the hypothesis of spillover that was discussed by early neofunctionalists was not sufficient and some revisions need to be made. He argues, "...if it is to retain any parcel of its predictive capacity, the spillover hypothesis must be accompanied by an a priori specification of the minimal conditions under which an original endowment of functional tasks is apt to be inherently expansive." (Schmitter, 1969:163)

Therefore, he suggests the additional concepts of scope and level to be developed alongside the hypothesis of spillover. [13] Adding scope and level can help to identify when there is a propensity for task expansion; so the higher the scope and level, the greater is the chance of regional activity developments. For instance, he describes the highest level of commitment that is most conducive to spillover would be "an agreement to devolve permanent control over a policy area to some autonomous supranational body."(Schmitter, 1969:63) This would probably be what some would consider a political spillover. On the other hand, the lowest level of commitment would be an agreement between representatives on distribution of mutual benefits.

Schmitter also assumes that the process of spillover is not always automatic. He does believe that there is a high probability that spillover would occur when elites move towards regional integration, but that this does not occur endogenously. He argues that spillovers would only be automatic when "there is a conflict between national actors (and) it will be resolved by expanding the scope or level of central institutions. While there is no guarantee that it will always be successful, manipulation of such crises by regional actors lies at the core of the integrative dynamic." (1969:164) He also argues that spillovers would be automatic when it is unconscious and involuntary but in neofunctionalism assumes that there is a role of bureaucracy and political elites, which actually challenges the idea of automaticity.

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[13] Scope implies number of social groups or policy sectors potentially involved and importance of these policy sectors for attainment of national actor defined goals. Level is the extent of commitment to mutual decision-making in terms of continuity (obligation to meet recurrently and to reevaluate periodically join policies) and in terms of techniques (nature of policymaking process itself). (Schmitter,1969:163)

He does however agree with Haas on the idea that the process of spillover has a cumulative tendency – "(it) tends to involve more national actors in an expanding variety of policy areas and in an increasing degree of joint decision-making." (Schmitter, 1969:165) Spillovers can increase because of politicization, when the process when joint decision-making becomes controversial to the point that there is more of an audience involved and interested in integration efforts. Spillovers will arise from the engagement of new actors and their differences in opinions. It is during this period that loyalties would shift, due to the objectives of the integrative scheme and learning about the difference in opinions among actors. The shift in expectations and loyalty will ultimately be towards a new political center, rather than replace national loyalties.

Arne Niemann (2006) also discusses the term spillover and how it was first used as shorthand for occurrence of (further) integration. He describes in detail the definition of spillover constructed by the pioneers of neofunctionalism, Haas and Lindberg. The first analysis was on functional spillover, which described how integration of one sector creates technical pressures to push states to integrate into other sectors, a concept that we have illustrated earlier. The main idea that he draws from the earlier works of Haas and Lindberg is that functional spillovers occur because some sectors within industrial economies are so interdependent that it is impossible to separate them from the rest. Therefore, regional integration of one sector would only work if followed by integration of other sectors, as the functional integration would lead to problems, needing solutions that can only occur by integrating more tasks. For instance, "integration in coal and steel sectors was regarded as viable only if other related sectors followed suit, such as transport policy, which was important in order to ensure a smooth movement of necessary raw materials." (2006:17)

Niemann also touches upon the role of elites that has been brought up in the neofunctionalism approach and attempts to explain their importance. Haas and Lindberg argue that national elites were assumed to realize that problems cannot be solved satisfactorily at the domestic level because of the functional – economic logic. This would lead to a spillover that included a gradual learning process whereby elites shift their expectations, political activities, and according to Haas, even loyalties to a new European center. As a result, national elites would promote further integration, thus adding a political stimulus to the process. Pressure from non-governmental elites would alter perceptions of political parties, trade associations, trade unions, interest groups. This implies that integration in a particular sector leads interest groups concerned to move part of their activity to the regional level. Groups may shift their focus and expectations to the European level as they become more aware of benefits of integration, which will make them promote more integration. (2006:18)

Niemann has discussed the importance of the spillover hypothesis in understanding the process of regional integration in Europe, but has criticisms of the theory nonetheless. He discusses how ambiguous the term spillover is and criticizes the lack of a clear definition. Spillover has been gradually broadened and has come to denote any type of neo explanation for political change to cover a multitude of different mechanisms and patterns of causation that seemed to have been involved in the expansion of tasks. (2006: 29) Therefore, he wants to identify conditions and mechanisms that are likely to impact on spillover processes and how they affect the dynamics of integration.

He does this by identifying several concepts of spillover – functional, political, social, exogenous, and cultivated, and modifies them according to his assumptions and ontology. The earlier section has already discussed in detail the types of spillover, which we will not go into here. However, we will discuss some of Niemann's revisions of these concepts. First, functional integration which depicted an expansive logic of sector integration has been modified to depart from a narrow focus on economic linkages and policy areas. Instead, it "allows for endogenous – functional interdependencies, i.e., all tensions and contradictions arising from within the European integration project and its policies which induce policymakers to take additional integrative steps in order to achieve their original objectives." (2006:30) Another modification to the early functional spillover notion focuses on how pressures induce integration steps in other sectors or policy areas, but also pressures to generate increased cooperation in the same field. The pressures to move toward integration were never clearly identified before. Here, he identifies pressures stemming from dissatisfaction with policy and goals.

Niemann has also adjusted the idea of spillover to include exogenous factors. He says including exogenous issues can incorporate factors outside the integration process itself and attempts to identify the changes in and pressures from the external environment that affect the EU as well as domestic structures. Niemann, along with Schmitter[14], believe that external factors are important contributors to the spillover process. Some external factors that can affect regional integration are threats or shocks, and one example

[14] Schmitter also develops an externalization hypothesis, which he discusses in his paper "Three Neofunctional Hypotheses about International Integration."

is the Cold War. The author argues that external factors have important contributing effects on further integrative steps. Externalization, as coined by Schmitter, also stresses the importance of a third party. Schmitter argues that "participants will find themselves compelled – regardless of their original intentions to adopt common policies vis-à-vis non participant third parties. Members will be forced to hammer out a collective external position…" (Schmitter 1969:165).

Case Studies of Spillover

There have been many instances of spillover, according to the neofunctionalists. Case studies of spillover can give us a clearer idea of what form spillovers have taken. One of the early examples of spillover is seen with the European Coal and Steel Community (ECSC). The ECSC was formed in 1951 and consisted of six member countries: France, Germany, Belgium, the Netherlands, Italy, and Luxembourg who formed a common market for coal and steel. It was the political plan proposed by Robert Schuman, and the main idea behind it was for the member countries to pool their coal and steel resources so that war could not occur within the community. The integration of coal and steel industries was seen as a spillover because it led to further cooperation. This was explained by the functional aspect of spillover, that deepening of one sector would create pressures for further integration in other sectors as well as a need for a European authority. Haas predicted the process of developing the ECSC would continue into the European Economic Community. He believed that the liberalization of trade within the customs union would lead to harmonization of general economic policies and spillover into political areas and eventually some form of political community.

However, the pace of integration was not always continuous as we have seen in the history of European integration, and spillovers did not occur as expected. After a promising start in the 1950s with the pace of integration, there was a slow down a few decades later. During 1960-1985, Europe saw protectionism and new trade barriers. There was also widespread fluctuation of exchange rates as well as periods of low economic growth. In addition, there was a negative attitude toward European integration, also known as Euro-pessimism, when the pace of cooperation slowed down.

There was dissatisfaction with the lack of free trade among the European countries and the Commission was looking for a solution to this problem. They came up with the idea of building a common market among the European countries, and wanted to see if this was possible. So in 1985 the European Commission, which included President Jacques Delors and Commissioner Lord Cockfield, drew up the White Paper, *Completing the Internal Market,* for the European Council in Milan in June of that year. This represented a significant movement towards banishing borders. After this, the result was an agreement called the Single European Act that helped provide as a commitment to the White Paper by spelling out a timeline to do create a common market. With a proposed date of December 1992, the launch of the integration process came back on its feet again. Things were looking up and European integration gained ground again because public interest was seen in the development of a common market. This revival of interest sparked a new momentum toward integration.

This new attitude towards integration also led scholars to reconsider the neofunctionalism theory and its idea of spillovers. Tranholm-Mikkelsen, for instance, looks at the reemergence spillover that has taken place after 1985. He argues that there has been functional links between 'negative and positive integration' after the White Paper was enacted, similar what Lindberg had described. The objective of the White Paper was to abolish any barriers among the member countries, which was an example of 'negative integration' because it is deregulatory and reflects a liberalizing strategy. Some of the sources of negative integration come from the abolition of physical frontiers that may lead to immigration problems, restriction of capital movements which can increase exchange rate volatility, reduction of state autonomy due to the abolition of barriers to goods and services, and the uneven distribution of economic benefits. However, Tranholm-Mikkelsen (1991) argues that one way negative integration can lead to spillover into the creation of a common market is through more positive integration to deal with the problems that have been created. He also examines how these functional links occur through the political process at national and supranational levels and finds evidence of political spillover.

He finds the importance of ideas and activities of governmental and non-governmental elites to affect spillover through social, environmental, and regional policies. With government elites, there is a high level of bureaucratic interpenetration. With non-governmental elites, those that are in the business sector are mostly pro-integration. Trade unions as well as interest groups have positive influences on policy positions and can also lead to political spillover. Lastly, Tranholm-Mikkelsen talks about how cultivated spillovers did exist from the Commission. Part of the reason the Commission played such a major role in the process of integration could be attributed to Jacques Delors. The Commission made strides toward "upgrading the common interest" (1991:15) as opposed to only being politically symbolic. The Commission was also significant in the resurgence of the integration movement because it helped to increase communication with experts and interest groups at both national and supranational levels in order to obtain information as well as seek advice and support.

Another example of spillover can be seen as the Common Agricultural Policy (CAP). The CAP was designed to help garner support for regional integration from European farmers. Eichengreen (2007) argues that the CAP demonstrates "how building a broad-based coalition supporting regional integration may require the extension of side payments, sometimes with enduring consequences." (4) He continued to say that the CAP led to increased cooperation, more than the Common Market itself. This had a lot to do with lowering incentives of cross-border arbitrage. The CAP was considered to be a program that gained the needed political support. While some spillovers have had positive feedback, they were still considered highly risky like the CAP. Willett et al. (2008) have argued that using the CAP to build support for integration was a high-risk strategy because it was based on bad economic fundamentals.

Spillovers have also been used to explain the Stability and Growth Pact (SGP). Functionally, the SGP had important implications for the European Monetary Union (EMU). The SGP had a legal framework within the Maastricht criteria, ensuring the countries observe the convergence criteria. It also developed a political spillover because each nation would be willing to transfer sovereignty to a supranational identity and countries would abide by rules at the European level.

According to Heipertz and Verdun (2005), the two most important forms of spillover by the SGP are functional and political. The EMU itself had generated many externalities like the rise in negative fiscal externalities as a result of the German reunification and also with the fact that national exchange rates were abandoned. Therefore the SGP was designed to be a way to "safeguard the credibility of the ECB independence" (Heipertz and Verdun, 997) when the market expected a bailout. It also was supposed to as an instrument for policy coordination, which was highly important when shocks and divergence occurred among countries. The SGP also contributed to the functional spillover of the legal framework of the Maastricht Treaty. It was designed to be consistent with the Treaty that established the European Community, but added more significance to it by defining possible fines that can be incurred, improve transparency, as well highlight the fiscal issues among the EMU members. Lastly, political spillover by the SGP was also developed but was more implicit. Hiepertz and Verdun argue that, "if one advances integrative measures in the area of budgetary policies, there should be a willingness to transfer sovereignty to a new supranational institution or at least subscribe to rules at the European level." (Heipertz and Verdun, 996) Political spillover could emerge in that way but they state that the reality shows a complete transfer to a 'supranational political fiscal body' is not going to happen soon.

