

ASEAN and the Challenge of Closer Economic Integration

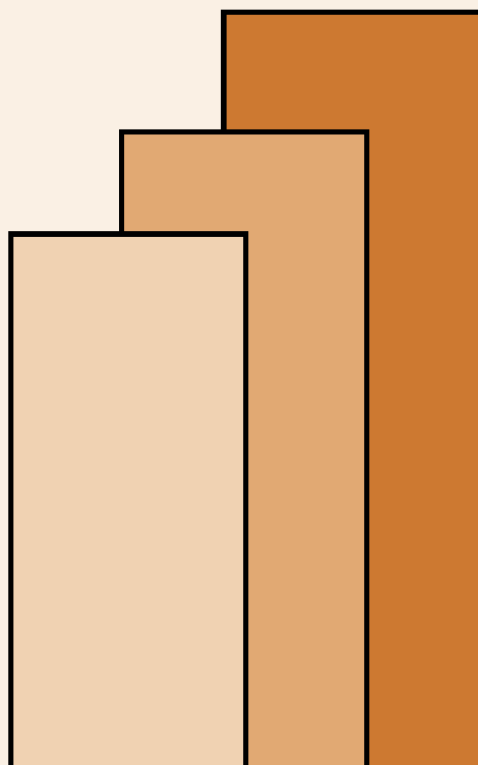
Ponciano S. Intal Jr.

DISCUSSION PAPER SERIES NO. 97-14

The *PIDS Discussion Paper Series* constitutes studies that are preliminary and subject to further revisions. They are being circulated in a limited number of copies only for purposes of soliciting comments and suggestions for further refinements. The studies under the *Series* are unedited and unreviewed.

The views and opinions expressed are those of the author(s) and do not necessarily reflect those of the Institute.

Not for quotation without permission from the author(s) and the Institute.



June 1997

For comments, suggestions or further inquiries please contact:

The Research Information Staff, Philippine Institute for Development Studies
3rd Floor, NEDA sa Makati Building, 106 Amorsolo Street, Legaspi Village, Makati City, Philippines
Tel Nos: 8924059 and 8935705; Fax No: 8939589; E-mail: publications@pidsnet.pids.gov.ph
Or visit our website at <http://www.pids.gov.ph>

April 9, 1997

ASEAN AND THE CHALLENGE OF CLOSER ECONOMIC INTEGRATION

Ponciano S. Intal, Jr.¹

Introduction

ASEAN has been at best a middling success as an economic association during the past thirty years. Nevertheless, as the ASEAN economies hog the limelight as some of the most dynamic economies in the world and as ASEAN's *raison d'etre* becomes increasingly economic rather than political, the challenge for ASEAN is to succeed into "irrelevancy" in the future in view of international and regional initiatives (e.g., APEC) and the unilateral policy decisions of ASEAN countries themselves. In the process, ASEAN becomes more influential and increases its negotiating leverage in the international arena. Ironically, as it focuses on strengthening economic linkages among the member countries, ASEAN may need to deepen its noneconomic (i.e., social, political and cultural) linkages and build a sense of community among the peoples of Southeast Asia to successfully deepen and widen the scope of economic cooperation in the region. By providing political and institutional push to stronger economic linkages and a greater sense of community in the region in an increasingly open and interconnected world, ASEAN could eventually become a resounding success.

The Strengthening Glue: The Evolution of ASEAN in the Past Thirty Years

Many studies on ASEAN have pointed out that ASEAN has generally been a success at the political and diplomatic front but largely ineffectual in the economic cooperation front. Nevertheless, the political stability and regional security that characterized the political and

¹ President, Philippine Institute for Development Studies. The author would like to thank Mr. Edsel Custodio, Assistant Secretary of the Department of Trade and Industry and Ms. Margarita Songco, Director of Trade, Industry and Utilities Staff, National Economic and Development Authority, for their insights and information on ASEAN economic cooperation.

diplomatic success of ASEAN contributed to the economic success of the ASEAN countries. In addition, ASEAN helped nurture the seed of identity and oneness among the peoples of the ASEAN countries.

Although some original framers of the ASEAN used the European Community as a possible model for the ASEAN (see Dosch and Mols, 1994, footnote 2, p.220), ASEAN was established in 1967 initially to primarily attain political stability and regional security in Southeast Asia. This is no mean achievement because of the many disputes and tensions between certain member countries during the 1960s (e.g., the Indonesian *konfrontasi* against Malaysia, the territorial dispute between the Philippines and Malaysia over Sabah and the separation of Singapore from Malaysia). In addition, internal political and security problems virtually hounded the founding ASEAN member countries as best exemplified by Indonesia during the latter 1960s and by the communist insurgency problems of almost all the founding ASEAN members. Regional security concerns were heightened by the ongoing Vietnam war that threatened to involve more of Southeast Asia and the ASEAN members themselves. Considering that the founding ASEAN members were highly heterogenous in terms of colonial experience and political development, the external communist threat (primarily of the Vietnam war and also of China and USSR) and the internal communist threat (i.e., domestic communist insurgency problems) provided key impetus for the establishment of ASEAN during the late 1960s.

The Bangkok Declaration of 1967 marking the foundation of the ASEAN nevertheless emphasized the pursuit of economic progress and social and cultural development. With political stability secured and regional security concerns manageable by the mid 1970s, ASEAN turned increasingly to strengthening economic cooperation among the ASEAN member countries beginning in the late 1970s. Thus, the ASEAN Industrial Projects (AIP) in 1976, the ASEAN Preferential Trading Arrangements (PTA) in 1977, the ASEAN Industrial Complementation (AIC) scheme in 1981 and the ASEAN Industrial Joint Ventures (AIJV) scheme in 1983 were introduced. The ASEAN PTA is a modest measure towards reduction of trade barriers in intra-ASEAN trade. The other major economic cooperation initiatives are primarily joint planned regional industrialization efforts within the region through "resource pooling and market sharing" (Pangestu, et al., 1992, p.337).

