



UNISCI Discussion Papers

ECONOMIC INTEGRATION IN EAST ASIA: AN ASEAN PERSPECTIVE

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Introduction

East Asia is one of the world's most dynamic and fastest growing regions. From 1980-2003, East Asia's average annual GDP growth was an impressive 9.2% compared to 5.9% for the rest of the world. Market-driven economic integration through trade and investment has been a major driving force in East Asia's growth and economic development over the past three decades. *De facto* economic integration in East Asia through decades of growth in intra-regional trade and investment has created an economic space that is, to some extent, as interconnected as a more formalized common market such as the European Union (EU).

This paper aims to examine developments in economic integration in East Asia from an ASEAN perspective. Within the region, the member countries of the Association of Southeast Asian Nations (ASEAN) have intensified their efforts to integrate their economies over the past few years. ASEAN consists of ten member countries (i.e. Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam) and is one of the world's most successful regional organizations. The ambitious project initiated by ASEAN two years ago to integrate their economies into an economic community by 2020 is currently underway. However, the project is beginning to lose some momentum and faces many challenges ahead.

1. De Facto East Asian Economic Integration

Intra-regional trade as a share of East Asia's trade has risen from 35% in 1980 to 54% in 2003. Within ASEAN, intra-regional trade as a share of ASEAN's total trade rose from 18% to 24% over the same period. This means that by 2003, almost half of East Asia's trade was with itself while for ASEAN it was almost a quarter. In 2003, intra-regional trade share for the EU was 64.4% and the North America Free Trade Agreement (NAFTA) was 46%. This would indicate that trade integration is relatively high in East Asia (Kawai 2005).

¹ *Las opiniones expresadas en estos artículos son propias de sus autores. Estos artículos no reflejan necesariamente la opinión de UNISCI.* The views expressed in these articles are those of the authors. These articles do not necessarily reflect the views of UNISCI.



How does one account for this high level of trade integration despite not having a formal regional economic arrangement? East Asia has long embraced trade liberalization avoiding the discriminatory trade practices practiced elsewhere. Increased foreign direct investment (FDI) inflows into this region over the past three decades has led to economic expansion and the development of regional production networks - reinforcing the nexus between trade and investment. East Asia's share of world FDI rose from 6.6% in 1980 to 17.3% in 2003. The trade-FDI nexus has been driven by unilateral reforms created by the "flying geese" pattern of relocating production processes to lower cost countries as domestic costs rise (Pangestu and Gooptu, 2004).

FDI has played an important role in Southeast Asia's economic development. The economic development model adopted by Southeast Asian countries over the past three decades was largely driven by strategies that favoured FDI from multinational corporations (MNCs) and industrial policies that promoted export-orientated industries. FDI inflows into the region have led to a high level of cross-border integration of production value chains and rapid growth in intra-industry trade.

Production networks in East Asia are also being reconfigured in recent years to take account of China's rapid industrialisation. China is fast becoming a major market for exports of specialised components and other intermediate inputs from Southeast Asia and elsewhere. So pronounced was the trend that exports of parts and components to China and Hong Kong in 2002 from 8 Asian economies grew by 40% while their other exports grew by only 6% (World Bank, 2003)². In this regard, Southeast Asia's key challenge would be to ensure that its economies are strategically well-placed to exploit the opportunities (both in trade and investment) of a rising China.

2. Towards an ASEAN Economic Community.

At the Ninth ASEAN Summit in Bali in October 2003, ASEAN leaders have agreed to establish an ASEAN Economic Community (AEC) by 2020. The AEC is one of three pillars (the other two being the ASEAN Security Community and the ASEAN Socio-cultural Community) that make up the ASEAN Community as declared by ASEAN leaders in the Bali Concord II.

In line with the ASEAN Vision 2020, it is envisaged that the AEC will be a single market and production base with free flow of goods, services, investments, capital and skilled labour³. This bold project would require a higher degree of regional economic integration than what exists today in ASEAN.

The ASEAN Economic Ministers' High Level Task Force (HLTF) on Economic Integration had unveiled a slew of economic initiatives with clear deadlines to expedite the economic integration process to realize the AEC. These initiatives which are annexed to the Bali Concord II include:

- Fast-track integration of 11 priority sectors⁴

² These eight economies were South Korea, Singapore, Taiwan, Malaysia, Indonesia, Philippines, Thailand and Vietnam.

³ The *ASEAN Vision 2020* envisaged "a stable, prosperous and highly competitive ASEAN Economic Region in which there is a free flow of goods, services and investments, a freer flow of capital, equitable economic development and reduced poverty and socio-economic disparities" (p.12).