Criticisms of Neofunctionalism and Spillover

So far, spillovers within the context of neofunctionalism have been discussed in terms of how they could explain the European integration process. However, there are criticisms of the theory and limitations of spillover that need to be addressed. First, Willett et al have argued the channels through which spillover leads to integration have not been fully discussed by the theory. For instance, they suggest that one of the channels through which spillover can occur is the building of trust and the spirit of cooperation over time. More emphasis needs to be placed on how repeat cooperation among member states can foster trust. Developing good relationships among member countries increases trust, making groups more willing to cooperate. Lastly, trust could also be seen as a prerequisite for peace, which was especially desired after World War II.

Another channel that has not been explored is how to move others to do something, or private sector lobbying. For instance, the benefits of integration would become apparent to domestic interest groups who would lobby according to their material interests. Willett, Wihlborg, and Permpoon (2010) also add that spillovers can come from "linkages (that) can operate both directly through anticipatory actions of governments or indirectly through changes in public attitudes and lobbying efforts of interest groups." Lastly, a channel through which spillover can develop is adopting policy that raises the cost of non-cooperation. This could possibly be seen as the CAP discussed earlier.

Over time, spillovers often did not take place as expected, which was one of neofunctionalism's shortcomings. Spillovers became an extremely contingent phenomenon, providing little understanding of general events. In addition, neofunctionalism could not be used to describe the changed atmosphere and slow down of the European integration project during the 1960s and 1970s. It could not explain the unevenness in speed and depth that spillovers occur. The pace of integration was quite variable, in fact. Keohane and Hoffman (1991), for instance, argue that spillovers occurred but not as much as expected. They say "we believe that spillover does not adequately account for major decisions such as those of the Milan Summit in 1985 and, subsequently those that led to the Single Act. If spillover and pressure from the European institutions had been sufficient to create such a step-level change, it would have occurred much earlier." (Keohane and Hoffman,19) Although they identify shortcomings of spillover, they do not believe the notion is unimportant. Rather it is more important to be aware of the limitations of spillover.

Furthermore, some have argued that the neofunctionalism hypothesis does not apply to the development of the SEA. Rather, some have argued that external events such as international competitiveness were what drove the SEA, not functional spillovers. The problem with Haas' theory is also that it has never addressed how long it will take for linkages to occur. There has not been sufficient discussion on what changes had to occur for spillover to take place. Schmitter (2005) does argue that it could be due to an increase in economic interdependence between member countries, external shocks, or a development of political competence, but Haas has never fully discussed the contributing factors in detail.

Haas and Lindberg also both claimed that spillover was not only expansive but also irreversible. This claim was not quite accurate, especially during the De Gaulle years. During these years, there was quite a challenge to the European Community. He ordered a stop to expansion of tasks by the Commission as well as took on a nationalist attitude, with concern only for the greatness and prestige of France. He took a realist view on the situation, stating that geopolitics was most important to nation states and he greatly distrusted supranational institutions. Neofunctionalism did not seem to be an appropriate theory to identify this phase of European integration. Greater clarity on spillover needed to be identified during this period.

Other questions also arise in regards to political spillovers. Many have speculated about why regional loyalties would take precedent over individual state interests. Haas initially used regional loyalties to describe political spillovers. He attempted to explain how actors began to direct their expectations to a supranational institution in decision making. Regional loyalties can emerge if there is a buildup of trust and increased spirit of cooperation. Also, having a secretariat can help foster increased loyalty toward a supranational institution, especially if the organization is credible and transparent. But many disagree with this idea. For example, Moravscik (1998) argues that institutions do provide members with information and reduced transaction costs, but they do not result in a transfer of loyalty. States have the ultimate influence over the process. This has been one of the major criticisms of spillovers within the context of neofunctionalism.

Another criticism that has been brought by liberal intergovernmentalists is that neofunctionalism had little or no explanatory power. Moravscik (2005), for instance, argues that "… neofunctionalism is not a theory, Haas' bias toward 'ever closer union' meant that this framework was overambitious, one-sided, and essentially unfalsifiable... (Neofunctionalism) is simply meaningless." (350) He states that neofunctionalism, in particular spillovers, was too ambitious identifying the process of integration as dynamic, provided a single framework for analyzing integration as a whole, and too predictive when assuming that endogenous factors only create integration. The disregard of geopolitics and mobilization of public opinion were some of the fallacies that Moravscik saw in neofunctionalism.

Moravscik also believes that Haas' theory underestimates the importance of domestic politics. He argues that neofunctionalists have viewed the nation state as obsolescent when examining the European Community (EC). However, he finds that the contrary to be true, and that the EC in fact centralizes domestic influence. He believes that it is the changes in domestic politics that lead to changes in interest and convergence, not just the participation of actors in the European Union. He adds that international cooperation also redistributes domestic political resources between the state and society. It does this by 1) shifting control over domestic agendas, 2) altering decision-making procedures, 3) magnifying informational asymmetries, and 4) multiplying potential domestic ideology justified for policies. He concludes that cooperation not only resolves international collective action problems but also domestic ones as well. This has important significance for explaining the motivation for creating international regimes. He finds that simply looking at the state preferences and power is not enough. Domestic politics are also integral to international negotiations and institutions.

Rather than using spillover to describe European integration, Moravscik hypothesizes a two-step approach towards the process of European cooperation, beginning with preference formation followed by interstate bargaining. In the first stage, national interest groups dictate domestic policy and their views on integration. The second stage then describes the outcomes of state preference and bargaining power. Like Keohane and Hoffman, Moravscik also believed that the Single European Act was not a result of spillover. And in contrast to Haas, he does not believe that spillovers were the drivers of European integration. Instead, he believed it was due to major intergovernmental bargaining as a result of preference convergence by the largest states within the Union.

Extensions of Neofunctionalism and Spillover

Although neofunctionalism has its criticisms and the concept of spillover has its shortcomings, the study of European integration would not be complete without this approach. In the end, no single theory can explain everything we would like to understand about the European integration process. It is difficult to determine which theory fits best. However, this theory contributed a lot to the identifying the road towards integration and therefore has been insightful. Because of the theory's importance to the study of regional integration, there have been many extended studies drawn from the earlier works of Haas and Lindberg.

For example, the works on spillover by Haas were later modified to include greater political and institutional roles in the European integration process. The political dimension is essential in order to understand why pace of integration was variable over time as well as understand the political factors that were integral continued integration. Some have argued that the shifts in political loyalty to a supranational institution and the ability to relinquish state sovereignty have contributed to making European integration possible, but this is still up for discussion. Commitment, for example, started in the early years of the European Monetary System, and was displayed by sustaining monetary policies that were in accord with stable exchange rates. Jeffrey Frieden (1997) discusses how credible commitment became vital to the EMS after the failure of the Snake, and how it continues to steer the course of European regional integration. Strong political will and loyalty consequently proved to be instrumental in European cooperation. The extent of commitment can be very important. This is open for criticism, however.

In addition, institution formation was fundamental to the European integration process. For "institutionalists" such as Haas, structural imperatives arose from institution building after the war, but the following steps for more institutions were greatly path-dependent. Once some power was delegated to supranational agents in the ECSC, those political agents crafted new projects and mobilized coalitions to extend supranational institutions. Some neofunctionalists believed that spillover led to the creation of the EEC, which is the direct foundation of today's EU, and its later development. Coalition-building among national interest groups also became the important factors in regional institutions. Groups could cooperate with each other across boundaries to generate the impetus leading to the formation of supranational governing bodies. Transnational interests among these coalitions create a desire for the development of a governing body that transcends the state level. The result is a spillover, as described by Sandholtz and Sweet (1998), in which these supranational governing bodies have reign over new, but related domains. For example, the three main institutions that govern the EU (i.e., the Commission, the Council, and European Parliament) alongside the European Central Bank have been essential to the integration process because, "they embody the principle of common good and common aims which transcend national interests and objectives." [15] The functioning of the EU is supported by these several institutions that make credible commitments to the harmonization of policies, serve as a surveillance mechanism, and offer mutual support. These governing bodies not only contribute to regional commitments, but they also rely upon the individual states for their own maintenance. It

[15] Wyplosz, Charles. 2002.

is from these national groups that they get critical skills and information necessary for their own validation and success.

Sandholtz and Sweet (1998) look more at complex spillovers and identify transnational transactions and supranational bargaining. They argue that the institutional structure is likely to generate feedback effects. They believe that "as institutionalization proceeds in any given policy sector, member states lose their mastery over that sector, becoming one set of important actors in a system in which power and control are increasingly diffused." Their notion of supranational institutionalism identifies two major dynamics that underlie the integration process – path dependency and principle agent relations. Path dependence, as discussed earlier, helps to identify the historical developments that led to the development of supranational institutions. Principle agent relations, on the other hand, have not really been discussed in the context of neofunctionalism. Here, Sandholtz and Sweet argue that these relations convey the possibility that institutional actors can develop some autonomy vis-à-vis their principals. Thus, their notion of supranational institutionalism departs from neofunctionalism, the sense that institutionalization of the European community cannot be reduced to the preferences of member governments.

The framework of neofunctionalism as well as spillovers has given us insight to the European integration process. However, over optimism led to the belief that spillovers would continuously occur and spur further integration. This dissertation finds that this is not the case. While spillovers may have accounted for some of the events that took place at first, it is clear that spillovers did not generate as much integration as thought. Especially looking at the current European crisis, it is quite evident that it was not the case because spillovers were not strong enough to keep integration moving forward. Therefore, it was not the way the neofunctionalists had expected.

Chapter 3. Historical Analysis of European Integration

Having reviewed the major theories concerning European integration, this chapter now looks in more detail the history of European integration. By exploring the different actions, events, and ideas that have occurred in the region throughout time, we can gain some understanding of monetary integration in Europe.

1920-1960

The first appeal of a united Europe was seen as early as 1929 when Gustav Stresemann, a German politician, asked the League of Nations "Where are the European currency and the European stamp that we need?"[16] He was considered the first to envision an economically integrated Europe. The following year saw the stock market crash, which affected the ability of the European countries to provide welfare to its citizens. Unemployment rates were high and countries also adopted 'beggar thy neighbor' policies. These international financial problems needed to be solved, which led some to believe that an impetus toward integration in Europe was needed.

However, it was not until the aftermath of World War II that the desire of European integration became most apparent. The war not only brought upon countless deaths but also economic ruin. After the two world wars, Europeans were determined not to let history repeat itself. As a result, the objective of ending political rivalry and promoting economic integration became forefront. Long run developments in European

[16] From the Stresseman Speech.

monetary integration were primarily seen here. Although monetary cooperation was not at the highest during this time, overall integration that led to the European Economic Community (EEC), European Monetary System, and eventually European Monetary Union were developed.