The results from the early economic cooperation initiatives of the late 1970s and the 1980s have been largely disappointing. The utilization rates and contribution to intra-ASEAN trade of the ASEAN Preferential Trading Arrangement had been negligible. The low utilization rates of the PTA stem from a host of implementation problems including the inclusion of irrelevant or untraded products, tariff preferences on zero tariff items, nonautomatic acceptance of product based on proof of origin and ASEAN content of the product, and others. The industrial development initiatives largely met tepid response from the private sector, partly because of the lengthy bureaucratic process of application and the difficulties of obtaining margin of tariff preferences (MOP) for the participating firms. Perhaps the only reasonably successful initiative is the second AIC scheme called brand to brand complementation (BBC) largely because of the participation of a few Japanese car manufacturers (see e.g., Pangestu, et al., 1992).

The policy environments of several ASEAN member countries during the 1970s and early 1980s explain to a large extent the poor results from the initial ASEAN economic cooperation initiatives. Specifically, the ASEAN countries with large domestic markets followed largely inward looking and protectionist trade and industrial policies during the 1970s and early 1980s. This was especially the case for Indonesia and the Philippines and, to a less extent, Thailand. Because the trade policy regimes were protectionist, commitments to and certainly implementation of regional economic integration initiatives were half hearted. For instance, there was a tendency for ASEAN member countries to commit a list of products for margin of tariff preferences in the ASEAN PTA at very detailed level of disaggregation and to include irrelevant or nontraded goods and items with zero tariff rates in the initial list of the PTA.

In addition, the economic integration framework underpinning the various regional industrialization schemes arising from the Kansu Report was itself inward looking, albeit consistent with the prevailing trade and industrial framework of a number of the ASEAN members at that time. Essentially, the regional industrialization schemes were meant to expand the market from a domestic economy to a region. These were done, however, behind the then relatively high external tariffs of a number of the ASEAN member countries. Being inherently market sharing and resource pooling schemes in a relatively protected regional market, it was therefore not surprising that the choice and approval of regional projects became highly bureaucratic in part

to balance out the benefits (including implicit monopoly profits) to each ASEAN member country from the regional projects. On hindsight, it can be considered fortuitous that the response to the initial regional industrialization schemes was tepid. Otherwise, the presence of a regional group resulting from such regional schemes could have prevented a redirection of the ASEAN economic cooperation initiatives that have taken place since the latter 1980s in response to changes in the domestic and international economic environments.

Indeed, the domestic policy environment in the ASEAN member economies has changed significantly since the latter 1980s. As a result, the ASEAN has correspondingly evolved. Being the largest economy in the ASEAN, Indonesia's dramatic shift in trade and industrial policy -- from an inward-looking industrial protectionism in the 1970s to an increasingly outward-oriented economy in the latter 1980s -- paved the way for the resurgence of ASEAN economic cooperation initiatives by the turn of the 1990s. Besides Indonesia, the Philippines also started to reform its economy in earnest beginning in 1986 towards greater export orientation and more stable macroeconomy. Thailand also undertook measures to further the export orientation of its manufacturing sector. Considering that Singapore, Brunei and even Malaysia have historically more open economies, the policy changes in Indonesia, Philippines and Thailand in the 1980s effectively changed the domestic policy environments underpinning intra-ASEAN economic cooperation.

At the same time, the international economic environment also changed significantly during the late 1980s and early 1990s, with benefits accruing to the ASEAN countries. The economic restructuring of Northeast Asia during the period for one, benefited ASEAN member economies greatly through substantial foreign investments and the corresponding transfer of technology. Such foreign investments, primarily export oriented and substantially undertaken by multinational corporations at the beginning, provided an impetus for greater openness to trade among the member economies. The ASEAN countries likewise increased their economic linkages with the rest of the Asia Pacific, in part because of the growing web of production and marketing linkages among multinationals (many of which are from East Asia) and their subsidiaries and partners in the region. Besides the growing integration of the ASEAN economies with the world economy, ASEAN needed to respond to the resurgence of regional economic groupings

especially the European Union, the North America Free Trade Area (NAFTA) and the Asia Pacific Economic Cooperation (APEC) which have increasingly shaped the dynamic of international trading environment in addition to or in conjunction with the GATT/WTO.

The ASEAN Economic Ministers meeting in Bandar Seri Begawan, Brunei Darussalam in December 1989 highlighted the significant change in the policy environment underpinning ASEAN economic relations when the national delegations led by Indonesia (and supported by the Philippines) called for "bold ideas and visions" for ASEAN. The call was made in part as a reaction to the perceived impending "Fortress Europe" arising from the shift from a European Economic Community to an Economic Union. The signing of the Framework Agreement on Enhancing ASEAN Economic Cooperation during the Fourth ASEAN Summit in Singapore in January 1992 capped the two-year flurry of meetings and discussions in response to the call by the ASEAN Economic Ministers in Bandar Seri Begawan in December 1989.

The most significant decision embedded in the Framework Agreement was the establishment of the ASEAN Free Trade Area (AFTA) within 15 years, a bold leap from the earlier ASEAN Preferential Trade Arrangement. The setting of a deadline was itself politically significant, indicating a stronger political will to enhance ASEAN economic cooperation. This is further manifested in the subsequent Fifth ASEAN Summit in Bangkok in 1995 when the 15-year period was shortened to 10 years, i.e., the target date of the establishment of AFTA became year 2003 rather than year 2008. The approach agreed to in establishing the AFTA is the Common Effective Preferential Tariff (CEPT) whereby intra-ASEAN trade in eligible industries will eventually face a tariff range of zero to five percent. ASEAN drastically narrowed the industries that are in the exclusion list from the CEPT scheme thereby providing meaning to the CEPT approach. Thus, in effect, intra-ASEAN trade cooperation changed from an earlier gingerly ASEAN PTA approach to a more activist and bolder framework under the AFTA.