⁴ *The 11 priority sectors are: electronics, e-ASEAN, healthcare, wood-based products, automotives, rubber-based products, textiles and apparels, agro-based products, fisheries, air travel and tourism.*



- Faster customs clearance and simplified customs procedures
- Elimination of barriers to trade
- Accelerated implementation of the Mutual Recognition Arrangements (MRAs) for key sectors (e.g. electrical and electronic equipment and telecommunications equipment)
- Harmonization of standards and technical regulations

In the area of trade in goods, the Common Effective Preferential Tariffs (CEPT) Scheme Rules of Origin (ROO) will be improved. This would include making the ROO more transparent, predictable and standardized and taking into account the best practices of other Regional Trading Arrangements (RTAs) including the World Trade Organization (WTO)'s ROO. To ensure transparency on Non-Tariff Measures (NTMs) and eliminate those that are barriers to trade, the following measures will be undertaken over the next few years:

- Establish an ASEAN Database on NTMs
- Set a clear criteria to identify measures that are classified as barriers to trade
- Set a clear and definitive work programme for the removal of such barriers
- Adopt the WTO agreements on Technical Barriers to Trade; Sanitary and Phyto-Sanitary and Import Licensing Procedures and develop implementation guidelines appropriate for ASEAN

One of the most important recommendations by the HLTF was the creation of a more effective dispute settlement mechanism (DSM) with powers to make legally binding decisions in resolving trade disputes among member states. The number of trade disputes will likely rise significantly as the region moves towards a higher level of economic integration. Hence, a credible DSM would be absolutely critical for the AEC to succeed. The following measures will be undertaken to enhance the DSM⁵:

- Establish a legal unit within the ASEAN Secretariat to provide legal advice on trade disputes
- Establish the ASEAN Consultation to Solve Trade and Investment Issues in order to provide quick resolution to operations problems (this would be similar to the EU mechanism)
- Establish the ASEAN Compliance Body

Economic integration within ASEAN has always been motivated by the need to make the region an attractive production base for domestic and foreign companies. By maximizing the complementarities among member countries to achieve economies of scale, and becoming an efficient manufacturer of products, ASEAN aims to become a single production base that would be a magnet for attracting FDI inflows.

An integrated ASEAN would also be an alternative to China as a regional production base for multinational corporations (MNCs). Some have referred to this as the "China+1" formula as MNCs would prefer to diversify their risk by investing in an alternative regional site rather than "put all their eggs" in one basket and invest solely in China.

Achieving a higher level of economic integration may seem daunting at first glance but ASEAN is not starting from scratch. This is because ASEAN has already put in place potential building blocks towards achieving the AEC. These potential building blocks would

⁵ For more details regarding the enhance DSM, please see Recommendations of the High Level Task Force on ASEAN Economic Integration (Annex 1: Mechanism of the Dispute Settlement Mechanism).



include economic integration initiatives such as AFTA, ASEAN Framework Agreement on Services (AFAS) and the ASEAN Investment Area (AIA). Looked at holistically, the formation of an AEC could be seen as a logical step up the economic integration ladder.

3. Challenges to ASEAN Economic Integration.

What are some of the key challenges facing the AEC project? At last year's ASEAN Summit in Vientiane, it was agreed that tariffs on these 11 priority sectors for fast track integration will be eliminated by 2007 for the ASEAN-6 countries and by 2012 for the CLMV. These deadlines are three years ahead of schedule. However, other than tariff cuts, there does not appear to be coherent framework in integrating these 11 priority sectors – this could result in the realization of 11 different goals instead of a single one.

The complete depoliticisation of the ASEAN DSM process - one of the main aims of the new enhanced DSM - would be a difficult task⁶. Even in the WTO where proceedings are more legalistic, disputes among member countries continue to be politically charged (Hsu 2003). The other concern is whether there will be sufficient resources to implement the new DSM system. Furthermore, the CLMV countries - and even some of the ASEAN-6 countries - may not have the technical capacity to fully benefit from the ASEAN DSM. Hence, technical assistance and legal training should be incorporated in this new system.

Besides the ASEAN-X formula, ASEAN may also use the “2+X” approach where two member countries that are ready to integrate certain sectors can go ahead first. In fact, the latter approach will particularly benefit Thailand and Singapore as both countries are keen to expedite economic integration and realise the AEC before 2020. Besides having no clear guidelines, this approach could be problematic as it does not require a consensus to be made by all member countries (unlike the ASEAN-X principle). Such an approach could alienate the less developed ASEAN member countries such as the CLMV. The other concern is that the bilateral nature of this process could lead to a *fait accompli* where the third “+X” country may be bound to whatever has already been agreed by the first two countries (Hew and Sen, 2004).