The idea of an integrated European region was primarily unfolded by several political elites who wanted to secure peace after the war. Winston Churchill, for example, stated that only a united Europe could bring about harmony in the region and he believed that it began with a partnership between France and Germany. Jean Monnet also wanted to make war unthinkable and believed in order to do so, increasing linkages within Europe was required. His plan was to place all the production of steel and coal in France and Germany under a common High Authority, which would be made available to the other countries in the European community. His work was proposed to Robert Schuman, who was the current French Foreign Minister. Schuman favorably accepted this notion and declared, "Through the consolidation of basic production and the institution of a new High Authority, whose decisions will bind France, Germany and the other countries that join, and this proposal represents the first concrete step towards a European federation, imperative for the preservation of peace."[17] The initiative later became known as the Schuman Plan and laid the foundation for the European Coal and Steel Community (ECSC).

The Schuman Plan, which proposed the joint management of the coal and steel industries between France and Germany, was one of the initial steps taken in the process of economic integration. Several principles were implemented in this plan. First, hostility

[17] Statement by Robert Schuman, May 9 1950, Paris.

between these two countries must no longer remain. This would not only lay the framework for peace in the area but also make war materially impossible. Furthermore, pooling the production would help raise the standard of living in the European Community (EC). The Schuman plan also stated that Europe will not be made according to a single arrangement; gradual steps will be taken towards solidarity. Lastly, the High Authority will be able to enforce and bind decisions it makes, which enforced the importance of supranational institutions. The Schuman Plan eventually led to the creation of the ECSC Treaty, and was considered the foundation of the European community.

Following the success of the ECSC, The Treaty of Rome was later signed on March 25, 1957 by France, Germany, Italy, Belgium, the Netherlands, and Luxembourg. The Treaty of Rome was set out to create a common market, implement common policies, and create a customs union between the six participating countries. The common market would be based on the four freedoms – goods, services, labor, and capital. It is designed to promote economic development, increase stability, and further raise the standard of living of member countries. Another objective of the treaty is the development of common policies which deal with such issues as trade and agriculture. Common policies were erected to improve job opportunities for its citizens.

The Common Agricultural Policy (CAP), for instance, allowed free trade in high priced agricultural goods within the Community by excluding low priced imports from outside. It has been argued that the while the CAP helps the European Union's farmers, economic efficiency is sacrificed. Finally, the customs union was constructed to remove trade barriers but common tariffs were placed on goods and services outside the union. During this period, the customs union was very successful with growth of the intra-

Community trade increasing to over 60 percent of the total trade of the participating countries.[18] The Treaty of Rome also demonstrated the significance of creating supranational institutions. During this time, the Council, Commission, and European Parliament were all generated. The institutions balanced each other, worked in conjunction with one another, and represented national as well as Community's interests. The significance of the Treaty of Rome is that it marked the development of a European Economic Community (EEC) and political integration, and also signified the success of Jean Monnet's idea of a gradual building of a united Europe.

1960-1970

Integration efforts continued, and serious discussion of full monetary cooperation came about in the late 1960s. The first blueprint for the development of the European Monetary Union (EMU) began with the Werner Report in 1969. The primary framework of the report listed three stages to monetary integration: 1) reduce fluctuation of margins between member currencies, 2) irrevocable fixing of exchange rates among participants, and 3) integration of financial and banking sectors for free movement of capital. The Werner report was ambitious but its progress was stunted due to the collapse of Bretton Woods.

The fall of the Bretton Woods exchange rate regime caused major turbulence in the 1970s. When the wave of instability on the foreign exchanges emerged, the European Community's members had to temporarily abandon the EMU project and refocus their efforts to minimizing exchange rate volatility. There was an attempt to set up the Snake, which was intended to minimize fluctuations of the Community currencies in relation to

[18] Eichengreen, Barry and Jeffry Frieden. 2000.

fluctuations against each other. The participating members concentrated on holding currencies within a 2.25% band. There were doubts about the effectiveness of the Snake and the oil shock of 1973 proved it to be unfeasible. Members had suffered balance of payments crises, forcing those countries to change or abandon those bands. Only Belgium, Luxembourg, Denmark, France, Germany, and the Netherlands continued to participate in the Snake and float jointly in 1975. Horst Ungerer (1997) sees this move as marking great political significance. While the move towards flexible exchange rates became the trend, the common exchange rate system among EC members was viewed by many to be essential for maintaining the common market in industrial and agricultural goods. Ungerer states that this was seen as a precondition for further progress of European integration. But the Snake ultimately failed to achieve a common policy response to a major shock such as the oil crisis and was rendered ineffective. It was largely a pragmatic move toward monetary unification but suffered from too many problems.

The breakdown of the Snake was clearly a setback for the European Community. In addition to the lack of progress of European integration during this period, high inflation levels and economic stagnation existed throughout the region. The leaders of France and Germany, President Valery Giscard d'Estaing and Chancellor Helmut Schmidt, set out to reignite monetary integration by designing a common exchange rate system for the entire community.

1970-1980

Consequently, the proposal to create a European Monetary System (EMS) was initiated. It was a blueprint for closer monetary cooperation and primarily a Franco-German initiative. The economic objectives would be to stabilize exchange rates and reduce inflation while its political goal would be to restore the movement towards integration and continue efforts to a full monetary union. The proposal of an EMS was presented at a Council meeting and featured a framework for a monetary arrangement that included a European currency unit (ECU).

The ECU was initiated as a "basket" currency that would be used by the member states of the European Union. The discussion for an EMS lasted several months and a lot of concerns arose. Germany, for example, was worried about the Bundesbank losing control over its money supply. On the other hand, France, the UK, and Italy were worried that Germany would continue to be what they viewed as overly restrictive. Italy was also worried whether it could survive within the system with its weak domestic economy. Meetings and further negotiations helped address most of the concerns, and the operation of EMS finally came into effect on March 13, 1979.

The objective of the EMS was to promote monetary stability in the EC. It aimed to promote "lasting growth stability, a progressive return to full employment, the harmonization of living standards, and the lessening of regional disparities in the Community."[19] The EMS served to replace the Snake and consisted of fixed but adjustable exchange rates that were kept within margins by required interventions and included short-term credit facilities. Within the EMS, the exchange rate mechanism (ERM) was also conceived as a monetary stabilization mechanism. The member

[19] Statement by the Commission, 1979.

currencies of the ERM were fixed against each other within a fairly narrow band of fluctuation based on a central European Currency Unit (ECU) rate, but floating against non-member countries. In addition to an ERM, a very short term financing facility (VSTFF) was also created to offer credit lines in unlimited amounts during interventions.

While the EMS showed some signs of success, big budget deficits and a decline in economic convergence amongst member countries still existed within system. However, over the ten-year period, the EMS did seem to reduce exchange rate variability. Budget deficits and relapses in economic convergence were not the only problems that the EC incurred in the 1980s. Unemployment levels were rising and productivity growth was slowing down, mainly due to the high transactions costs linked to currency conversion and uncertainties due to exchange rate fluctuations.

1980-1990

The Delors Committee promptly advised the EU to move towards creating a single currency. It laid out a framework consisting of three stages. Even though a timeline was not set, the committee suggested that it should quickly aim to complete the first stage by removing all capital controls and head towards a single market. The second stage consisted of developing a European system of central bank (ESCB). The ESCB's main function would be to serve to form and implement independent monetary policy. It would also remain committed to objective of price stability. Lastly, an irreversible locking of exchange rates transpires and ultimately a single currency would occur in the last stage of the integration process.

1990-2010

The Single Market Program was initiated in 1992 to remove obstacles to intra-European competition by having free mobility of capital, labor, goods, and services; and also aimed at increasing productivity levels in the region. To implement these measures, the Single European Act (SEA) was added to set to start measures to harmonize the internal market and remove barriers between the countries. It was adopted in 1986, and marked complete liberalization of capital movements by the EC countries. The Single Market could be seen as a variant of the 'bicycle theory.' The bicycle theory, popularized by Bergsten (1975) suggests that if liberalization ceases to move forward, then it will collapse. In this case, the Single Market was seen to be integral to the European integration process as well as to sustaining growth among the member countries. It needed to advance in order for it not to falter. The pooling of economic resources was believed to eventually lead to a political construction of Europe. When a sufficient degree of economic integration has been achieved then political integration would follow. But we are able to see that more is needed in order keep integration moving forward. There is a need for more harmonization of policies and increased cooperation in all areas that needs to occur. Integration cannot only be a political objective either. Increased cooperation in both the economic and political arenas needs to occur so that integration can continue to move forward.

In order to further advance the integration process, the European Commission held a meeting in Hanover in 1998 stating that "upon adopting the SEA, the State members confirmed the objective of the progressive achievement of economic and monetary union"[20] and decided to form a committee presided over by Jacques Delors. Delors, along with governors of central banks of EC members and a few other experts, would examine how a European monetary union (EMU) would happen. The committee would advise a politically and economically viable framework for monetary integration. The Delors Report was organized into sections that reviewed economic integration in the EC, defined and characterized a monetary union, and listed the stages toward EMU development. It also followed as a plan to introduce EMU and include an institutional framework to allow policy to be decided and executed at the Community level.

The Maastricht Treaty was signed in 1993. It set out the EMU as a formal objective. It proposed to replace the national currencies with a single currency and create a European Central Bank (ECB) that would conduct a single monetary policy. The treaty was very similar to the Delors report and also inducted three stages of transition to complete monetary union. First, it would eliminate capital controls and make the members enter the ERM. Secondly, countries would have to meet a number of economic convergence criteria as a precondition to the EMU. A convergence of inflation rates, government budget deficits, long-term nominal interest rates, and exchange rate stability are some examples of the criterion that needed to be met. The final stage should begin by 1999 and would have a fully functional European Central Bank. Soon after a single currency will be introduced; with the benefits being a reduction in transaction costs and removing uncertainty in exchange-rate fluctuations, and thus promoting intra-European trade and investment.

It seemed that a plan was set and a single currency was in the near future, however, issues remained within the EMS. Whereas it was fairly effective in terms of

[20] Statement made by the European Comission.

reducing fluctuations in currency, improving coordination of monetary policy decisions, and lowering inflation levels; the EMS remained faced with challenges. One of its main challenges was the asymmetry in the system, with Germany taking a role of the 'hegemon.' While its prominence in the EMS helped serve to reduce inflation levels, any shocks related to Germany would have a significant impact on the entire region. Since Germany could set monetary policy for itself, others had little control. It seemed that some of the other central banks were not able to keep inflation under control so they chose Germany to set the policies. Since countries fixed their exchange rates to the deutschmark, the Bundesbank dictated monetary policy.

Another major shock was the reunification of Germany in 1990. The reunification gave rise to large budget deficits and increased fears of inflation. It was unprecedented that Germany, a large county that was large and rich, merged with another country that was smaller and had lower standards of living. There was a lot of money that was invested in the merger, which led to a large government budget deficit. The response by the Bundesbank was to increase interest rates, which worsened the position of a lot of other member countries because adjusting their monetary policy would be costly. This particularly became problematic for countries like Italy who had large deficits. Speculative attacks stemmed from this and the result was inevitably a crisis.

The problems that occurred during this time reflected a currency crisis. Willett and Wihlborg (2011) find that the European crises of 1992-1993 illustrate examples of the unstable middle hypothesis. The hypothesis states, "regimes at the two ends of the exchange rate spectrum, hard fixes like currency boards and currencies at one end and floating rates at the other are much less prone to currency crisis than intermediate regimes with flexibility that is substantially limited." (3) The initial speculation started when other European economies deteriorated and there was strong pressure for domestic economic expansion. This led many speculators to believe that the countries would give up the peg to the German mark and that devaluation would occur. Speculative attacks continued which led to Britain and Italy withdrawing from the ERM, Spain and Portugal devaluing its currency, and the fall of the Franc.