The Singapore and Bangkok ASEAN Summits also encouraged further refinements in the regional industrialization program towards greater outward orientation and greater reliance on the market and the private sector; e.g. the AICO. (It is nevertheless expected that the AICO

would essentially be superfluous when AFTA is established and as WTO inconsistent fiscal incentives need to be eliminated at the turn of the century.) The ASEAN Heads of States also called for greater cooperation activities in a wider range of areas like infrastructure, agriculture, tourism, human resource development, and others. Indeed, the ASEAN Heads of States agreed during the Bangkok ASEAN Summit that the member countries should move towards "closer economic integration" after year 2003 through the strengthening of current cooperation efforts, initiation of new areas of cooperation, and promotion of closer coordination among ASEAN members at international fora. In their first informal summit in Jakarta in 1996, the ASEAN Heads of States mandated the ASEAN Economic Ministers to develop a vision for ASEAN towards the year 2020, the target year for free trade and investments in APEC under the Bogor Declaration. The ASEAN visioning activity in effect helps define the parameters towards "closer economic integration" in the ASEAN towards the year 2020.

In summary, over the past thirty years, ASEAN has moved increasingly from the political and security concerns to economic concerns, from the immediate to the more visionary, from inward orientation to outward orientation, and from gingerliness and halfheartedness to greater confidence and ambition. The evolution of the ASEAN during the past thirty years parallels the evolution of the individual ASEAN member countries themselves during the period. The increased political support for ASEAN cooperation as indicated by the ASEAN Summit statements apparently does not arise from a more positive reevaluation of the performance of the early ASEAN economic cooperation initiatives. Rather, it reflects a better appreciation of the potentials and benefits of ASEAN-wide cooperation in the face of the resurgence of large regional economic groupings, e.g., the European Union, APEC and NAFTA as well as the sharp growth of large economies like China. The resilience of ASEAN in the face of the significant changes in the domestic and international economic and political arena highlights the fundamental value of ASEAN to its member countries, i.e., as a strengthening glue that helps shape the sense of identity and the common economic future of the ASEAN member countries.

The Emergence of the ASEAN Economies

Together with China (which was the world's fastest growing economy during the past one and a half decades), most of the ASEAN member economies were among the top performers in the world in terms of economic growth during the 1980s and the first half of the 1990s (Table 1). The sole exception in the ASEAN had been the Philippines although by 1995, the country has finally shaken off its sluggish growth of the past one and a half decades. What is noteworthy about the growth performance of Indonesia, Malaysia and Thailand is the acceleration in the average growth rate in the first half of the 1990s from the already comparatively high growth rates of the 1980s. This is a telltale sign that the countries have indeed "taken off" to "tigerhood" (i.e., sustained high growth rate) following the growth experience of the Asian Newly Industrializing Economies (NIEs).

The macroeconomic indicators in Table 1 further elaborate on this "tigerhood" of most of the ASEAN member economies. Investment rates shot up to being among the highest in the world during the past decade. Domestic saving rates also generally increased substantially especially in Malaysia and Thailand. The tailenders are the Philippines and Vietnam although there have been indications of improving saving and investment rates for the two countries in recent years. With the exception of Singapore, which has attained the rank of a high income country, domestic investment rates were higher than domestic saving rates. The gap in investment financing was provided especially by the rising tide of foreign investments.

The structure of domestic output in the ASEAN countries shows a sharp drop in the share of agriculture, except in the Philippines. What is noteworthy about the experience of Indonesia, Malaysia and Thailand is that the drop in the share of agriculture did not arise from a stagnating agriculture but in fact from a sector with a growing level of agricultural trade surplus (or for Vietnam, from an agricultural trade deficit to an agricultural trade surplus) during the 1980s and early 1990s. (The Philippine agricultural surplus declined tremendously during the 1980s and was virtually gone by the early 1990s.) Thus, for the ASEAN member economies (with the exception of the Philippines), a relatively robust agricultural performance underpinned the remarkable rise of the industrial sector during the 1980s and early 1990s (Intal, 1995).

The structure of exports of the ASEAN countries changed dramatically during the past one and a half decades. Whereas they were largely primary product exporters in 1980 (with the exception of Singapore), the ASEAN countries have primarily become exporters of manufactured products by the early 1990s. Perhaps the most remarkable transformation in export composition are Indonesia and Malaysia. For Indonesia, the share of manufactured exports to total merchandise exports rose from about 2 percent in 1980 to more than 50 percent by 1993 while Malaysia's manufactured exports rose from 17 percent of total merchandise exports to 70 percent during the same period (Table 1). Even tiny Singapore increased its reliance on manufactured exports from 50 percent in 1980 to 80 percent in 1993.

The remarkable transformation of the export sector of the ASEAN countries coincided with the significant increase in the trade orientation of the economies during the period. The most remarkable has been the performance of Malaysia whose export orientation rose from a high of 58 percent of GDP in 1980 to an even higher 90 percent of GDP in 1994. Even sluggish Philippines increased the share of exports to GDP from 24 percent in 1980 to 34 percent in 1994. The share of exports in Indonesia declined but behind it is the sharp increase in the share of non-oil exports and the decrease in the real price of oil exports (compared to 1980 when world oil prices rose sharply explaining the high share in 1980). The export share of Singapore also declined... but this was from an extremely high 207 percent of GDP reflecting the reduction in the role of Singapore as a transit/reexport point for Indonesia and Malaysia during the 1990s.

Behind the emergence of ASEAN countries as one of the fastest growing regions in the world is the combination of, on the one hand, rising costs and appreciating currencies in the main investor countries of Northeast Asia and , on the other hand, relatively good economic governance and favorable structural factors in the ASEAN countries. In the process, there has been significant changes in comparative advantages in East Asia during the past one and a half decades.

