Chapter 2B

Framework towards Sustained High and Equitable Growth in ASEAN

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Chapter 2B

Framework towards Sustained High and Equitable Growth in ASEAN

The Report proposes a framework of four key pillars and one strong foundation towards sustained high and equitable growth in ASEAN which thereby allows the region to further move up economically and step up regionally and globally. The four pillars are mutually reinforcing, and the foundational element accentuates the mutual reinforcement among the four pillars. Note that the four pillars deepen, amplify and/or temper the four pillars in the AEC Blueprint 2009-2015.

Framework

To achieve the ASEAN Leaders' vision and the indicative outcomes discussed in Chapter 2A, this Integrative Report proposes a framework consisting of four pillars and a foundation towards the attainment of the "ASEAN Miracle" of ASEAN RISING. The four pillars are similar to, evolved from, and deepen the four pillars of the AEC Blueprint. In addition, the proposed framework includes "Responsive ASEAN" as the strong foundation of the four pillars. To a large extent, this Integrative Report's proposed framework builds on and deepens the *Jakarta Framework on Moving ASEAN and AEC Forward Beyond 2015* that ERIA presented, together with the ASEAN Secretary General, to ASEAN Leaders through H.E. President Yudhoyono during the ASEAN Summit in Bali in November 2011.

Figure 2B.1 summarises the four pillars and one foundation for ASEAN moving forward beyond 2015. The four pillars are:

- Integrated and highly contestable ASEAN
- Competitive and dynamic ASEAN
- Inclusive, resilient and green ASEAN
- Global ASEAN: RCEP and ASEAN voice

The strong foundation supporting the abovementioned four pillars is:

- Responsive ASEAN

Figure 2B.1: Four Key Pillars and One Strong Foundation for ASEAN Moving Forward Beyond 2015

The rest of the section elaborates on the framework which is underpinned by the following key premises:

1. Competitive industries and private sector dynamism are the core of ASEAN economic development.

2. It is best to pursue inclusive and balanced growth through greater reliance on dynamic economic forces tempered by prudent safety net programs, rather than on activist and fiscally unsustainable subsidisation policies and income redistribution programs.

3. The pursuit of sustainable development brings out the complementarity among green growth, energy security and food security.

4. Keep ASEAN centrality in a dynamic pro-active diplomacy.

Note that the four pillars are not independent of each other; in fact, they are highly interrelated. Thus, a key challenge for AMSs and ASEAN is to find that balance and virtuous cycle among them, given that the measures needed to realize the four pillars are not easy at all. And precisely because the measures are tough, each AMS and ASEAN need to be responsive, bringing in the various stakeholders in the process of regulatory improvement and institution building needed to effect the ASEAN Miracle.

An integrated and highly contestable region (Pillar 1) with robustly growing, expanding and increasingly innovative industrial clusters (Pillar 2) linked more to a vast and robustly growing East Asia arising from a successful RCEP (Pillar 4) and operating under much more improved investment climate and responsive regulatory regime (Responsive ASEAN) can be expected to entice a much larger investment response and engender greater competitiveness in both domestic and foreign markets. This would lead to a markedly higher foreign trade, and ultimately, to higher economic growth and eventual elimination of poverty. Robust agricultural productivity growth, growing SMEs, greater physical connectivity between peripheries and growth centres, the drive for energy efficiency and green development, and greater disaster resiliency (which are all part of Pillar 3) also contribute to greater competitiveness, investment attractiveness, and dynamism of ASEAN (Pillar 2). Such greater competitiveness and dynamism is quantitatively expressed in terms of the increased share of ASEAN to the total FDI, trade and GDP envisioned in the previous sub-section. Thus, the implementation of the four pillars and foundation that comprise the proposed framework can be expected to lead to the attainment of the proposed desired indicative outcomes presented in the previous section.