The AEC end-goal of a “single market” connotes an EU-type common market where there is complete freedom of internal trade and free mobility of capital and labour plus the harmonization of all laws, regulations and taxes. However, as it stands, ASEAN governments are not even prepared to establish a customs union let alone a common market. (A customs union is essentially a group of countries where trade barriers among member states are removed and a common external tariff policy is established with non-member states.) Hence, it remains conceptually unclear what kind of economic entity the AEC will be in 2020⁷.

Given the diversity within ASEAN in terms of income and economic development, a realistic end-goal for the AEC fifteen years from now would be an “FTA-plus” arrangement that covers a zero-tariff AFTA (with elimination of all non-tariff barriers) plus some elements of a common market i.e. freer movement of goods, services, investments and capital (ISEAS, 2003; Hew and Sen, 2004; Hew, 2005).

⁶ To ensure de-politicisation of the DSM process, an appellate body comprising of well-qualified, independent and experienced professionals will be established as the appeal body for the panels' decisions. It will also adopt the existing WTO DSM panel selection procedures, including the listing of qualified individuals who can serve as panellists and members of the appellate body.

⁷ Hew, D.: “Beware Trade Bloc Losing Momentum”, *Straits Times*, 18 April 2005.



4. Are FTAs a Stumbling Block to Regional Integration?

In recent years, there has been a proliferation of bilateral and regional free trade agreements (FTAs) in the region. FTAs appear to be a popular means of trade liberalization in the face of slow progress made at the multilateral rounds of the World Trade Organization (WTO). Besides creating a regional FTA among themselves (viz. AFTA), ASEAN is also keen on establishing strategic and economic linkages with its neighbours. In fact, ASEAN has been seen as a “hub” for a number of regional FTAs not only with East Asian countries (viz. China, Japan and Republic of Korea) but also with countries outside the region viz., India and CER (Australia and New Zealand).

This process is very different from the market driven trade integration that characterized the region in the past. It also diverges from the Asia Pacific Economic Cooperation (APEC)’s practice of open regionalism where member countries undertake trade and investment liberalisation on a voluntary and non-binding basis and in accordance to the most favoured nation (MFN) principle⁸.

Until the late-1990s, the increase in economic inter-dependence (as a result of growing intra-regional trade and investment) in the region took place without any formal framework of economic cooperation. The new trend towards FTAs is preferential in nature and places more emphasis on formal economic cooperation via trade agreements between two or more countries.

The proliferation of FTAs in East Asia could give rise to a host of technical and administrative complications including mismatches in the phasing of tariff reductions under overlapping arrangements and implementation of different rules of origin under separate FTAs. This is the so-called “spaghetti bowl effect” which may actually turn out to be a stumbling block to regional economic integration rather than a facilitator⁹. Uncoordinated proliferation could also lead to inconsistent provisions between FTAs, especially on the rules of origins, hampering the cross-border production networking process which has been so crucial to the region’s economic development (Feridhanusetyawan, 2005).

Singapore which has been a champion of bilateralism in the region has signed FTAs with New Zealand, Japan, US, EFTA, Australia and half a dozen other countries. Neighbouring countries like Thailand and Malaysia are also taking the bilateral route. However, one should also be careful in embarking on too many bilateral FTAs since it would put a strain on valuable and limited negotiating resources, which probably could be put to better use at the multilateral level. Also, it is not yet clear as to how individual bilateral trade deals of ASEAN members, for example with Japan, will be consistent with those of negotiations at the regional level like the ASEAN-Japan Comprehensive Economic Partnership (CEP) Agreement. Since the Japan-Singapore agreement and the JMEPA are unlikely to be similar in terms of their negotiating framework (and so would be proposed the Japan-Thailand FTA), the important question is whether bilateral deals will take precedence over the regional agreement or vice-versa, once all these deals are enforced (Hew and Sen, 2005).

Nevertheless, at this stage it is too early to properly examine the adverse welfare effects of FTAs (viz. trade diversion). Thus, even if the FTA route is preferred, the focus should be on high quality comprehensive trade agreements with minimum exclusions. Perhaps the time

⁸ Asia-Pacific Economic Cooperation (APEC) was established in 1989 is an open dialogue group that provides a forum for facilitating economic growth, cooperation, trade and investment in the Asia-Pacific region. APEC aims to establish a free trade area in the Asia-Pacific region by 2010 for developed countries and by 2020 for developing countries (*APEC Bogor Declaration*, 1994).