Fast rising wages and the appreciation of the Japanese yen, South Korean won and new Taiwan dollar during the latter 1980s forced labor intensive firms in these countries as well as Hong Kong to move offshore to the lower wage countries of ASEAN and China as the export

platforms. The initial large capital shift from Japan and the Asian NIEs in the latter 1980s created a positive dynamic of export oriented industrialization in the ASEAN and China, thereby pulling further investments, both domestic and foreign, into the process up to the present. Table 2 presents the changes in the values of revealed comparative advantage (RCA) indices for Japan, Asian NIEs, ASEAN and China during the period 1970-1990. It shows that Japan has lost its comparative advantage in labor intensive manufactures and has moved strongly into technology intensive manufactures. The table also indicates that the magnitude of revealed comparative advantage of the Asian NIEs in labor intensive manufactures also waned and these economies are increasingly into capital intensive manufactures. Moreover, it shows that while ASEAN countries maintained to some extent their revealed comparative advantage in primary products, they have gained comparative advantage in labor intensive manufactures. The dynamic shifts in comparative advantage in East Asia, popularly described in terms of a "flying wild geese", accelerated in the past decade because of the marked increase in investment flows and technology transfer from Japan, the Asian NIEs and even the United States to the middle income ASEAN countries and China.

That the middle income ASEAN countries (and China) became the destination of choice for capital especially from Japan and the Asian NIEs reflects the favorable macroeconomic and structural factors in these countries compared to other competitor developing country regions. Inflation rate, for example, was generally low, especially in Malaysia and Thailand as noted in Table 1. In the case of Vietnam, the big drop in inflation occurred only in recent years, coincident with the growing foreign investor interest. Fiscal management has been prudent and in recent years, Thailand, Malaysia and even the Philippines have registered fiscal surpluses. Human capital, although low by the standards of Japan and the Asian NIEs, is better than in other Asian developing regions, especially South Asia. Infrastructure has been significantly better than other Asian developing regions. Historical linkages and business networks especially among the Chinese business community eased up the socio-cultural costs to direct investments. Finally, government policy actively courted foreign investments in contrast to the large barriers to foreign investments evident in key South Asian countries like India up until the early 1990s.

To sum, the significant economic restructuring and changes in comparative advantage in East Asia especially in Japan and the Asian NIEs during the 1980s brought the middle income ASEAN countries into the "flying geese" loop and served as major impetus for the economic restructuring and changes in comparative advantage in these countries in the future. Nevertheless, the internal dynamic of economic restructuring implicit in "flying geese", however, also suggests that the economic success of the ASEAN countries will lead to secularly rising wages and costs in these countries. That is, ASEAN countries would eventually face the problems that Japan and the Asian NIEs faced earlier in terms of adjusting to their declining international competitiveness vis a vis lower wage developing countries or areas like some South Asian countries, interior China. Even within ASEAN, the shift in comparative advantage occurs, given the significant difference in wage costs between member countries like Malaysia and Vietnam. Thus, the economic emergence of ASEAN countries brings not only opportunities but also challenges to each of them. How far joint cooperative efforts under ASEAN can ease the adjustment process for the ASEAN countries becomes one of the important challenges to ASEAN itself.

The Role of ASEAN to ASEAN Economies

Frankel and Wei (1996) found that, contrary to general perception that intra-ASEAN trade is relatively low especially if Singapore is excluded from the sample, trade intensity among ASEAN countries is in fact relatively high given the stage of economic development of the member countries. At the same time, however, the two authors show that at least for the period up to the early 1990s, the relatively high intensity of intra-ASEAN trade was not the result of ASEAN economic cooperation agreements. The rate of increase of trade within ASEAN could be explained largely by the rapid growth of the countries, without additional push from the ASEAN agreements per se. In short, until the early 1990s, ASEAN was not a significant factor in the trade performance (in value and direction of trade) of the ASEAN member countries.

Frankel and Wei's finding of lack of impact of ASEAN on the trade performances of ASEAN economies, drawn from analyses using gravity models, can be explained in part by the

implementation difficulties of ASEAN preferential tariff agreements as noted earlier (e.g., Pangestu, et. al., 1992). Frankel and Wei's finding also suggests that the ASEAN economies have so far been trading among themselves comparatively intensively despite the inefficacy of ASEAN. Nevertheless, the issue remains whether or not an improved and invigorated ASEAN could accelerate the intensity of intra-ASEAN trade and investments in the future, apart from the historically positive effects of economic growth and extent of overall trade orientation of the ASEAN member economies themselves. Results of recent analyses suggest that the likely impact of the AFTA on trade and production in the ASEAN economies would be modest, especially in comparison to general MFN tariff reduction (e.g., Imada. et.al, 1991; Derosa, 1993). However, such analyses are static in character and do not take into consideration dynamic effects like economies of scale, technology adjustment and skills improvement.

Notwithstanding the poor historical experience with, and the modest prognosis on, the impact of ASEAN economic cooperation, there has been an intensification of efforts in recent years within the ASEAN to improve and deepen the economic cooperation relationships among the members. Such flurry of intense efforts are partly a response to multilateral and regional initiatives, especially the APEC which has clear, though nonbinding, targets of trade and investment liberalization within APEC by year 2020 and which has instituted work programs over a wide range of areas, including a few which are not yet tackled in the World Trade Organization (WTO). These initiatives put increasing pressure for ASEAN to make a difference. Otherwise, it will fail, rather than succeed, into eventual inconsequence.

More fundamentally, the flurry of intense efforts in the ASEAN reflects faith on the potentials of the ASEAN and the likely key contribution of ASEAN economic cooperation to ASEAN countries. That is, as a mechanism for strengthening the glue among the member countries, ASEAN can help the member countries adjust better jointly and individually to the rapidly changing international and domestic environments the countries face. ASEAN succeeds as it grows ultimately into "irrelevancy" (i.e., ASEAN is a transitory measure) and at the same time increases the stature of ASEAN member countries in the global arena (e.g., ASEAN plays a significant voice in international negotiations).

Current quantitative models do not capture the largely facilitative character of ASEAN. One facilitative role of ASEAN is in helping lock in the trade liberalization process in a member country. This essentially political economy role has already happened in the case of the Philippines. Specifically, the discussions leading to, and eventual signing of, the Framework Agreement on Enhancing ASEAN Economic Cooperation by the ASEAN Heads of States during the Singapore Summit in 1992 to implement the ASEAN Free Trade Area helped change the debate significantly in the Philippines on trade and industrial policy. With the ASEAN Summit decision on the AFTA, the long debate in the Philippines on the merits and demerits of trade liberalization versus trade protection significantly died down. The lobbying effort shifted instead to one of pushing for a longer adjustment period towards the intra-ASEAN "free trade" regime as the domestic opponents to trade liberalization in the private business sector realized the futility of fighting the "inevitable", i.e., open, competitive trade in manufactures at least within the ASEAN. This dramatic shift in mindset on trade policy especially by the country's industrialists had contributed significantly to the acceleration in trade and investment liberalization efforts of the Philippine government in recent years. In the process, the Philippines turned from being one of the more protectionist economies to one of the more liberal and open economies in Asia at present.