The turbulence did not stop there. Public opposition to the Maastricht treaty led to a postponement of the EMU. The negative result of the Danish referendum and the uncertainty of the French referendum resulted in speculative monetary problems, forcing Italy and UK to withdraw their currencies from the ERM. This led their governments to withdraw from the system and allow their currencies to depreciate. Unemployment and interest rates continued to rise, and many found that the old narrow band ERM was not workable. Therefore the currency fluctuation bandwidth was increased from 2.25 to 15% in order to counter speculative pressure against France. There was great disappointment in the Maastricht Treaty, but exchange rate commitment continued to bind the member countries together. There was also fear that convergence might fail, but Eichengreen and Frieden argue that the pessimism was exaggerated. Economic developments actually showed that convergence of policies and institutions were more successful than thought.

Recession soon passed and the majority of the political elites supported a united currency. Interstate negotiations for the Stability and Growth Pact (SGP) were conducted in 1997 and demonstrated the commitment towards monetary cooperation. The pact was formed to provide budgetary discipline and ensure that member nations not only meet the convergence criteria but also kept to them. Following the SGP in 1998, countries prepared to fix their conversion rates to the Euro. This year marked the establishment of the European Central Bank (ECB), which would formulate a single monetary policy for the members of the euro zone. And finally in January of 1999, the eleven members fixed their exchange rates of the currencies and conducted a single monetary policy under the responsibility of the ECB. The Euro was now recognized as the single currency. And as of 2010, the Euro is the currency for twenty-seven countries.

Global Financial Crisis (2009 – present)

In the late 2000s, Europe was hit with several different crises in the region. First, it was evident that the U.S. subprime market had impacted Europe directly. The global impact had a devastating effect on the European economies. However, as Willett and Wihlborg (2011) have argued, "the crisis in Europe also had a substantial home-grown element. In many European countries real estate prices had risen to levels which appeared incompatible with long-term equilibrium already in 2007." (22) Many fears evolved during this time, especially in terms of insolvency. Rescue packages were undertaken. Nonetheless, since the situation in the U.S. was worsening, the negative impact it had on Europe was also growing. The crisis had spread to Central and Eastern European countries.

In 2010, Europe found itself in the middle of a sovereign debt crisis. The single currency did not produce the endogenous effects like "substantial improvements in the flexibility of the intra euro adjustment mechanisms" (Willett and Wihlborg, 25) that many politicians hoped it would. There were also problems on fiscal limitations that made things more difficult. The lack of fiscal policy coordination hurt the region tremendously.

The crisis that hit Europe was quite different from country to country. For instance, in Ireland and Spain it was the real estate bubble. For Greece, it was the loss of competitiveness as well as its large fiscal deficits. The crisis that hit Italy in 2011 could be seen as a result of the increased interest rate on sovereign debt.

Chapter 4. Lessons from Europe Pre-Crisis and Implications for Asia

The European experience has often been used as a model for monetary integration and a benchmark for comparison for Asian cooperation. Although the European experience can give insight to the process of integration, this chapter will argue that Europe's case is unique and will not likely be replicated. However, there are several lessons that can be drawn from it. But different interpretations of the lessons from the European integration process can lead to quite different conclusions. These different conclusions have led to disagreements about what lessons can be applied as well as their relevance to Asia. Some lessons may be more applicable to Asia than others, while others are debatable.

This chapter will first analyze the various lessons from the European integration process pre crisis and the following chapter will look at the lessons derived post crisis. There are a number of lessons that may help Asia to develop a proper strategy for monetary cooperation, while others may not be as useful a guideline. Thus, careful look at these lessons and their implications is imperative in understanding both the European process as well as determine what relevancy it has for the Asian case.

Monetary Union as an Inevitable Outcome

One of the prominent interpretations of the European experience is that once the integration process has started, monetary union will be an inevitable outcome. Caution should be taken if the European integration process is interpreted in this way. There are a lot of people who have not studied the European case in depth and implicitly assume that once countries start to integrate, it will automatically lead to a single currency. A great deal of disagreement stems from this incorrect interpretation of the European experience. This notion that once some form of integration has occurred and that it will lead to further forms of deeper cooperation has been loosely interpreted from the neofunctionalist literature, particularly from their idea of spillover.

Neofunctionalism, as discussed earlier, emphasized the importance of spillover, which generally typifies how integration in one sector will lead to integration in other sectors. Some forms of spillover can be seen in the functional sense, or how integration in one area generates the need or pressure for coordination in other areas. Another form of spillover is political, which refers to the transfer of loyalties, trust, and willingness to cooperate. Changes in identities and loyalties have facilitated the process of cooperation. Much of the literature on spillover has rested on unintended consequences of many policy actions that have generated monetary cooperation. Therefore, people often tend to generalize that once integration has occurred, it will continue to do so automatically and smoothly. However, this is too narrow of an idea and this was not the case in Europe, where cooperation was more of a muddling through process. Spillovers do not move in a linear pattern nor are they automatic. This dissertation finds that the idea of integration occurring automatically through spillovers is greatly exaggerated in the neofunctionalist literature.

Using this notion strictly and without a deeper understanding of the history of European integration demonstrates how people often misread history, and can lead to drawing the wrong lesson from Europe for Asia. For instance, inferring that developing certain high cost strategies will hopefully create spillovers can be a dangerous scenario. In this case, the Common Agricultural Policy (CAP) comes in mind. The economic costs have been very large, and the economic benefits of the CAP are questionable. Therefore, pursuing high cost strategies in hopes of creating spillovers for further integration to proceed with caution. Additionally, spillovers are more influenced by institutions and their frameworks than being automatic or an unintended consequence. Mechanisms and channels through which spillovers occur have not been studied in sufficient detail, and thus people often tend to assume automaticity of spillovers.

Cohen (2003) agrees that predictions of monetary unions being inevitable are wrong. He argues that deep commitment is required since monetary unions represent collective action and willing partners that will fully give up sovereignty are scarce. Political linkages are needed to achieve full monetary integration and most countries lack these influences to make monetary union possible. Europe may be an exceptional case where the countries have overcome their obstacles so replicating their path may be unlikely. One obstacle with respect to Asia is concern with national sovereignty, which challenges stronger forms of cooperation. A deeper look at the history of European integration has showed us that the process was quite influenced by special circumstances unique to Europe. Actually integration was a low probability event rather than an inevitable one, in this case.

One of the special circumstances specific to Europe is associated with the role of mental models and the decisions that policymakers played in making integration possible. One clear mental model is the importance of tying Germany to the rest of Europe through economic institutions to promote peace. German chancellors were willing to make a sacrifice for integration because most felt guilty about the war and did not want another war to happen. Thus, it was important for Germany to tie with the rest of Europe especially politically. Helmut Kohl was willing to promote monetary integration if France agreed to political integration. France sought a Franco-German rapprochement and agreed it would not impose harsh economic suppression on Germany. It was with this commitment from these two countries that made the creation of the EU possible, but a highly unlikely event. Without these leaders and their mental models, integration would probably not occur.

Economic and Political Conditions Specific to Europe

Certain economic as well as political conditions have made the European integration process possible. This section looks at the difference between the two regions and considers what conditions were essential for European monetary integration compares that to Asia. First, there were several initial economic conditions present that could be seen as making monetary cooperation probable. European integration was facilitated by its homogeneity in economic structure, high levels of intra-regional trade, and a large degree of openness among its countries. Many of the economic and political factors that influenced European integration are different in Asia. Economically, Asia shows greater diversity in their economic structure, development, and socio-political factors. Variance in per capital income is greater in Asia than in Europe, which suggests that countries in ASEAN are far more diverse than in the EU. East Asia's diversity may make the process of integration more complex. Also the needs for economic cooperation in Asia have also been quite different than that of Europe.

Politically, Asia and Europe are also quite different from one another. The desire to integrate, especially among government leaders, was more prominent in Europe. Willett (2000) argues European integration was greatly motivated by abstract political idealisms of many elites such as Monnet and Kohl, who showed that strong political commitment leads to community building. Without Monnet and Kohl, the pace for integration would not have been set. The desire for a political community has not been as evident in Asia. For instance, Reuven Glick (2005) states, "... there is no apparent desire for political integration in East Asia, partly because of the great differences among those countries in terms of political systems, culture, and shared history. As a result of their own particular histories, East Asian countries remain particularly jealous of their sovereignty." (2) Other authors have also agreed with the notion in Asia there is little support for becoming politically united. Eichengreen (2000), for instance, points out how there is a limited desire for integration in Asia while Salvatore (2008) states Asia wants to achieve monetary and financial stability through integration, but does not have the political cohesion deemed necessary.

This dissertation argues that the political dynamics that made integration favorable in most of the euro countries are not present in the case of Asian countries.

There is a lack of political will as well as few credible regional institutions in Asia, making it quite different from Europe. A lesson that Asia can draw is that monetary arrangements without political commitment can be fragile and crisis prone. Political consensus, commitment to cooperation, and the need to relinquish national sovereignty can contribute to making monetary integration possible. Without the support of these factors, the potential gains from monetary cooperation are unlikely.

Although differences between the two regions are apparent, the European process can still serve useful for Asian integration. For instance, Bayoumi, Eichengreen, and Mauro (2000) state that the European experience can come in handy when Asian countries develop the needed political commitment to move forward to full monetary cooperation. They suggest that the Asian region needs a mechanism for managing this transition and the Maastricht Treaty can serve as an example of how a smooth transition can be carried out. Strengthening central bank independence, enhancing wage and price flexibility, and strengthening the financial sector are some of the steps that Asia will need to take before fully committing to monetary integration. Also, harmonizing monetary policies over the transition is crucial. In Europe, the transition began with banks following the Bundesbank, mainly because of its prowess to deliver low inflation levels. When the European Central Bank was created, monetary policy became more symmetric between member countries. The Asian region will need to develop a transition procedure like that of Europe. They conclude that because the EMU is an interlocking web of economic and political arrangements, and that it can serve as an example only if Asia's desire of monetary union is part of a wider integration project.

Not only were economic and political factors important, but geopolitics also contributed to the development of European monetary cooperation. The initial objective of developing a European monetary union seemed to be exchange rate stability, which was ultimately part of the commitment to develop trade integration. However, the main underlying rationale was the geopolitical objective of reducing the likelihood of future wars within Europe. World War II had left such an impression that the most deliberate goal for integration was peace. War, especially between France and Germany, was to be inconceivable.

In contrast, World War II left a different impact on Asia. It triggered decolonization and a sense of nationalism. Thus, we see a clear difference from Europe and Asia, where European integration was possible because it was part of a larger process of political integration. These acts of reconciliation and cooperation were necessary to protect and strengthen community building. Countries will need to be willing to relinquish national sovereignty as well as provide genuine political will for monetary union. Clearly missing in Asia is the geopolitical objective of peace, which was a prominent concern for the European countries and prompted their desire for integration.

