

ASEAN: Regional Integration and Reforms*

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Key Issues:

- ASEAN regional trade agreements plays a major role in East Asia Integration
- Facilitation and transparency are key for further integration

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This brief explains the motivation behind ASEAN's integration into East Asia, the role ASEAN reforms play in the integration, as well as its future direction. If ASEAN members continue to improve trade facilitation and regulation transparency, regional integration can become a vehicle for multilateral integration, domestic reforms, and institution building.

In the last 2 decades, growth in trade and increased integration within ASEAN and between ASEAN and East Asia have become the dominant story of the ASEAN economy. In 2003, the ASEAN Economic Community was founded with four pillars: a single market and production base, a competitive region, equitable economic development, and integration into the global economy. Among the four pillars, a single market and integration into the global economy are where ASEAN has progressed the most. The creation of the ASEAN Trade in Goods Agreement in 2010 and the fact that most intra-ASEAN trade is already at zero tariff is proof of a single market progress. Meanwhile integration into the global economy was realized through free trade agreements (FTAs) signed and implemented with six of its East Asian partners: Australia and New Zealand (AANZFTA), China (ACFTA), India (AIFTA), Republic of Korea (AKFTA), and Japan (AJCEP).

In November 2011, ASEAN took a bold step towards deeper integration in the East Asia and Pacific region by forming the Regional Comprehensive Economic Partnership (RCEP). The agreement consolidates five existing ASEAN FTAs with the aim of making them broader and more comprehensive. Since then, ASEAN has successfully advanced integration in East Asia. ASEAN trade with its East Asian partners has grown and displaced trade with the European Union (EU) and the United States (US). Furthermore, ASEAN trade and investment have continued to increasingly integrate with those of its East Asian trading partners.

ASEAN's expansion into East Asia, despite uncertainty and a slowing global economy, raises questions on the true motivation behind this ambitious move. In this brief, we explain some of the reasons for ASEAN's expansion to include East Asia, its role in East Asian integration, as well as current efforts and its future direction.

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Trends of ASEAN Trade

In the last 2 decades, two events dominated the trends of ASEAN trade. First, the growth of intra-ASEAN trade surpassed any other type of trade by an average of 10.5% annually, compared with overall ASEAN trade of 9.2%, and ASEAN's trade with non-ASEAN countries of 8.9%. Second, ASEAN has made significant shifts in its trading partners. Trade with previous trading partners including Japan, the US, and the EU has declined, while trade with China sees more than five times increase in the share of exports and imports (Figure 1).

Figure 1a. Share of ASEAN Exports by Destination

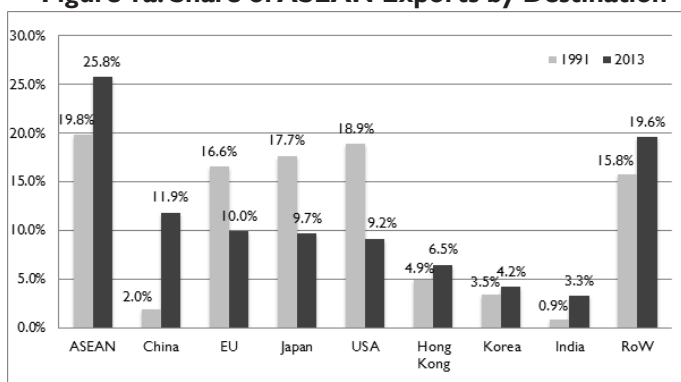
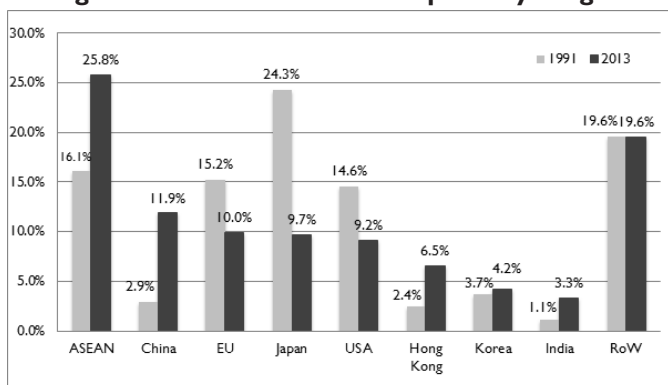


Figure 1b. Share of ASEAN Imports by Origin



ASEAN = Association of Southeast Asian Nations; EU = European Union; USA = United States of America; RoW = Rest of the world. Source: Authors' calculations based on UNCOMTRADE.

When we look only at ASEAN's trade with its six FTA partners, both the share of ASEAN's exports and imports of goods to and from trading partners in East Asia increased particularly over 2000–2012. ASEAN's exports to six of its trading partners increased from 25% to 34% of its total exports, while imports increased from 33% to 35% (Figure 2).

Foreign direct investment from its FTA partners to ASEAN has also increased, particularly after the global financial crisis in 2009 affecting investment markets in the US and the EU, as many investors based in the six partners saw Southeast Asia as one of the more promising investment destinations.