Of course, the acceleration of the establishment of the AFTA may have also been instrumental in the acceleration of trade liberalization and tariff reduction in Indonesia, whereby Indonesia will reduce tariffs to a 0-10 percent range by year 2003 on an MFN basis, with intraASEAN trade facing the 0-5 percent tariff range under CEPT. Still, this function of the ASEAN as helping lock in trade liberalization programs may be considered as most important mainly to the Philippines and perhaps Vietnam. This is because the other member countries are either very open economies (Singapore, Brunei and to a lesser extent Malaysia) or have been pursuing major trade liberalization and economic deregulation initiatives since the mid1980s (e.g., Indonesia).

The official stated objective of the AFTA is to make ASEAN economies "...more efficient and competitive in the global market and thus make ASEAN countries attractive as production bases for MNCs... geared for the rest of the world. At the same time, consumers will source goods from the most efficient producers in ASEAN, thus creating intra-ASEAN trade" (ASEAN

Secretariat, 1993, pp.1,5). The two expressed roles of ASEAN economic cooperation, primarily through the AFTA, are therefore to improve production and economic efficiency and to improve (or least maintain) the attractiveness of the ASEAN region for foreign investments. The last point has become more salient as an important impetus in recent years for the efforts to deepen economic cooperation within the ASEAN. The strong attraction of China and the growing interest of foreign investors in India, two huge economies in terms of population with relatively lower wage costs as well as the emergence of other investment areas like Eastern Europe and Latin America point to the need for ASEAN countries to form a large intra-ASEAN market (about 420 million people) that would make ASEAN remain an attractive investment area for foreign investors. Considering the significant link between foreign investments, exports and economic growth in the ASEAN countries, the rise of a number of alternative potential major investment sites in the rest of the world as a result of the worldwide pattern of trade liberalization and economic deregulation has made the investment attraction role of AFTA an important consideration for government officials in the ASEAN.

The drive for improved efficiency through increased intra-ASEAN competition underscores the market driven and outward orientation of the AFTA. It is sometimes argued that the trade creation effect of AFTA would be small because the member countries have similar economic structures. Nevertheless, it is precisely because of their similar structures where the pressure for efficiency arising from increased competitive pressure under a free trade area is greatest. In effect, firms in the member countries would have to streamline to where they have competitive niches. In the process, there would be greater intra-ASEAN trade and, at the same time, with more streamlined firms and industries, the ASEAN region as a whole would increase its international competitiveness in a number of industries of importance to the ASEAN countries.

Put on a broader perspective, ASEAN can contribute to ASEAN countries by helping facilitate the adjustment of the member economies to the demands of increased world competition and the changing environment of world trade. In addition to helping lock in the trade liberalization process in member economies as discussed earlier, another aspect of the facilitative role for easing adjustments in the member economies is increased economic and technical

cooperation among the ASEAN member economies in order to address supply or technology bottlenecks (e.g, scientific research capability) and to increase the effectiveness of each member's interventions and investments to address said bottlenecks. A third aspect of the facilitative role of the ASEAN in the area of economic adjustment is for the conduct of joint cooperative actions that would improve the capability of each member country to meet the changing demands of world trading rules. For example, there is a growing impetus for harmonization of standards consistent with international standards. This is expected to facilitate and enhance trade within ASEAN as well as with the rest of the world.

A final role that ASEAN plays, which has so far been its most salient contribution to the member countries, is to strengthen the voice of the ASEAN members in international economic and diplomatic relations and negotiations by taking a common stand on major international concerns and issues. It is clear that a market of about 420 people with rapidly rising incomes is better heard than seven separate individual voices in international negotiations and relations arena.

In the end, all of these actual or potential roles of ASEAN are meant to help integrate the ASEAN economies among themselves and in the process help integrate each ASEAN member with the rest of the world (Chirathivat, p.1996). . This inherently facilitative view of ASEAN economic cooperation essentially assumes that the ASEAN would not erect tariff and nontariff barriers against the rest of the world. Indeed, recent policy decisions of the ASEAN member economies point to unilateral trade liberalization on an MFN basis at the same time that there is a growing commitment to a faster trade liberalization among themselves under the AFTA. In the case of the Philippines, the tariff reform program that aims to reduce tariffs to an range of 0-5 percent, if not altogether a uniform 5 percent tariff, by year 2004 is consistent with the AFTA program. As a result, potential trade diversion effects of AFTA for the Philippines would be minimized. Drawing from the Philippine case, AFTA would essentially be transitory as the member economies would eventually have low tariffs on an MFN basis. As such, strengthening ASEAN economic cooperation would be on an "AFTA plus" framework towards a proposed "ASEAN economic region".

The Challenge of Closer Economic Integration and the Road toward an Economic Region

The ASEAN Heads of States decided during the 5th ASEAN Summit in Bangkok in 1995 to move towards "closer economic integration" beyond the year 2003 when the AFTA process is expected to be completed. In furtherance of this decision and the call of the Heads of States during their Informal Summit in Jakarta in 1996 for the ASEAN economic ministers to prepare a vision for ASEAN for the year 2020, the ASEAN Economic Ministers agreed in their informal retreat in Cebu in March 1997 to propose for the creation of an "ASEAN economic region" by the year 2020.