Also, while in Europe while there was reconciliation between Germany and France, there has not been such a strong rapprochement between China and Japan in Asia. With the historical as well as political disputes, and also a strong sense of nationalism developed from World War II, forming some sort of regional identity will be difficult in this area. There isn't a geopolitical objective in Asia, also there is a great deal of distrust in the region, this makes integration difficult but at the same time that much more important. Potential gains can only be reaped if the community-building project starts with strong political commitment. Countries will need to be willing to relinquish national sovereignty as well as provide genuine political will for monetary union.

Supranational Institutions

The use of institutions to build cooperation has been strongly emphasized in the literature on European integration and can serve as an important lesson for Asia. The development of credible regional institutions should be promoted in Asia in order for regional integration to proceed. The EU has demonstrated that institutions have helped to make commitments as well as the harmonization of some policies possible. Surveillance mechanisms and mutual support from member nations have also sprung from the development of regional institutions and have helped to push integration forward in Europe. Wyplosz (2002), for example, stresses the importance of collective institutions that were used to deal with trade and exchange rate management in Europe. Without institutions like the European Commission, European Central Bank, and the European Parliament, integration likely would not have proceeded like it did. The Commission, especially, has been at the forefront of integration. Its proposals of new common initiatives have helped to advance common European interest beyond the national level. Consensus has also been reached with the help of the Commission.

One lesson from Europe is that having strong institutions was crucial for the initial development of a monetary union. Ruffini (2006) states, "One of the strongest lessons to be drawn from the European experience is that institutions have played a crucial role, allowing the Union to reach far more tangible results than the ones that could have been achieved with only inter-governmental negotiations." (20) In addition, Jean

Monnet also states 'nothing is possible without the people, nothing can last without institutions.' Institution building has been fundamental to the European integration process. Its path shows how institutions were integral to integration because "...they embody the principle of common good and common aims which transcend national interests and objectives. They make retrenchment, never far below the surface of natural instincts, virtually impossible."[21] The EMU exemplified a durable regional agreement due to a credible commitment to the harmonization of policies, the existence of strong and transparent institutions, and a political consensus among states. The formation of collective supranational institutions has fundamentally advocated regional integration in the Europe.

One of the ways institutions were crucial to the success of European regional integration was because they provided rules for governance. Consequently this lesson can serve a loose framework for Asia to follow. Europe's experience shows that it is imperative for Asia to build stronger and more transparent institutions so that durable regional arrangements can exist. Institutions can help create a type of coordination mechanism as well as help enforce commitment, which was essential to the EMU.

Sweet and Sandholtz (1998) also emphasize the importance of institutionalization, or known when a supranational identity occurs, rules will create its own momentum. They contend that "because of institutionalization, EC policy domains can become more supranational without some, or at times a majority of, governments want it or being able to reverse it." Rules are the key to institutions because they identify the actors involved and the strategies they establish for the game. Institutions are also significant because they are dynamic, constantly changing to adapt to situations presented. They can serve to

[21] Monnet Speech.

be regulatory but at the same time create new rules when existing ones are not adequate. Since institutions come with defined rules, it makes the supranational governance sticky and often times irreversible. Rules as well as a venue for negotiations can help to foster cooperation.

Thus, the European experience can provide a positive lesson for Asia in that institutions are significant to move towards monetary cooperation. Developing an institution with a regional staff to enhance policy dialogues will be fundamental. Europe's experience also shows that proceeding with monetary integration could potentially be disadvantageous if Asia has no institutional support. Institutions can help create a type of coordination mechanism as well as help enforce commitment to policies, which was vital to the EMU.

Unfortunately, Asia does not have collective institutions like that of Europe. And a major hindrance to institution formation in Asia is the lack of acceptance of supranational institutions. This is largely because Asian countries tend not to have mutual trust for one another. Asia has been reluctant to build institutions essentially because of the historical and political circumstances. Many leaders have become quite suspicious of supranational institutions and are not willing to sacrifice their sovereignty for increased cooperation. As Eichengreen (2007) points out, "Whereas in Europe, WWII discredited nationalism and fostered intellectual support for development of transnational entity thru which destructive nationalist tendencies might be channeled and suppressed, Asian countries most of which are newly independent, took from the experience of war and occupation a newfound respect for national sovereignty." (20) Reuven Glick (2005) adds, "East Asian governments appear much more suspicious of strong national institutions.

Early on European countries were willing to contemplate compromises of national sovereignty to achieve the goal of greater integration." (2) Thus it is important to create effective institutions in order for Asian integration to be able to proceed.

Asia can look to Europe and see the benefits from developing more institutions. For example, Asia has made progress with the approach of the Chiang Mai Initiative (CMI). Park and Wang (2005) argue that while the CMI is a good start towards integration, it is hindered by several issues and requires improvement. In order for it to reach its full potential, it should be continually supported and strengthened. One of the major factors impeding the institutionalization of the CMI is the issue of leadership between China and Japan. The rivalry between these two countries negatively affects the progress of Asian integration. Nationalism and antagonism between these countries make progress difficult. However, despite the barriers, the CMI can still aid in the process of increasing regional cooperation. Park and Wang suggest that the CMI should be used to monitor economic developments within the region, serve as a forum for policy dialogue, and impose needed structural and policy reforms in order to become a more credible institutional framework. The CMI is a positive step for Asia, but more needs to be done in order for it to meet its full potential.

Although most scholars have agreed that institutions played a great role in the development of the EMU and that it serves purposeful lessons for Asia, some believe otherwise. They see that these institutions are not likely to be created in Asia and thus this lesson may not be applicable to the region. For instance, Angresano (2004) stresses that each region is contextually specific, and therefore the institutional frameworks created by Europe cannot be transferred to Asia. He finds that imposing supranational institutions like that in Europe would only generate new and unexpected problems because there will not be popular acceptance by the Asian public for European institutions. In addition, Parsons and Richardson (2003) argue that institutions are not as important to develop in Asia. Rather, they emphasize that integration will work only if it is democratic and legitimate. It is most important to remember that that institutions may be strong enough to establish a policy but may not be strong enough to make it work well.

Sequencing of European Integration

The sequence of integration has been a subject of debate in terms of applicability as a lesson for Asia. Europe's particular sequencing was trade integration, exchange rate stabilization, capital account liberalization, and finally a complete monetary union. Europe started with trade integration and had a fixed but adjustable exchange rate, but kept domestic and external financial markets under tight control. Wyplosz (2002) argues that Europe demonstrated that capital controls were a crucial prerequisite to trade integration. Fully liberalizing capital controls would have hampered movements toward formally stabilizing exchange rates. But once the Common Market became developed, financial markets were liberalized and exchange rate stability was maintained. Capital controls were eventually removed and monetary union emerged.

There is a lot of disagreement on how Asia should proceed, some even argue that the sequencing in Asia should be the reverse of that in Europe. Asian countries have only demonstrated the desire to promote integration to avoid another financial crisis by stabilizing their exchange rates through monetary cooperation through only modest regional trade agreements. Given Asia's high degree of financial liberalization and development of cross-border financial linkages that have already been achieved, it is not likely to follow in the European path.

The question is what path should Asia follow? Glick (2005) believes that Asia will follow an entirely different path from Europe for several reasons. First, Europe pursued trade liberalization through free trade areas and customs union before focusing on monetary integration. Since Asia's formal trade liberalization has been slower, it will apparently follow another route. In addition, there is a large disparity between the two regions with the timing of capital account liberalization. Asian countries generally liberalized their capital accounts before their financial markets were fully developed while Europe did not liberalize capital movements until much later. Lastly, there is no central anchor currency in Asia. The deutschemark in Europe was used as the internal anchor, but there is no evident candidate in Asia as of yet. He concludes that the dissimilarities between the two regions will entail Asia following a different path toward monetary cooperation than Europe.

But is European sequencing necessary for Asia to follow so that monetary integration can occur? This is questionable. Sequencing may or may not have an impact on the development and success of Asian integration because it is remains debatable that it was even essential to the development of the EMU. Since there are no empirical grounds that Europe's particular sequencing is the best path, this dissertation finds that it is not well-suited lesson for Asia to follow. Rather, Asia should pursue a sequence of its own to meet its individual needs and situations. It does not need to adhere to the sequence Europe has followed because there has been no systematic evidence that a particular sequencing like that of Europe needs to be followed. As Wang (2004) argues that there are no theoretical grounds for trade integration to start first. While he argues that that monetary integration can come before trade integration, the euro crisis suggests that this can be a dangerous approach. Sequencing may not have an impact at all on the development of monetary cooperation and other factors may be more important. One such factor could be institutions, and as Wyplosz (2002) suggests, "in the end, sequencing matters less than the building up of common institutions." Deeper and wider integration requires a well developed supranational institution, and the Asian countries have not developed one as of yet.

The Need for a Hegemon?

Another debatable lesson that may not be fit for Asia is the need for undisputed leadership in order for integration to occur. A leader or hegemon can serve as a coordinator of rules and regulations, and can facilitate resolution of distributional conflicts amongst participating countries. It has been argued that leadership can be crucial to determining the success or failure of regional integration. In the European context, realists have suggested that a regional hegemon has a major influence on the success of a monetary union.

According to Cohen (2001), hegemony is one of the political conditions critical in sustaining a monetary union. Proponents of hegemonic theory propose that Germany's economic stature provided the driving force for EMU development. Its large economy, low inflation levels, and independent central bank made Germany attractive for becoming the home of the anchor currency. The Bundesbank also became the most credible inflation fighter. For these reasons, Germany was seen as the most influential contributor to the economic and political stability of the European region. Although the influence of hegemony is widely accepted as an important factor in regional integration, a controversial viewpoint holds that EMU success was solely dependent on the presence of a main dominating economy. And without this influence monetary integration could not thrive in Europe.

Others contend this notion that a hegemon is needed for integration to occur. A study of six actual and proposed regional arrangements by Joseph Grieco (1997), on the other hand, points out that when looking at the relative share of GDP as a measure for hegemony, the success of a monetary union is not dependent on a single dominating state. He further argues that in the case of the European Community that the presence of a hegemon is neither necessary nor a sufficient condition for integration to occur. But in the case of the EMU, the role of Germany was undoubtedly important. Its place in EMU development, as Charles Wyplosz (2002) notes however, was unplanned and unforeseen. It took many years before the deutschemark evolved as the center currency, in large part due to the lack of adequate monetary policy among other large countries. Although the role of a central figure is definitely helpful in the development of a successful monetary union, it is controversial whether or not hegemony is absolutely necessary for integration to occur.

If leadership does emerge, what form will it take? It could either be a single entity or found in the form of joint leadership. For instance, some would consider the joint leadership by France and Germany, and not Germany alone, was what made integration possible. France was needed politically, as it was considered a great negotiator. Germany, on the other hand, was needed economically. The two countries formed a very powerful leadership together. Having either one alone would not have made it possible.

Some scholars see the lack of leadership, which is often emphasized when comparing Asia to Europe, as one of the hurdles East Asia faces with regional integration. Currently, there is no politically dominant country in the East Asian region. Only China and Japan seem like prominent contenders for the leadership role. Brian Bridges (2004) argues that Japan does possess potential economic hegemonic power and the means to mediate and resolve distributional conflicts in the region. However, its slow domestic economy puts severe limitations on it emerging as a leader. China, on the other hand, has high economic growth rates and its influence on the East Asian region has been substantial. China and Japan will not be able to replicate the relationship France and Germany had. First of all, there is a great deal of hostility between the two countries, making reconciliation difficult. Also, the French and German political elites that motivated integration are unseen in Asia. Only time will tell who may take the leadership role, if anyone. Therefore, what kind of leadership is needed in Asia? Is a hegemon necessary (or sufficient) for integration to succeed? Due to the ambiguity of hegemonic theory, this dissertation finds that this idea does not serve as a useful lesson for Asia.