Pillar One: Integrated and highly contestable ASEAN

"ASEAN Economic Community (AEC): a potential game changer for ASEAN Economies"

S. Hansakul and W. Keng, DB *Research*, Deutsche Bank, 14 June 2013, p.1

"Catching the ASEAN wave"

T.L. Lim, G.D. Powell and A. Chng, *Outlook*, 2012 No.1, Accenture

The titles of the two articles in the house publications of two well- known multinationals quoted above probably best sum up the palpable anticipation in the air about AEC and the prospects of ASEAN, dubbed as the "newest hot spot in today's global business" (Lim, Powell and Chng, 2012, p.7). The reason for the anticipation and optimism is simple: ASEAN is the third largest economy in Asia after China and Japan; ASEAN has the world's third largest population after China and India; ASEAN has a larger middle class than India; and ASEAN is one of the most robustly growing regions in the world. In short, ASEAN is a large and robustly growing market, offering a large potential for business growth which interestingly is the most important reason for US firms' expansion in the region as the results of the ASEAN Business Outlook Survey 2014 show.

The challenge is to make ASEAN more of an integrated, nearly single, economy rather than a collection of 10 economies. The reality on the ground at present is more prosaic. Results of the 2009 ERIA survey of firms–both locally owned and foreign owned--show that access to the ASEAN market differs in importance in the firms' decision to invest and current or future operations. Thus, for example, while the Cambodian firm respondents consider access to the ASEAN market as a marginal factor in their investment decisions and current operations (as Cambodia's export market shifted to the West), firms in Indonesia and the Philippines consider access to the ASEAN market as a significant factor in their current and future operations. In the case of Singapore firms, access to the ASEAN market was a significant factor in their decision to invest in Singapore as well as in their current and future operations. Similarly, Vietnamese firms are considering ASEAN in their future operations even if it is a minor factor in their current operations. Perhaps, it is the Thai private sector that is most animated by the prospects of an integrated ASEAN as indicated by the conferences and seminars on AEC 2015 being held in the country.

An integrated ASEAN is important to firms in the region. The ASEAN Business Outlook Survey 2014 of the US Chambers of Commerce in the ASEAN reports that about three fourths of their respondents from US companies operating in ASEAN consider ASEAN integration as important to their companies' business in ASEAN. Similarly, the regular review of the AEC and the list of recommendations of the federation of Japan chambers of commerce and industry in the ASEAN on AEC underscores the fact that the operations and expansion of production networks by Japanese and other multinationals would be better served by an integrated ASEAN. Indeed, a key strategy for a more competitive ASEAN in this Integrative Report is the deepening of the production networks within ASEAN and with the rest of East Asia.

An ASEAN single market?

Establishing an integrated ASEAN is of course at the heart of the AEC Blueprint for 2009-2015. Indeed, the Blueprint's aim is even more ambitious, i.e., a "single market and production base", the Pillar 1 of the AEC Blueprint. The key strategies under Pillar 1 of the AEC Blueprint reflect ASEAN's ambition, i.e., free flow of goods, free flow of services; free flow of investment; free flow of skilled labour; and freer flow of capital.

What is a single market? What does it entail? There are essentially two ways of assessing what a single market is and what it entails, i.e., either as **process** of economic integration or as the **outcome** of economic integration. As ***process*** of economic integration, the focus is on the degree of mobility of goods and services as well as factors of production; ***a single market means that goods, services and factors of production can move across countries as easily as within countries***. As ***outcome*** of economic integration, the focus is on the degree of divergence of prices of goods, services and factors of production across boundaries; a single market means the prices of goods, services and factors of production are virtually equalised across countries adjusted for transport cost. Clearly, the idealised conception of single market presented above can only be approximated in reality. The idealised conception in terms of single price from economic integration is virtually impossible to obtain since there are very large gaps in the levels of development among member states in the case of ASEAN. The challenge is how to be as close to the idealised conception as possible because there are significant policy and institutional implications in moving closer to the idealised state.