There are a number of "models" of economic integration in the economic literature to choose from in defining and implementing "closer economic integration". These include, apart from the free trade area which ASEAN aims to approximate by year 2003 through the AFTA, a customs union (which requires member countries to have the same external tariffs), then a common market (where, in addition to being a customs union, there is a free mobility of labor and capital) and, finally, a single market or economic union (where there is also unification of fiscal, monetary and social policies among the members). In their informal retreat in Cebu, the ASEAN economic ministers agreed that the vision of the ASEAN for the year 2020 is the creation of an "ASEAN economic region". The vision is to enhance AFTA by eliminating tariffs in goods and services and allowing free flow of services and investments. In addition, there will be greater cooperation in various areas like professional and financial services, science and technology, transportation and communication, energy and utilities, and food and energy security arrangements. The choice of a terminology different from the established forms of economic integration is likely deliberate because the ASEAN economic region appears to be a free trade area *plus* some of the characteristics of a common market (e.g., free flow of investments) but without the imposition of a common external tariff under a customs union.

The creation of an ASEAN economic region is, to a large extent, a logical extension of the many initiatives in ASEAN economic cooperation currently underway as recorded by the Department of Trade and Industry (DTI, 1997), these initiatives are covered by a number of important agreements, to wit:

- * ASEAN Framework Agreement on Services (1995)
- * ASEAN Agreement on Customs (1997)
- * Basic Agreement on the ASEAN Industrial Cooperation Scheme (1996)
- * ASEAN Agreement for the Promotion and Protection of Investments (1996)
- * ASEAN Framework Agreement on Intellectual Property Rights (1995)
- * Agreement on ASEAN Energy Agreement (1996)
- * ASEAN Petroleum Security Arrangement (1986)
- * Agreement on ASEAN Food Security Reserve (1979)
- * Agreement on the Conservation of Nature and Natural Resources (1985)
- * Multilateral Agreement on Commercial Rights of Nonscheduled Services among ASEAN Countries (1971)

The specifics of deepened economic cooperation initiatives in the areas above as well as in new areas underpinning an ASEAN economic region remain to be spelled out and agreed upon in the future. Nevertheless, suggestions from national delegations include the establishment of "seamless transportation networks" and "enhanced telecommunication networks" (Singapore, 1997), establishment of regional centers of excellence in technology and science, creation of ASEAN Patent System and the ASEAN Trademark System, and mutual recognition arrangements in professional services.

The ASEAN initiatives and plans are influenced to some extent by the developments in the APEC and the WTO. Thus, the institution of a "free trade area - plus" economic region in the ASEAN follows and deepens to a large extent the initiatives in the APEC. For example, the establishment of a regime of free trade in goods and services and free flow of investments in the APEC for the year 2020 are goals set out in the Bogor Declaration during the Third APEC Summit in 1994, although there is yet no clear statement that free trade means zero tariff and nontariff barriers or whether the Bogor goals can accommodate a 0-x percent range, where x is a very low number (e.g., 5). ASEAN's vision calls for zero tariffs and nontariff barriers in the ASEAN. Whether or not it will be operational before the year 2020 would likely depend on the agreement in APEC on what the free trade goal in the Bogor Declaration means. If the APEC pursues the strict definition of free trade (i.e., zero tariffs and nontariff barriers), then ASEAN

may decide to complete this process earlier than the year 2020 (the target date in APEC) in order to make a difference.

Virtually all the areas of initiatives in the ASEAN are in the APEC. This may seem to suggest that ASEAN is getting to be superfluous given the initiatives in the APEC, especially because much of the trade of each of the ASEAN member economies is concentrated within the Asia Pacific region. Considering that ASEAN members are important members of the APEC, the role of ASEAN as a complement to APEC is that the extent of economic cooperation relationship among the ASEAN members would have to be deeper or undertaken earlier than the target in the APEC, if ASEAN has to make a difference vis a vis APEC and WTO. That is, to some extent, ASEAN may have to be "APEC -plus". The ASEAN vision for 2020 appears to aim for deeper economic cooperation relationships, as indicated by Singapore's proposed concept of a "seamless transportation network" within the ASEAN.

Implementation Issues. The challenge for the ASEAN and the ASEAN members is in the implementation. The political economy of trade liberalization is always problematic in any country except for small city states like Singapore. For the AFTA, it is likely that the most important problem area is with respect to agriculture and agribased manufacturing. The recent debate in the Philippines on the ASEAN margin of preference for sugar, in the face of declining domestic sugar prices, exemplifies the political economy problem of trade liberalization. As the agriculture sector faces adjustment problems because of the rapid economic changes in the ASEAN countries, the call for protection could in fact increase in these countries as what happened in South Korea, Japan and Taiwan. The recent farmer demonstration and "camp-in" in Bangkok may be a portent of the future political economy problems in the ASEAN with respect to agriculture. This will eventually have a bearing on the implementation of the AFTA.

In addition, the current CEPT arrangement does not include "sensitive" unprocessed agriculture products. Moreover, the time table for tariff reduction for unprocessed agriculture products extends beyond the year 2003. This results in tariff distortion. Specifically, agribased processing manufacturing industries could face negative effective protection if the agricultural inputs have high protection rate or have domestic prices significantly higher than import prices.

As a result, the domestic processing industries would have difficulty competing with processed food imports from other ASEAN countries. Because the Philippine agriculture sector has lagged behind those of Indonesia, Malaysia and Thailand during the 1980s, it is the Philippines which is most vulnerable to this distortion in effective protection and thus to greater pressure from the food manufacturing industry to deviate from the AFTA timetable unless protection to agriculture is reduced. Recent analyses indicate that in the Philippines, the rate of agricultural protection has already surpassed the rate of protection in the manufacturing sector. The shift in relative protection occurred in the Philippines much earlier than historically in other countries. Clearly, unless Philippine agriculture improves significantly its productivity which will reduce the effective rate of protection in agriculture, it is likely that a large segment of the Philippine food processing industry will face adjustment problems by year 2003 with the full implementation of the AFTA.