Meeting OCA Criteria and Endogenous OCA

Optimum currency area (OCA) theory has been widely used when considering the costs and benefits of forming a monetary union. Several studies use OCA to determine whether forming an Asian currency area would be optimal, using the European monetary union as a comparison model. This section first explores whether OCA criteria has been satisfied in Europe as well as compare it to Asia. It will also examine endogenous OCA criteria and determine what lessons Europe can provide for Asia, if any.

There have been various studies on the European experience and OCA theory. Most studies find that Europe has scored fairly well on some measures of OCA like openness and diversification, but low on labor mobility. When comparing the two regions of Asia and Europe, several studies have showed that East Asia comes close to Europe in terms of fulfilling OCA criteria, but they often looked at only a few criteria. For instance, early works by Bayoumi and Eichengreen (1994) looked at correlations of macroeconomic disturbances and found that Asia is not very different from Europe. They also find that the degree of openness in Asia is comparable to Europe. Their later work in 1996 looks at composition of trade, nature of shocks, and factor market flexibility and still finds that Asia is more or less a good candidate for a common currency.

One of the criteria they looked at was the size and correlation of disturbances. The smaller and more correlated disturbances are the better chances for monetary arrangement. ASEAN countries demonstrate a high level of correlation but a large size in shocks. Nevertheless, they argue that the Bayoumi and Eichengreen find that "evidence on macroeconomic disturbances does not obviously indicate that ASEAN is further than Europe from satisfying the symmetrical-disturbances criterion." Therefore, they concluded that Asia satisfies standard optimum currency area criteria for monetary integration as well as Europe did. They also found that its intra-regional trade as a share of regional GDP is similar to that of the euro area. However, they feel that East Asia is "less of an optimum currency area than Western Europe" due to the diversity in their economic structure since integration occurs more easily if countries have similar economic structures but this can also be argued the other way.

As previously mentioned, Europe's homogeneity has helped facilitate the adoption of policies to support economic and monetary integration. Asia will face challenges with monetary cooperation due to the disparity of economic development levels that exist. They also say that the political preconditions present in Europe are missing in Asia. Later work by Zhang, Sato, and McAleer (2003) had mixed findings, however. They state that "Overall, the results show that underlying structural shocks are less symmetric in the East Asian region than in the European region... This finding is consistent with our earlier conclusion that it is less feasible for the entire East Asian region to form an OCA, but possible in some sub-groups..." (572)

Although these studies concluded that Asia comes as close to fulfilling OCA criteria like Europe did, it is sometimes overstated. Applying OCA analysis to Asia to focus on only a small number of factors can easily overstate the actual case. The study by Willett, Permpoon, and Srisorn (2010) finds that there are some criteria in which Asia does not fare so well, one being the flexibility of domestic economies. Studies of growth correlations and patterns of shocks show that these vary a good deal over time. They don't present as strong support for a common Asian currency as is sometimes implied. Lastly, there is a lot of disagreement on what should be the benchmark for comparison. There has not been a lot of detailed analysis on what is high or low correlations. The study concludes that there is not enough "strong support for the idea that Asia should put major efforts into attempting to create a common currency in the short or medium terms." (Willett, Permpoon, and Srisorn, 32)

On the other hand, others have argued that even though East Asia is far from satisfying all OCA criteria, and that Europe did not fulfill these conditions before forming a monetary union either. However, the euro crisis suggests that OCA criteria can be quite important for how well a currency area works.. One of the reasons scholars have argued this is because they found that OCA had little relevancy in the formation of the EU. Willett (2005) has argued that OCA theory is often viewed as playing a small, if any, role in the support of European leaders for the euro. The EU members pursued regional integration with the mentality that they would be better off inside than outside. In addition, Wyplosz (2002) has also argued that OCA did not play a crucial role in Europe and that initial conditions are not key factors to successful integration, but real convergence was key. Starting with a small group of homogenous countries has worked for Europe, and can provide a lesson for Asia to follow. In addition, Kawai and Motonishi (2004) argue that political commitment is more important than fulfilling OCA criteria. They argue that if countries meet some criteria initially, it could be successful as long as there is political commitment to fix the exchange rate. This dissertation, however, finds that although OCA may have little relevancy in Europe, Asia should not be disregard it when forming a monetary union.

While some scholars have disagreed on whether Europe has met OCA criteria initially or not, others have assumed and incorrectly drawn from the European experience the idea that OCA criteria may be fulfilled ex post even if they are far from met ex ante. The original contribution of endogenous OCA by Frankel and Rose (1998) correctly emphasizes that what was relevant for OCA analysis was not only levels of trade integration and business cycle synchronization under flexible rates, but what would happen ex post under fixed rates. Initially, Europe exemplified a great deal of economic asymmetry but did not meet all theoretical requirements of OCA when the EMU was launched. However, some have argued that over time it is becoming more symmetric and approaching OCA. Ruffini, for example, argues that the European integration experience demonstrates a self-validating and partly endogenous process. The implementation of regional policies can help promote economic relations between member countries and potentially lead to a convergence of their macroeconomic performances. The Maastricht criteria can be seen as a key example of how member countries achieved common policies and convergence in economic performance.

Therefore, a common conclusion is that OCA criteria tend generally to be satisfied better ex post as the implementation of common policies within the area make economies of member countries closer to each other. This idea came to be known as the endogenous OCA theory developed by Frankel and Rose (1998). It has been a widely accepted analysis, but the controversy comes when "further contributions to endogenous OCA literature that argued that since the adoption of fixed exchange rates would increase the costs of rigidities, economic efficiency considerations would force large increases in labor and product market flexibility."[22] However, actions that are induced as a consequence of endogenous OCA have been greatly exaggerated by some. Willett, Wihlborg, and Permpoon (2010) look at the effects of trade flows, business cycle synchronization, and structural reforms to improve labor and product market flexibility in Europe. They find an increase in both intra area trade and business cycle synchronization after the creation of the euro but also find similar increases between the euro zone countries and other Western European countries. They argue that "simple before and after

[22] From Srisorn and Willett (2009).

comparisons will fail to give an accurate picture of the degree of endogenous responses generated by the common currency itself." (Willett and Permpoon, 6)

Therefore, while OCA criteria can be endogenous, Willett, Wihlborg and Permpoon (2010) argue "... there is a danger with such analysis, however. Those who favor a currency union or dollarization on other grounds may tend to exaggerate the degree of endogeneity and some have gone so far as to suggest that almost any currency union can become optimal ex post." Belief that initial acts of integration would lead to extremely powerful further responses or spillovers can be a highly dangerous conclusion. The point is that not only do the endogenous responses need to be in the right direction but they need to be strong enough to make the currency area work well. Many of the OCA criteria have yet to be fulfilled in the European region. Therefore, one must take caution when looking at this as a possible lesson for Asia.

In addition, this dissertation also finds a close similarity between neofunctionalism and endogenous OCA theory. Neofunctionalism's notion of spillover rests upon the idea that initial actions toward integration in one area can lead to the promotion of actions of integration in other areas. Endogenous OCA theory, similarly, finds how induced actions will improve the operation of a currency area. Both theories interpret the process of integration as a dynamic process and some advocates even tend to imply that it is automatic. However, the implication of the two theories can be greatly exaggerated. It is important to recognize that both theories lack the attention to micro analytic political economy foundations. Monetary union is not inevitable as discussed earlier; rather the conditions that lead to monetary cooperation are highly contingent. Conditions that occurred in Europe are most likely not going to occur in other regions.

Also, one must not disregard the importance of meeting traditional OCA criteria and cannot rely on the fact that reforms will occur ex post.

Drawing from the study of Srisorn and Willett (2009), several lessons can be drawn from the interrelationship between endogenous OCA and neofunctionalism. First, there is a strong influence of the institutional framework on spillovers. Economic interest groups as well as elites have helped to create spillovers and generate moves toward integration. Secondly, careful consideration must be taken when choosing policies to promote cooperation. Certain risky policies used to garner support from specific groups, like the CAP, can be of tremendous costs in the long run. Along with this, adopting measures that increase costs of non-cooperation among countries can also be dangerous. Finally, the lesson in the importance of mental models and actors' support for integration has a large influence on integration. Particularly important are the elites, who have supported integration and were able to overcome resistance and major obstacles with their initiatives.

Progress Made In Fits and Starts

It must be remembered that the evolution of the European monetary integration process was a slow and evolving one. Deep integration occurred in the region due to gradual confidence building steps for mutual trust.[23] Europe went through many decades experimenting with regional monetary cooperation before adopting monetary union. This was a long and growing process of cooperation and coordination. Goals have been ambitious but clear since the beginning. In order to reach the goals they followed a step-by-step approach, which included a timetable. It took many decades before the goals

[23] This may have been reversed during the euro crisis.

were met, but it finally did become reality. It is not an inevitable outcome, as some have imagined. Wyplosz (2002) said "Europe's message to Asia is that monetary union is a long way down the path of gradually increasing cooperation… in the end, Europe's integration has always been characterized by a process of muddling through… Integration can be seen as a dynamic process, but one that is not predetermined. But time is not of the essence, opportunities are." (28)

In addition, Angresano (2004) adds that "…movement toward an ASEAN + 3 Community can be expected to evolve slowly, and simultaneously, although at different paces, as chosen institutional responses to regional economic and political problems. In any case, each country's economic, political and cultural interests, rather than any ASEAN +3 solidarity comparable to that in Europe, will drive the future path of integration in the region." (41) Therefore, this dissertation finds that seizing opportunities will be key. Setting the right policies will be difficult and a lengthy process, but it is imperative for leaders to choose the 'right' moment to launch regional projects and take that opportunity.

Following Europe step by step may not be useful for Asia but utilizing the experience as a framework can lead it to increase cooperation in the region. One proposal mentioned by Oh (2005) discusses that promising strategies must deal with the two major issues of stabilizing exchange rate within the region and providing international liquidity in urgent situations. The CMI, which can be seen as a short-run agenda, could provide immediate liquidity support and seeks to prevent crisis through the promotion of regional cooperation through swap arrangements. Other agenda items include a lender of last resort or an Asian Monetary Fund to reduce reliance on the IMF. Finally, a long-term goal can be seen in the form of a monetary union. If this is indeed a long-term goal for Asia, the region will have to decide the countries involved as well as an anchor currency. While this isn't required, having an anchor currency or an ACU can help with the transition. And it can be based on a composite unit. Proposals not only need to focus on exchange rate coordination, but will also have to stress monetary policy coordination.

Exchange Rate Mechanism for Increased Cooperation

The European Community first introduced the Exchange Rate Mechanism (ERM) in 1979 as part of the European Monetary System (EMS) to reduce exchange rate variability and achieve monetary stability in Europe in order to prepare for the monetary union. It served as a means to reduce variability among member countries' currencies and the European currency unit (ECU). It is based on fixed currency exchange rate margins but with the exchange rate variable within those margins. The ERM also helped maintain stability between the Community currencies while allowing them to float against other currencies. And it was also viewed as a way to increase cooperation and achieve policy convergence.