Figure 2a. ASEAN's Exports of Goods to Six FTA Partners (% of its total exports of goods)

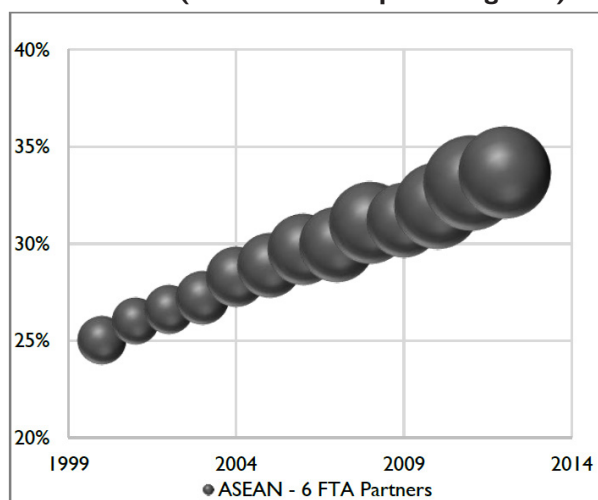
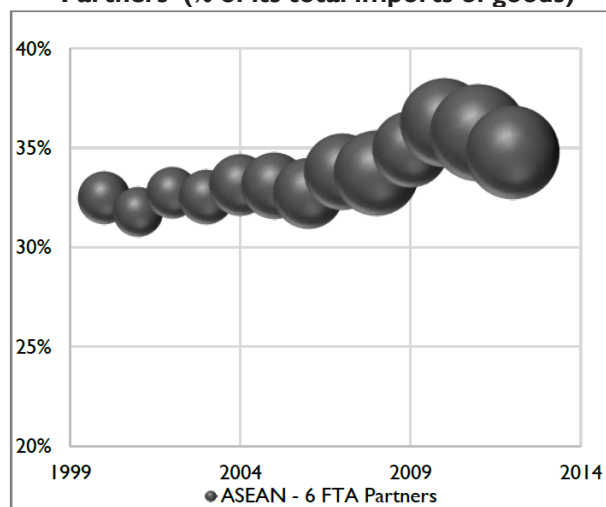


Figure 2b. ASEAN's Imports of Goods from Six FTA Partners (% of its total imports of goods)



ASEAN = Association of Southeast Asian Nations; FTA = free trade agreement.

Sources: Authors' calculations based on UNCOMTRADE (accessed January 2014). Data on exports for Brunei Darussalam were available only for 2002, 2003, 2004, 2006, and 2012, and data on exports for Myanmar were available only for 2010. Data on imports for Brunei were available for 2002, 2003, 2004, and 2006 only, and those on Myanmar imports were available for 2001 and 2010 only.

The Role of Regional Trade Agreements in East Asian Integration

The main drive of ASEAN to expand into East Asia is expressed in the ASEAN Free Trade Area (AFTA), the strategy of which is for ASEAN to be a regional production centre and to make the region more competitive by drawing on the resources from the different ASEAN economies, regional production centres, and increasing global value chains.

The growth of regional production networks will be central to East Asian integration. If East Asian integration is fully concluded, firms can enjoy the advantages of the regional cumulation of 16 members, which no existing

regional trade agreement currently provide. For example, a firm in Southeast Asia that imports and uses inputs from China and exports to Japan can benefit from the cumulation of Chinese and ASEAN contents together.

In improving regional networks, ASEAN has shown an increasing role as a production base, which is expected to continue to increase. Efficient and effective production networks and global value chains, however, require the smooth flow of people, goods, and services that can only be obtained with low tariffs, well-managed transparent non-tariff measures, efficient supporting services and logistics, and conducive trade facilitation measures such as customs and behind-the-border policies.

The growth of ASEAN trade is dominated not only by trade of intermediate goods and machinery but also by the increasing demand of final goods. Economic growth, growing populations, and greater purchasing power have given ASEAN countries, particularly Indonesia, Malaysia, Thailand, and Viet Nam, a promising economic prospect.

Ing (2012) coined the phrase 'the 3Ds' referring to durable macroeconomy, domestic consumption, and demographic dividend to describe the economic benefits ASEAN can gain. The first 'D', durable macroeconomy, represents four ASEAN countries, Indonesia, Thailand, Malaysia, and, lately Viet Nam, that have recorded average growth of more than 5% annually over the last decade. This was accompanied by a declining ratio of debt to gross domestic product from an average 67% in 2000 to 24% in 2011 and an improvement in consumer and business confidence (EIU, 2014; Tradegeconomics, 2015). Japan, the largest foreign direct investment investor in Southeast Asia, listed all four countries as top investment locations.