⁹ Bhagwati (1995) called this the “spaghetti-bowl” proliferation of preferential trading agreement.



has come to find means of “multilateralizing” these FTAs by adopting a comprehensive Common Framework Agreement among ASEAN countries that can form the basis of future FTA negotiations. This would imply that all ASEAN countries should agree on signing only those FTAs that are WTO-consistent, have a comprehensive agenda of liberalization and economic cooperation (with minimum exclusions), as well as also allow for inclusion of newer members as parties to the FTA on similar terms and conditions (Sen, 2004).

5. Greater Institutional Development

It is also important to note that deeper economic integration in ASEAN cannot be successfully achieved without establishment of a stronger institutional structure with a better enforcement mechanism. There is thus a need to streamline, strengthen and enhance coordination among the existing institutions, as well as design better enforcement mechanisms in order to facilitate and expedite economic integration. In this regard, the European experience is worth noting as institutional development started at an early stage of economic integration (ISEAS, 2003).

ASEAN still maintains a very loose institutional structure although there has been a strengthening of its institutions in the recent years. ASEAN does not presently operate on the overriding principle of using a formal, detailed, and binding institutional structure to prepare, enact, coordinate, and execute policies for economic integration. The “ASEAN Way” of dialogue is still very much entrenched: i.e., *Musyawah* (discussion and consultation), *Mufakat* (unanimous decision) and Consensus.

Schwartz and Villinger (2004) argue that ASEAN’s weak institutional structure has been a major reason for the relatively low impact of ASEAN’s erstwhile initiatives to reduce tariffs and eliminate non-tariff barriers. The ASEAN Secretariat clearly in its present form does not have the resources, the enforcement power and sufficient expertise to carry out many of its economic tasks effectively.

To be fair, ASEAN has, in recent years, been moving towards a more structured rule-based system to regulate and enhance economic relations and integration amongst its members. Progressive steps have also been achieved in terms of the content and directives contained in the newer ASEAN trade and investment agreements since the 1990s, with binding rules and procedures now more clearly set out in such documents.

The recent and more structured, detailed, and binding procedures adopted in the 1996 ASEAN “Protocol on Dispute Settlement Mechanism” also augurs well for the formation of a formal institutional infrastructure and the integration of ASEAN although this Protocol is yet to be enforced by any member country at the present. The enhanced DSM that is proposed in the Bali Concord II seeks to address the existing problems in the Protocol.

6. ASEAN’s Treaty of Rome?

At the ASEAN Summit in Kuala Lumpur last December, a ten member Eminent Persons Group (EPG) was appointed to examine the possibility of ASEAN having a Charter. The EPG is expected to submit their recommendations for the consideration of ASEAN leaders at this year’s summit in the Philippines.

The Charter should provide ASEAN not only with a legal personality but also set out the long-term direction for the region. In this context, the proposed Charter comes at a propitious time as ASEAN currently faces many economic challenges.



When considering economic inputs for the Charter, there is no need to “reinvent the wheel” as key economic integration measures are already outlined in the ASEAN Concord II and the Vientiane Action Programme 2004-2010 (VAP). The VAP is a six-year strategic action plan which was launched at the 2004 ASEAN Summit in Laos. The VAP aims to intensify the economic integration process by developing and implementing measures that would put in place the essential elements for ASEAN to function as a single market and production base. These measures will also continue to be relevant and applicable beyond the deadline of the VAP. They include accelerating trade and investment liberalization and reducing business transaction costs.

Although most of the essential economic elements have been identified for the Charter, the main problem lies in its effective implementation and compliance by member countries. It is therefore crucial that the Charter should be designed to ensure that economic commitments are legally binding and that non-compliance will result in punitive measures such as trade sanctions. In this context, the Charter should ensure that the ASEAN DSM is given some much needed “bite” to make it more effective.

As mentioned earlier, it is also important to note that deeper economic integration cannot be successfully achieved without the establishment of a stronger institutional structure. Having an ASEAN Charter is an important step in creating a more rule-based institutional structure for ASEAN. Furthermore, a change in mindset is required if ASEAN wishes to remain economically competitive. This includes reviewing the consensual “ASEAN Way” of making decisions that clearly slows down the economic integration process.

Like the 1957 Treaty of Rome which laid out a roadmap to realise the EU, the ASEAN Charter provides a golden opportunity to follow a similar route. For ASEAN, this would mean establishing a common market as the final goal. Given that ASEAN is made up of countries at very different levels of economic development, however, a common market is unlikely to be established by 2020. Nevertheless, it is a long-term goal that ASEAN should strive to achieve.