But as we can see, monetary arrangements without coordinated macroeconomic policy and sufficient structural reforms can be dangerous. A look at the 1992-1993 ERM crises is a prime example. Although it seemed that there were a lot of positive aspects of the ERM initially, we find that there were several issues that made it not be maintained. First, there was great asymmetry in the region, especially between Germany and the other member countries and specifically with policy interests. The demise of the ERM could be seen as a result of the German reunification. In addition, there was also greater exchange rate uncertainty caused by the ERM. This gave room for speculative attacks to occur. And finally, while the EMS did seem to increase policy cooperation among the EU countries, it did not increase them enough to avoid crises. Therefore, this dissertation finds that even though the ERM seemed to help increase cooperation initially, it was severely flawed. The lesson is that without proper macroeconomic policy coordination it is impossible to maintain monetary arrangements. Additionally, macroeconomic surveillance, transparency, and regular dialogue are needed to avoid crises.

Chapter 5. The Euro Crisis and the Lessons for Asia

This chapter now turns to the current Euro crisis and what lessons it has for regional monetary integration in Asia. There have always been doubts on the sustainability of the euro area and many believed that it would eventually lead to a breakdown. When the crisis hit in 2007 the outlook for the euro area was especially grim and those who opposed the creation of the euro were not surprised by the outcome. As Milton Friedman (2005) stated, "The Euro is going to be a big source of problems, not a source of help."[24] There were several underlying problems from the start. This section will examine those problems that led to the crisis, highlighting some of the major causes. Then it will examine what lessons can be drawn from the crisis and what issues Asia will have with monetary integration. Although the euro crisis has produced mostly negative lessons, they are still profound for Asia.

[24] From New Perspectives Quarterly Magazine, 2005.

Overview of the Crisis

There were several problems in the Euro area that led to the crisis in late 2007. The crisis started as a sovereign debt crisis. First, big countries like France and Germany sharing the same currency with smaller countries like Greece and Portugal was problematic. When smaller economies could not trade with the rest of the world, it became less competitive and its currency loses its value. In addition to this problem, the euro also made borrowing easier among member countries. Smaller countries like Greece, Portugal, and Ireland were allowed to borrow at very low interest rates, which led to excessive borrowing that led to a pileup of government and private sector debt. In addition to these problems, the US housing bubble burst which led to a global recession in 2008 through international trade and financial linkages. Government budget deficits exploded and there was also widespread unemployment in these countries. Large bailouts were given to the smaller member countries with Portugal and Ireland making strides to improve their deficits but Greece has yet to get it in order. Now the crisis became a banking crisis, with countries that had large sovereign debt holdings and stock prices of several banks plummeted. These are some of the problems that the Euro area incurred and the repercussions remain. Looking at the euro crisis and some of the challenges it faced during these past years will help to give a better insight on lessons it can provide for the Asian region.

False Mental Models

One of the major lessons is that there are serious dangers when following false mental models. Willett and Srisorn (2011) have emphasized the dangers of wishful thinking and how narrow range of views can lead to a wide array of problems. This is typically seen as the bicycle theory. In the case of Europe, the agenda of integration was primarily rushed by politics. The desire to develop a common currency came from a small set of elites who only had geopolitical considerations in mind. One of the main geopolitical objectives was to reduce the future likelihood of wars. This narrow view led decision makers not to pay any attention to any of the economic grounds necessary to proceed with further integration. For example, OCA theory was ignored. Instead of meeting preconditions before entering into a union, many believed that these conditions would be met ex post, which did not happen. The belief in strong effects from endogenous OCA could be considered wishful thinking. Thus with this problem of false mental models, confirmation bias arises, which multiplies when normative views do not match with reality. Willett and Srisorn (2011) illustrate that this problem was apparent when dealing with the euro crisis. The crisis was first dealt with as solely a liquidity problem and not an insolvency one. Solutions to these problems then were not appropriate and did not boost confidence as expected. In order to avoid these biases, there needs to be more communication and learning. This can help with policymaking and thus future problems can be circumvented.

Monetary Integration Takes Time

Another lesson is that monetary integration should not be rushed, it is a gradual process and takes time. This lesson is not a new one, as it has been discussed in the earlier section. However, the Euro crisis emphasizes again how important this lesson is and that Asia should really be cautious when moving forward with monetary integration.

There are many problems that can arise in a fixed rate arrangement – member countries lose monetary independence, and they are especially prone to crisis when they cannot adjust their economies internally and their imbalances grow too large. Real exchange rate appreciation can decrease its competitiveness, which leads to current account deficits and balance of payments crises. Concern for member countries arises when there are initial economic and political problems in the area, like in Europe. These problems first manifested in the EMS crisis in 1992 and have recurred since then. Strong political commitments as well as macroeconomic and fiscal coordination have been missing in Europe. There was also an absence of adjustment mechanisms to help correct these imbalances in Europe. Therefore, the lesson for Asia would be that flexibility is key. Volz (2010) suggests that "managed floating regimes guided by currency baskets are one option to keep relative intra-regional exchange rate stability while avoiding the dangers of fixed, rigid arrangements." (9) This could be a viable option for Asia since especially since monetary union may not be an immediate goal at the moment.

Crisis Management

The current European crisis also shows how important crisis prevention, control, and resolution mechanisms are important in a monetary union. A type of facility can be set up to help examine the causes of the crisis as well as implement supervisory guidelines to promote intra-regional stability. These facilities can also help to boost economic growth and competitiveness. Crisis control and mitigation is also important to help stabilize the financial system. And finally, resolution mechanisms must be in order to provide temporary support when a crisis happens. In addition, exit strategies must also be discussed and considered. Asia can really learn a lot from developing these mechanisms especially since it has gone through a crisis itself. It has already seen how important prevention is because finding a resolution during the crisis is extremely difficult. Therefore, there is a need to increase dialogue and cooperation among the Asian countries. The Chiang Mai Initiative Multilaterilization is a good step but more needs to be done to make it fully functional and reliable. A regional surveillance agency like ASEAN+3 Macroeconomic Research Office (AMRO) is also moving Asia in the right direction. AMRO's objectives are to monitor and analyze regional economies and to contribute to early detection of risks, swift implementation of remedial actions and effective decision-making of the CMIM.[25]

Spread of Crisis Can Be Quick and Costly

The crises in Asia in 1997 and Europe in 2007 have both showed how quickly crises can spread among countries, especially those that are integrated, and therefore surveillance and monitoring are important. Crises can come in many varieties and there needs to be a way to deal with the different types of shocks.[26] Europe has demonstrated that prudent regulation and supervision of financial firms are needed. Therefore, regional financial architectures need to be built to help manage risks. Asia can take an agency like AMRO and build upon it to use for surveillance and monitoring. In addition, there is also a need for dialogue to occur among member countries and a place that Asia could do this is through the Asian Financial Stability Dialogue (AFSD) put forth by the Asian Development Bank (ADB). The AFSD would be quite similar to the Financial Stability

[25] More information can be found at http://www.amro-asia.org/.
[26] Please see Willett, Wihlborg, Zhang 2011.

Forum and would consist of central bank governors, finance ministers, and financial market supervisors. It can help to increase dialogue within the region as well as coordinate early warning signal analysis. This would be beneficial to Asia in many different aspects.

The Euro crisis has provided several lessons for Asia. This dissertation has found that Europe does not set a roadmap for Asia to follow, and thus these lessons although negative can be insightful. They can shed light on the pitfalls that occurred and thus what to avoid in the future.

Chapter 6. Asian Cooperation and Future Prospects Analysis of Asian Integration

This chapter now looks at what has happened so far in terms of cooperation measures in Asia as well as examine what the future holds the region in terms of monetary integration. Pursuit of regional integration in Asia was not apparent until the late 1990s. A movement towards Asian integration was brought on by several factors such as the financial crisis of 1997, growing economic interdependence, development of the Chinese and Japanese motives in integration, and gaining popularity of regionalism in areas such as Europe. Paul Bowles (2002) describes the Asian region prior to the crisis as ill defined and lacking in formal institutions. For instance, Asia only had weak regional economic institutions like the Asian Pacific Economic Cooperation (APEC). Regionalism during this time was also market-driven, mainly led by Japanese multinational companies (MNC) and overseas Chinese businesses. Much of this changed after the crisis, however.

Growing economic interdependence with the U.S. also became a concern. Attempts to reduce U.S. influence was seen when the U.S. rejection of the Asian Monetary Fund (AMF) proposal led to changes in motivation to limit the power of U.S. and international financial institutions like the IMF. Political resentment resulted in a post-crisis climate that was focused on bringing more power to the state through increased emphasis on regional monetary and trade dimensions, while keeping the U.S. out.

In addition to this, China and Japan also had their part in a more cooperative environment in the region. Japanese policy towards integration was also redirected from supporting overseas investments of multinational corporations to a more developmental structuring of the regional economy. This occurred in an effort to increase Asia's political bargaining power at the international level, while ultimately boosting intra-regional trade and export growth.

And lastly, the popularity of regionalism such as that in Europe spurred inspiration for closer cooperation in the Asian region. Several factors have contributed to the motivation towards cooperation and this section will aim to look at what has happened so far and possible future steps Asia will take.

The most formal type of institutional cooperation seen in Asia is the Association of Southeast Asian Nations (ASEAN), which was established in 1967. Its main purpose is to offer the member countries of Thailand, Indonesia, Malaysia, Philippines, Singapore, Brunei, Myanmar, Vietnam, Laos, and Cambodia with a regional organization that would preserve their common interests, promote economic development, and encourage peace and stability in the region. The Manila Declaration, proposed at the

ASEAN summit in December 1987, could be seen as one of the first initiatives made towards promoting economic cooperation. It identified two major objectives - economic and political. Economic cooperation will be promoted through increased intra-regional trade by improving preferential trade agreements. It would also enhance cooperation in such areas as energy, agriculture, transportation, communication, and tourism. Political cooperation, on the other hand, would consist of cooperating as a unit to solve social problems such as Kampuchea and refugees from Indochina. Member countries would recognize peace and stability in the region, as well as work together at an international level.

Promoting trade was the priority during the early 1990s. This began with the talk of an ASEAN free trade zone (AFTA) and the Singapore Declaration stating it would be done within fifteen years. AFTA was implemented in 1993, with the Common Effective Preferential Tariff (CEPT) in place. Under this agreement, countries would gradually lower tariffs on each other's imports. Although though the benefits of AFTA have yet to be seen, the goal of establishing an ASEAN Economic Community was still in the works.

Following the introduction of AFTA, the ASEAN Regional Forum (ARF) was brought forward. This forum was designed to increase dialogue in the region and had two main objectives. First, it was used to foster constructive dialogue and consultation on political and security issues of common interest and concern. Secondly, it was used to make significant contributions to efforts towards confidence-building and preventive diplomacy in the Asia-Pacific region.[27]

ASEAN Vision 2020 visualizes the ASEAN Economic Community for the future. "Its goal is to create a stable, prosperous and highly competitive ASEAN economic

[27] Taken from the ARF website: www.aseanregionalforum.org.

region in which there is a free flow of goods, services, investment and a freer flow of capital, equitable economic development and reduced poverty and socio-economic disparities in year 2020."[28] The plan promises to advance economic integration and cooperation by implementing AFTA and free flow of investments by 2020. Members within the community will also discuss macroeconomic and financial policies in order to promote stability amongst itself.