The issue of liberalization of the services sector will also pose a lot of implementation problems although the time table for this sector's liberalization goes beyond the AFTA target year of 2003. Market access issues in the services sector would include the right of establishment; hence, it is woven intimately with the issue of national treatment of foreign (i.e., ASEAN) investments in the services sector. Despite the unilateral liberalization efforts in the services sector in a number of ASEAN countries, there remain constraints on the extent of foreign equity in domestic enterprises. Moreover, some sectors are either off limits to foreigners or have much more limited allowable foreign equity participation. For instance, foreigners are barred in the retail sector in the Philippines and Indonesia although they have been entering through the backdoor through technical cooperation contracts with local firms or through the use of local dummies. Services liberalization is also related to the issue of mobility of people, especially professional people, given the nature of product provision in the services sector. Fostering free trade in services is complex and ASEAN may need to define more clearly its strategy of attaining "free flow of services" within the ASEAN in terms of subsector coverage, market access, mobility of people within ASEAN, and time frame. ASEAN's dilemma is not unique. APEC itself is also currently struggling with this issue. Like ASEAN, APEC would also need to clearly define its strategy of meeting the Bogor goal of free trade in services within APEC by the year 2020. It is likely that the process of defining the nature and strategy of attaining free trade in the services sector in the ASEAN would be in tandem with the parallel process in the APEC.

In both the goods and services sectors, free trade within the ASEAN raises the issues of trade diversion and trade creation because of the second-best nature of a free trade area compared to general MFN tariff reductions. Trade diversion occurs when, as a result of a free trade arrangement with a group of countries, a country sources its imports not from the least cost source in the world but from a less efficient partner country simply because of the preferential tariff treatment to partner country exports compared to nonpartner country imports. Trade diversion is likely to be higher when there is a higher level of protection of the partner countries, a smaller share of the trade with the partner countries to their total trade, and a more price elastic demand for the products of the partner countries. Recent analysis (Ramasamy, 1995) indicates that the trade diversion arising from the AFTA will be highest for the Philippines at 10 percent of its exports to ASEAN members, followed by Singapore (8 %), Thailand (8%) Malaysia (5 %) and lastly, Indonesia (3 %). Such estimates did not take into account more recent tariff reform initiatives in these countries. For example, the estimate for the Philippines would drastically change given that the country will be reducing its MFN tariff rates in conjunction with the tariff reductions under the AFTA, thereby minimizing trade diversion. In addition, trade between the Philippines and the other ASEAN member countries, especially with Singapore and Thailand, has risen dramatically in the past two years, much of it in electronics products which face low MFN tariffs.

In the standard static analysis in customs union theory, a free trade area is only welfare increasing for the member countries if the trade creation effect is greater than the trade diversion effect. Trade creation occurs when a partner country produces a product more efficiently, thereby allowing for a reallocation of domestic resources away from a higher cost domestic source for the given product. Trade creation is likely to be higher if the rate of protection before free trade is higher, and if the magnitude of trade among the partner countries in the free trade area is greater. Ramasamy (1995) found that for the Philippines, Indonesia and Thailand, trade creation is greater than trade diversion under AFTA. Hence, AFTA is net welfare-enhancing for these countries. In contrast, AFTA is projected to be net welfare-losing for Malaysia and Singapore because trade diversion is greater than trade creation. Nevertheless, static analyses like Ramasamy's excludes the longer term dynamic effects of greater competition, economies of scale and intra-industry trade. Considering that the fastest growing segment of intra-ASEAN trade is

in fact intraindustry trade especially in electronics where both Singapore and Malaysia are major producers and exporters, it is clear that the estimate of trade creation effects of AFTA is likely to have been significantly underestimated.

A more fundamental issue than measuring the trade diversion and trade creation effects of a free trade is the alternative of moving towards a "first best" solution instead -- that is, trade liberalization on an across-all-countries MFN basis rather than among the ASEAN members only. By definition, trade liberalization on an MFN basis is potentially more beneficial than a free trade area because there is no trade diversion effect but only trade creation effect. This question of liberalization on an MFN basis being more beneficial potentially than an ASEAN free trade area is probably more relevant and salient with respect to the services sector.

Specifically, considering that the sources of new technology, systems and marketing linkages are mainly the non-ASEAN developed countries rather than the ASEAN members (with the possible exception to some extent of Singapore), is it not better for the Philippines, for example, to just liberalize the (specific) services sector to everybody rather than to ASEAN participants only? What is the special merit in giving preferential treatment to ASEAN providers and investors when the country can get more benefit from a generalized liberalization of the sector? The answer, of course, depends partly on the political economy dynamics in each ASEAN member. One important consideration for a free trade area is that members of the free trade area give reciprocal access to each other's sector while a generalized liberalization will be essentially unilateral given that there is yet no agreement on free trade in goods and services in the WTO. Considerations such as those discussed above would likely help shape the actual implementation of the AFTA and ASEAN's free trade program in the services sector.

As ASEAN moves into free trade of goods and services within the ASEAN region, ASEAN needs to delve on domestic policy issues that bear on the nature of competition in the region. Of critical importance is government subsidies. Government-owned corporations or government-linked corporations are an important segment of the economy in a number of ASEAN countries. This is most evident in Vietnam as well as in specific industries in other ASEAN countries. Clearly, direct production subsidies to such firms distort the nature of

competition in the region. Similarly with respect to agriculture because subsidies have a bearing on the domestic prices facing the inputs of food processing industries in the region. Thus, ASEAN needs to agree on what subsidies are acceptable in terms of magnitude, form or function, in the context of a free trade regime in the region. In effect, ASEAN needs to define its own competition policy rules in the region. Such rules, apart from the issue of subsidies, may also consider business practices, especially unfair trade practices of multinationals within the region. It will have to deal with the issue of export subsidies because a free trade arrangement generally proscribes antidumping measures against each other member's exports.