The second 'D' refers to the fact that more than 65% of gross domestic product in these economies is accounted for by domestic consumption. This has not included the fact that the growing purchasing power and middle class will lead to even greater growth in domestic consumption, both in the ASEAN region and in East Asia. The third 'D', demographic dividend, describes the fact that about 50% of the population in Southeast Asia is part of the labour force. More importantly, wage growth in Indonesia and Viet Nam has been lower than in China, particularly since 2005, which makes these countries more attractive as investment destinations. This means that these countries could still be sites for relocation as China's labour costs rise.

FTAs within ASEAN and between ASEAN and its East Asian partners arguably have also had a role, directly

and indirectly. Despite the debate on whether regional agreements will create or divert trade, scholars agree that regional agreements among natural trading partners, including in the case of ASEAN and ASEAN+1 FTAs, tend to be trade creating. East Asian integration aims to improve trade creation without (or at least minimizing) trade diversion; thus, it promotes the principle of 'open accession', which allows any country to join the partnership later. ASEAN has entered into ASEAN and ASEAN+1 FTAs, so that it is not only a political integration unit but it has also advanced significantly in integration of trade in goods, services, and investment. East Asian integration has also been designed not to be simply an 'extensive regional trade agreement' that includes five out of seven manufacturing gainers in the last 3 decades – China, Korea, India, Indonesia, and Thailand (Baldwin, 2013). It is more as a 'responsive vehicle' that consists of trade and investment commitments combined with economic and technical cooperation and capacity building to stimulate the effective implementation of trade and investment agreements for all members. In the long run, entering into regional agreements also drives unilateral and domestic reforms.

The Way Forward: ASEAN's Efforts in Advancing Regional Integration

Several challenges await ASEAN in deepening integration. For a start, tariff elimination across East Asian countries may face challenges as not all members have a bilateral FTA between them. The current RCEP negotiations indicate that, although it has been relatively easy for countries that have FTAs to consolidate coverage of goods for tariff reduction, it has been much harder for countries that do not have an FTA with each other, such as China and India, to do so.

Evaluation of the utilization of FTAs also shows that use is increasing, but remains low. On average, the use of AFTA and ASEAN+1 FTAs was 21% and 18%, respectively. There are two main reasons for the moderate take-up of FTAs: (i) the limited availability of information about FTAs and how to use them, and (ii) the small benefit margins of FTAs.

The AFTA rules of origin (ROO) and the ASEAN+1 FTAs have a simple and transparent structure, with a large chunk of trade flows subject to a 40% regional value content (RVC-40) or a change of tariff classification (Medalla and Balboa, 2009). Whereas the official costs of obtaining an FTA COO (certificate of origin) are perceived to be reasonable, the procedure is cumbersome. A recent econometric analysis (Cadot and Ing, 2014) on the cost of compliance with ASEAN's

ROO at the Harmonized System (HS) six-digit product level uncovers evidence of moderately restrictive effects, with an average tariff equivalent across all measures and products, of 3.40% (2.09% using trade-weighting).

There are two policy recommendations can be drawn from this exercise: (i) generalize alternate ROO such as regional value content or change in tariff heading, and (ii) simplify and streamline ROO in light industries such as apparel, footwear, and prepared foods. Furthermore, if East Asian integration will allow deviation from common concessions in trade agreements, it should start to think about indicators of deviation, such as the percentage level of deviation, and a period for deviation.

As tariffs decrease, there will be increased pressure to use other trade instruments to 'protect' domestic industries that typically involve non-tariff measures (NTMs). To prevent a hidden protectionism agenda, there is a need to improve transparency in NTMs and to implement a system of evaluation of NTMs.

First, East Asian integration should provide business with more options to use these vehicles by generalizing an 'alternate rule', such as by giving exporters the option of using either a regional value content or a change of tariff classification. Second, in increasing commitments to liberalization in the services sector, ASEAN could consider something innovative, such as setting a level of commitment in advance and designing targets to achieve these commitments over a certain period.

Third, in terms of investment, the ASEAN Comprehensive Investment Agreement (ACIA) is the most comprehensive investment agreement compared with the all ASEAN FTA+I agreements. Therefore, ASEAN could consider using ACIA as a reference point. ACIA consists of the four pillars of liberalization, protection, facilitation, and promotion. Simultaneously, ASEAN could also propose a 'single negative list' approach to be implemented in any East Asian integration agreement. Moreover, East Asian integration could be an avenue for facilitation and promotion, and domestic investment reforms to improve investment procedures and inquiry handling.

Fourth, to further increase trade in goods, services, and investment, ASEAN should continue its efforts in trade and investment facilitation. These include improving trade across borders, improving transparency in trade regulations, and improving investment facilitation and promotion, such as in the clarity of procedures approving and rejecting investment and for handling investment inquiries.

Last, standards and mutual recognition of standards are also equally important, if there is to be free movement of professional workers and goods, which is part of achieving a single market and regional production base. It is also increasingly important for participating in regional or global value chains.

Overall, ASEAN should advance its regional integration as a vehicle for multilateral integration and domestic reforms as well as institution building. To achieve this, it should set feasible levels of commitments that are achievable within a specified time-frame.

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