With this ASEAN Vision plan in mind, policy dialogue has steadily increased among ASEAN members and its three counterparts, namely Japan, China, and Korea. The ASEAN +3 forum holds annual summit meetings to consult on a range of issues. One of the main issues concerns regional integration. At the 6th annual summit in 2002, the discussion was based on regional integration in the ASEAN region. The focus was mostly on enhancing ASEAN competitiveness and ensuring momentum towards regional integration. The idea of an ASEAN Economic Community as an end goal for the "Roadmap for the Integration of ASEAN and Vision 2020" was put in place.

ASEAN has also promoted cooperation by developing the ASEAN Surveillance Process (ASP) in 1998. The ASP has stemmed from the Manila Framework as a regional surveillance mechanism. It consists of meetings generally held twice a year, which help to provide an opportunity for information exchange on cooperation developments as well as strengthen policymaking in the region. Its other objectives are to help institutional strengthening, offer peer review, discuss policy options for crisis prevention, and serve as an early warning system. All ASEAN members are required to support the surveillance process and submit relevant information and data. It is questionable whether the ASP has had much effect, but it is important to recognize that at least is has become a channel of

[28] Taken from ASEAN website: http://www.aseansec.org.

communication in the region. There should be continuous dialogue in the region and perhaps a formal Secretariat who can give timely policy advice.

Policy dialogue among members has not stopped there. It continues to be a major contributing factor to regional integration efforts, as seen in the Executive's Meeting of Asia Pacific Central Banks (EMEAP). This cooperative organization of central banks in the East Asia and Pacific region was developed in 1991 with the primary objective of strengthening the supportive relationship among its members. Each central bank could connect with one another, providing for information exchange and increased communication. One of its central contributions is the development of the Asian Bond fund, which will be discussed later on.

In addition to increased dialogue, the advancement of regional financial arrangements can help to promote integration. Since the underlying reason behind regionalism in Asia stems from the reaction to the crisis, it was likely that talks about a financing mechanism would arise. The U.S. rejection of the Asian Monetary Fund (AMF), for instance, was one of the major motivations to limit the power of the U.S. and international financial institutions like the IMF. Many of the countries in ASEAN were resentful of how they were treated by the international community. As a result, Japanese officials initiated the creation of an AMF after the financial crisis. Visible controversy arose when the AMF was proposed; with the US and IMF opposing the notion. The AMF was considered to be a regional alternative to the IMF, offering a $100 billion fund. It would be composed of ten members, which did not include the U.S. Haruhiko Kuroda was the main proponent of the AMF idea, but the origins of it are not quite transparent. Although there was initial favorable reaction to the notion of an AMF, it dissipated when the U.S. and IMF expressed strong resistance and China did not offer support either. Without the support, the idea of an AMF simply dissolved. However, it was replaced with the Manila Framework, which represented a victory for the IMF centered approach. But the Manila Framework lacked institutions and did not have a regional orientation like the AMF.

Paul Bowles discussed that the aftermath of the Asian crisis resulted in a more state-centric Asia that developed policy resulting from political backlash against the IMF and the U.S. Therefore, it was important that Asia had its own regional financing arrangement. One key proposal was in fact an offspring of the AMF, the Chiang Mai Initiative that was set out in May 2000. Although the CMI seemed to be a sensible approach, there were some fundamental problems with it. One of the issues is that the swap lines and credits offered will not be large enough to enhance financial stability. For instance, Eichengreen suggests that resources will be better used if they are put toward a securities market in the region, so that the fundamental problem of exchange rate instability can be addressed. In addition, most members have agreed that the CMI needs a surveillance system that monitors economic developments, serves as institutional framework for policy dialogue and cooperation, and imposes structural and policy reform. Since the beginning, some members have opposed the idea of linking the CMI to the IMF.

In order to also enhance regional liquidity, the creation of the Asian Bond Fund (ABF) was put forward. As mentioned earlier, the EMEAP was involved with launching the ABF. The bond fund had an initial size of $1 billion and was invested in US dollar denominated bonds. The EMEAP studied the feasibility of establishing an Asian bond fund with the aim of (a) providing a catalyst, as a lead investor, for private investors to consider investment in Asian issues, particularly domestic currency bonds, and (b) to diversify investment of foreign currency denominated assets held at central banks and monetary authorities away from US and European securities into Asian bonds.[29]

There have been measures taken by the ASEAN +3 Community that have demonstrated interest in monetary cooperation. Policy dialogue, surveillance, and the initiation of regional financing mechanism have helped move Asia in the direction of closer cooperation. Although some of the steps have yet to be taken, it is evident that there are continuous strides to promote the integration process. Like Europe, it will take time. It will be interesting to see what the options are for Asia and speculate what the future holds.

Chapter 7. Conclusion

The historical and theoretical analysis of the European integration process as well as the various lessons it provides has shed light on the prospects for Asian integration. This dissertation finds that there is clearly no one size fits all scheme. It is apparent that the two regions differ vastly. Therefore, some of the factors that have initially contributed to monetary cooperation in Europe are not present in Asia, like geopolitics. Geopolitics was a major motivating factor behind integration in Europe because there was a strong desire to reduce the likelihood of war and also a need for peace, which was the initial objective of integration. Unlike Europe, Asia does not have a similar geopolitical

[29] http://www.asianbondsonline.adb.org

objective that binds the region together. There is a lack of a common goal mainly because of the distrust among some of the Asian countries.

Although the regions are different in many aspects, understanding the process of European integration can still serve useful for Asia if full monetary union is its long-term goal. This dissertation has highlighted several lessons that Europe has provided. Before the crisis, most of the lessons may have been more of a guideline for Asia to follow. For instance, the European experience demonstrated the importance of institutions. Supranational institutions played a major role in allowing integration to occur, mainly through the creation of spillovers, enforcing commitment, as well as serving as a coordination mechanism. Asia could also benefit from developing institutions, but it is important to make them strong enough to work well. Transparency and dialogue would be key here.

On the other hand, after the crisis of 2009, the lessons were more cautionary. There have always been doubts on the sustainability of the EMU especially because of the deep-rooted problems in the area. The crisis highlighted some of the pitfalls that Europe had encountered. One of the mistakes it had made was ignoring the OCA theory. Instead of meeting preconditions ex ante, many believed that convergence would occur ex post. The danger of wishful thinking and false mental models led many to believe that endogenous OCA would occur. Also, the crisis demonstrated that spillovers did not occur as expected. There was great over optimism in expecting integration to continuously move forward.

The common lesson throughout the entire European integration process, however, was that monetary integration takes time. If Asia decides to form a monetary union, then it will have to remember that it is a long and gradual process. It is also not an inevitable outcome either, as sometimes assumed when looking at spillovers. A lot of caution needs to be taken when proceeding with monetary cooperation, and the process should not be rushed. Europe may have shown that integration is possible, but may not be desirable.

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Appendix:

Quotes from different authors on the of various definitions of spillover:

1. Mehmet Ugur (1997) states, "spillover either in terms of institution-building or with respect to the inclusion of new policy areas, is not an automatic and linear process determined by interdependence between policy issues, but a non-linear process shaped by the extent to which convergent developments internal to the member states tend to emerge as a result of societal assertiveness and, therefore, call for convergence management at the European level." (499) He also states that supranational institutions will tend to assume a significant degree of activism in policy areas that contribute to the legitimacy of the member states and the EU without involving major (especially tax-financed) redistributional commitments which could easily lead to the emergence of a 'veto group' reaction. What is involved here is not an institutional 'spill-over', but an innovative division of labor that serves the interests of both supranational institutions and the member states. (499)

2. Lee Mc Gowan (2007) sees two aspects of spillover. The first is the shifting loyalties and expectations that have reinforced supranational regulation. The second is any initial decisions to integrate in the above fashion produces, and unintentionally, both economic and political spillovers that push regional integration forward. Mc Gowan also examines the different types of spillover. First he looks at the technical or functional spillover and says the best depiction of this type of spillover is seen in the Single European Act in the late 1980s, which sparked renewed interest in neofunctionalism. "It should be noted that

spillover was not promoting a European solution for idealistic reasons, but rather a desire by the actors to enable and ensure harmonious policy development across the EU. The pivotal idea being put forward by Haas and others centered on the suggestion that spillover became an automatic response."[30]

Mc Gowan also looks at how political spillover was deemed to take place when such cooperation empowered supranational officials to act as informal political entrepreneurs in other areas and led member state governments to delegate further powers to these actors. Political spill-over was also deemed to affect the loyalties of key political actors at the member state level. In other words it was possible to see a reaction to integration from interests groups and bureaucrats and other domestic actors who began to direct their expectations and operations to the supranational EU level of decision making. (7)

Mc Gowan also discusses the concept of political spillover and how it was initially deployed by Haas to explain the process whereby the expectations of societal actors changed to the degree that they opted for more and deeper integration. It was generally held that specific elite actors would pursue more supranational integration and to serve their own interests. Put simply, 'as the process of integration proceeds, it is assumed that values will undergo change, that interests will be redefined in terms of regional rather than purely national orientation as that the erstwhile set of separate national group values will gradually be superseded by a new and geographically larger set of beliefs' (Haas, 1958:13).

[30] McGowan, Lee. "Theorising European Integration: revisiting neofunctionalism and testing its suitability for explaining the development of EC competition policy?"

There is also brief discussion on cultivated spillover which placed its emphasis on the institutional interchanges between the EU actors and their ability to influence and actually advance the process of European integration. Stone-Sweet, Sandholtz and Fligstein have produced some of the most recent influential works here and their theory of supranationalism emerged as a refined form of neofunctionalism in the late 1990s. (7)

Finally, Mc Gowan describes how geographical spillover, or the pull and potency of the EU rules, resulted in voluntary policy convergence throughout mostly the 1990s among the EU15, but they also impacted on those states which either border the EU (e.g. Norway) or aspired to join the EU as membership became conditional on adopting the EC competition rules such as the newly acceded states of Central and Eastern Europe. Growing cooperation extends to other competition authorities outside Europe and although it is still too soon to speak of policy convergence at the global level – as there are major differences – it seems a longer term possibility as norms and values are being shared and exported beyond Europe's borders. (7)

3. Schmitter and Kim analyze "spillovers" or "unintended consequences" that occur when states agree to assign some degree of supranational responsibility for accomplishing a limited task and then discover that satisfying that function has external effects upon other of their interdependent activities.[31] Does not believe that economic integration leads to political integration – states that trade liberalization alone, so-called "free trade areas" (FTAs), is very unlikely to produce such "spillover" effects. (8)

[31] Schmitter, Philippe and Sunhyuk Kim. "The Experience of European Integration and the Potential for Northeast Asian Integration"

"Spillover" is also more likely if the tasks involve a variety of relatively autonomous and discrete state agencies—and especially not just foreign ministries who will normally try to monopolize intergovernmental transactions—and if these agencies are staffed by technical and not politically appointed personnel. (37)

4. Keohane and Hoffman (1991) argue that spillover is an ambiguous term. It can simply be used an enlargement of "an authoritative and legitimate international task." (19)

5. Joseph Nye (1970) defines spillover as referring to a situation where "imbalances created by the functional interdependence or inherent linkages of tasks can press political actors to redefine their common tasks." (200)

6. According to Schmitter (1970), his definition of spillover states, "…tensions from the global environment and/or contradictions generated by past performance (within the organization) give rise to unexpected performance in pursuit of agreed-upon objectives. These frustrations and/or dissatisfactions are likely to result in the search for alternative means for reaching the same goals, i.e. to induce actions to revise their respective strategies vis-à-vis the scope and level of regional decision-making."