Apart from fostering competition in the ASEAN region through the enhanced AFTA and the competition rules, ASEAN would have to focus increasingly on facilitation measures, including the strengthening of economic and technical cooperation among member economies. Facilitation of trade and business includes issues related to customs procedures and systems, harmonization of tariff nomenclature, simplification or implementation of rules of origin to prevent circumvention, standards and mutual recognition agreements including those of certification bodies, and even possibly some harmonization of fiscal taxes or incentives. Simplification of customs procedures and rules of origin is important to encourage greater intra ASEAN trade. The experience in the European Free Trade Association suggests that the transactions cost of meeting the requirements on rules of origin can be significant. Thus, suggestions have been made to institute a *de minimis* rule such that when the tariff preference (i.e., the difference between the MFN tariff and the AFTA tariff) is at most x percent (say, 3 %), preferential rules of origin can be waived and nonpreferential rules of origin currently being finalized under the WTO and ICU would suffice (Stephenson, 1996). Similarly, standards can be a source of technical barrier to trade. As such, harmonization of standards within the ASEAN consistent with international standards together with mutual recognition of certifications can help minimize the possible use of standards as a technical barrier to trade. To a large extent, this is being addressed in the WTO. ASEAN's potential contribution therefore is primarily in encouraging accelerated implementation within ASEAN.

Finally, as in APEC, policy consultations and economic and technical cooperation initiatives can contribute to easing the process of adjustment to a more liberal trading environment

and to increasing the benefits from economic liberalization. Economic and technical cooperation can run a wide gamut of initiatives in different areas of interest or concern e.g., human resource development, science and technology, infrastructure, environment, and others. Perhaps more than the decision on what area to focus, it is likely that the most important issue is the nature of economic and technical cooperation initiatives. The logical model of development cooperation for ASEAN is the Manila Declaration on an Asia Pacific Economic Cooperation Framework for Strengthening Economic Cooperation and Development which was signed during the APEC Ministerial and Leaders Meetings in Manila in November 1996. The Manila Declaration emphasizes dynamic partnership among equals and with the private sector. To some extent, the implementation of the principles of the Manila Declaration may best be undertaken in the ASEAN because none of the ASEAN members is a major donor. Thus, joint ECOTECH activities are likely to be jointly funded for the mutual benefit of the members.

Concluding Remarks

Despite the lackluster performance of the ASEAN in the field of economic cooperation until the 1980s, the ASEAN member countries have decided to invigorate it and vested in it more ambitious goals of economic cooperation among the members. From a preferential tariff area, ASEAN has decided to move towards a free trade area by the first decade of the next century and is envisioning the creation of an ASEAN economic region, a FTA-plus regime, by the year 2020. The invigoration of the ASEAN is rooted largely in the domestic liberalization and outward orientation of the members and in the accelerating initiatives from regional groupings like the APEC in the face of fast changes in the international economic environment.

There is some internal dynamic to the process of deepening relationships envisioned in the ASEAN. As ASEAN moves towards a free trade area, there are correlative concerns that need to be addressed jointly by the member countries in order to ensure the success of the free trade area. Most of these correlative measures are facilitation measures, institution-building initiatives and policy consultation processes or agreements. The widening array of economic cooperation initiatives and imperatives facilitates and, at the same time, is helped along by a deepening sense

of community among the peoples of the ASEAN countries. In the end, ASEAN, which was started primarily on noneconomic concerns in the late 1960s, will have to rely more on a deepening sense of community and identity in the region in order for it to fulfill its challenge of making a difference in economic cooperation within the ASEAN region. By becoming a unified region with a growing sense of identity, ASEAN becomes an even more important voice in the international arena.

REFERENCES

- ASEAN Secretariat (1993). **The ASEAN Reader**. Jakarta.
- Blomquist, H. (1993). *ASEAN as a Model for Third World Regional Economic Cooperation?* **ASEAN Economic Bulletin**, Vol. 10 No. 1 (July 1993)
- Chirathivat, S. (1996) *ASEAN Economic Integration with the World through AFTA*. in Ariff, M. *et. al.* **AFTA in the Changing International Economy**. Singapore: Institute of Southeast Asian Studies.
- Department of Trade and Industry (1997). *Closer Economic Integration (ASEAN Vision Towards 2020)*. Mimeo.
- Department of Trade and Industry (1997). *Summary Record of the Fourth AEM Retreat*. Mimeo.
- Derosa, D. (1993). *Sources of Comparative Advantage in the International Trade of the ASEAN Countries*. **ASEAN Economic Bulletin** Vol.10 No.1 (July 1993)
- Dosch, J. and M.Mols (1994) *Why ASEAN Cooperation Cannot Work as a Model for Regionalism Elsewhere--A Reply*. **ASEAN Economic Bulletin** Vol11 No.2 (November 1994)
- Frankel, J. and S.Wei (1996). *ASEAN in a Regional Perspective*. Pacific Basin Working Paper No. PB96-02, Center for Pacific Basin Monetary and Economic Studies, Federal Reserve Bank of San Francisco.
- Imada, P., M. Montes and S. Naya (1991). *A Free Trade Area: Implications for ASEAN*. Paper presented during the Joint IPS-ISEAS ASEAN Roundtable: ASEAN Economic Cooperation in the 1990s. Singapore, 27-28 June, 1991.
- Intal, P. (1995) *Economic Incentives, Structural Adjustment and Agriculture in the Asia Pacific Region*. Paper presented during the FAO Expert consultation on Monitoring the Impact of Structural Adjustment Programme on the Agricultural Sector, Phuket, Thailand, 23-26 January.
- Pangestu, M., H. Soesastro and M. Ahmad (1992). *A New Look at Intra-ASEAN Economic Cooperation*. **ASEAN Economic Bulletin**, Vol.8 No.3 (March 1992)
- Pangestu, M., C. Findlay, P. Intal and S. Parker (eds.) (1996). **Perspectives on the Manila Action Plan for APEC**. Manila: PECC, PIDS and Asia Foundation
- Ramasamy, B. (1995). *Trade Diversion in an ASEAN Free Trade*. **ASEAN Economic Buletin**, Vol.12 No.1 (July 1995)

Singapore (1997). *Singapore's Vision for ASEAN 2020*. Mimeo.

Stephenson, S. (1996) *The Economic Impact of Rules of Origin in the Asia Pacific Region*. Paper presented at the Trade Policy Forum IX, Pacific Economic Cooperation Council, Seoul, Korea, 11-14 September, 1996.

Yamazawa, I. and S. Okuda (1994). *Basic Trade Statistics for the APDC Project on Changing Comparative Advantage Patterns and Intraregional Trade Expansion in Asia and the Pacific*. Mimeo.