7. ASEAN+3 and the East Asia Summit

The ASEAN+3 (China, Japan and Korea) grouping - in which the inaugural summit was held in Manila in November 1999 - could pave the way for the future establishment of an East Asian economic community. The Asian financial crisis of 1997-1998 proved to be a major catalyst for the establishment of the ASEAN+3 as practically every country in the region was adversely affected in varying degrees from the crisis. “...for many ASEAN members the crisis underscored the benefits of establishing formal economic links to the more developed economies of Japan and South Korea and the dynamic market of China as a means of averting any possible future crisis” (Stubbs, 2002 p.449).

To date, ASEAN+3 has made significant inroads in the area of financial cooperation. In May 2000, ASEAN+3 finance ministers agreed in Chiang Mai, Thailand to set-up a regional financing arrangement called the Chiang Mai Initiative (CMI). The CMI has 2 main components: i) an expanded ASEAN Swap Arrangement (ASA) and ii) a network of bilateral swap arrangements (BSAs) among ASEAN countries, China, Japan and Korea.

The ASA which was originally established among the ASEAN-5 countries (Indonesia, Malaysia, Philippines, Singapore and Thailand) in 1977 had a total facility of US\$100 million. This was augmented to US\$200 million a year later and to US\$1 billion under the CMI (and with the inclusion of all ASEAN members). The BSAs is a swap arrangement in which each party can request the other to enter into a swap transaction to provide liquidity support to overcome balance of payments difficulties in the specified currency up to the



specified amount. As of 10 November 2004, the total size of the BSAs were US\$36.5 billion. On 4 May 2005, ASEAN+3 finance ministers agreed to strengthen the CMI by making it a more effective and disciplined framework¹⁰. Measures to enhance the CMI are as follows:

- Integration and enhancement of ASEAN+3 economic surveillance to enable early detection of irregularities and swift remedial policy actions.
- Clearly defining the swap activation process and the adoption of a collective decision-making mechanism of the current network of BSAs
- Increasing the size of the available swaps by up to 100%, while noting exact size could be decided by bilateral negotiations.
- Improving the drawdown mechanism where the size of the swaps that could be withdrawn without the IMF-supported programme be increased from the current 10% to 20%.

These new measures appear to be an important first step towards creating a multilateralised CMI under which all countries are able to pool their international reserves. In other words, the enhanced CMI could eventually realized the earlier failed attempt during the 1997 Asian Financial Crisis of creating an Asian Monetary Fund.

Ostensibly, the inaugural East Asia Summit (EAS) in Kuala Lumpur last December could be a first step towards realising of an East Asian Community. However, the summit included not just the ASEAN+3 countries but also India, Australia and New Zealand. Although, it has been agreed by the participants that the next EAS will be held in the Philippines (the host of the 2006 ASEAN Summit), it would be hard to imagine seeing ASEAN in the driver's seat of the EAS for long given the inclusion of larger and more influential economies such as Japan, China, Australia and India in the summit. While the modalities for the EAS remain unclear, conflicting agendas arising from an expanded membership would make it an unsuitable platform for East Asian community building.

Concluding Remarks

The East Asian Vision Group (EAVG) 2001 report envisioned East Asia moving from a region of nations to a *bona fide* regional community. The EAVG envisaged that East Asian economic integration would serve as a catalyst for regional community building. As this paper has shown, there are already a number of institutional arrangements that provide the building blocks for the realization of such a vision.

However, among these institutional frameworks that have been emerged, the recently held EAS with its inclusion of non-East Asian countries does not appear to be a suitable platform to achieve this objective. Instead, the ASEAN+3 framework appears to be the best way forward to expand East Asian regionalism and East Asian community building. To build a genuine community, it would require greater institutional development and political commitment among its member countries to make the crucial decisions to integrate their economies beyond what exists today.

In East Asia, economic integration will be problematic as long as its two major powers i.e. China and Japan are unable to get rid of their historical baggage. Both countries continue to view each other's intentions with deep suspicion. As this certainly will take some time to be resolved, it is important for ASEAN to keep the momentum of the AEC project and to do

¹⁰ The Joint Ministerial Statement of the 8th ASEAN+3 Finance Ministers' Meeting, Istanbul, Turkey, 4 May 2005, in <http://www.aseansec.org/17448.htm>



this, ASEAN must demonstrate to the international community that it is indeed committed to the project.

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