Single market is usually couched in terms of the process of economic integration; this is the focus of the discussion in the rest of this section. ASEAN implicitly defines "single market and production base" in terms of five core elements, namely, (1) free flow of goods; (2) free flow of services; (3) free

flow of investment; (4) freer flow of capital; and (5) free flow of skilled labour. The ASEAN core elements bring out the core essence of a single market; that is, the movement of goods, services, and factors of production (capital and labour) between member states of a trade bloc is as easy as within the member states themselves. In effect, there are virtually no barriers (especially policy or regulatory based) in the movement of goods, services and factors of production. In so doing, the differences in prices, wages and rates of return would eventually be narrowed as much as possible assuming no changes in technology and comparatively common preferences in the member states.
Thus, to a large extent, the key strategies under Pillar 1 of the AEC Blueprint are consistent with the critical anchors of a single market. Nonetheless, it is in the contents of what the freedoms stated above entail that really define a single market. Here, the European Union (EU) and Caribbean Single Market and Economy (CSME) cases are instructive because, especially with respect to EU, the measures in the AEC Blueprint 2009-2015 fall significantly short of what would be required to have something close to a single market indeed. In this sense, it can be viewed that the measures in the AEC Blueprint 2009-2015 are **measures** "**towards** a single market and production base".

The **EU** single market or ***internal market*** is the closest to the fundamental essence of a single market. Thus, for example, to ensure free movement of goods, member countries are prohibited not only from levying customs duties but also from imposing import charges that have equivalent effect to customs duties, discriminatory taxation, and quantitative restrictions as well as directly and indirectly discriminatory rules that have the equivalent effect of quantitative restrictions. Member states can only restrict movement of goods on exceptional cases such as risk related to public health, environment, or consumer protection. Similarly, the free movement of services and freedom of establishment means any national or company of a member state can take up any activity in any member state and cannot be discriminated against based on nationality or manner of incorporation.

Additionally, free movement of workers means that workers can move to any other member state and be employed under the same conditions as the nationals of that member state. There is free movement of people wherein EU citizens can live, work, study or retire in any EU member state they so desire. And for the Schengen area, there are no border controls and therefore no physical barriers to movement within the Schengen area. Note that EU itself considers that the road to a single market is not yet complete, with gaps such as missing legislative pieces, administrative obstacles and enforcement issues still to address. (See the EU Single Market website for an extended discussion of the EU internal market.)

The CARICOM Single Market and Economy (CSME) of Caribbean countries regional integration also aims for a very close approximation of a single market and economy. It includes elements such as right of establishment wherein any CARICOM firm can be established in any other CARICOM member state without restrictions, free movement of labour where all obstacles to intra-regional movement of skills, labour and travel are abolished, social services (e.g., education, health) are harmonised, social security benefits are transferable, and common standards and measures for accreditation and equivalency are established. CSME also has a common external tariff which allows for free circulation within CARICOM of externally sourced goods after proper duties are paid for in the country of first entry. For free movement of goods and services, all barriers are eliminated and standards are harmonised to ensure acceptability of goods and services traded. There are other elements in the CSME including harmonisation of company, intellectual property and other laws, coordination on indirect taxes and budget deficits, harmonisation of foreign investment policies, etc. A number of the key elements have been implemented or partly implemented (see the Caribbean Community Secretariat website for details).

Clearly, based on the above, CARICOM and, of course, EU are much closer to the fundamental essence of a single market than ASEAN is, per the measures included in the AEC Blueprint for 2009-2015. Among others, the current AEC Blueprint is definitely less ambitious than either CARICOM or EU on the mobility of labour as well as on the right of establishment. Similarly, it is also more cautious with respect to standards and conformance, and likely, on non-tariff measures. It is therefore best to view the implementation of the measures included in the AEC Blueprint for AEC 2015 ***as the first milestone (or first stage)*** on the road to ASEAN's ultimate goal of an ASEAN single market (and production base).

Integrated and highly contestable ASEAN

What then is the **second stage** of ASEAN's road to a single market and production base post 2015? This Integrative Report considers that the second stage is the deepening of ASEAN integration towards an integrated and highly contestable ASEAN but not yet a single market. As the EU and CARICOM cases suggest, there are a number of major policy and institutional changes needed to be done in ASEAN in order to get very close to a single market. These changes include, among others, the right to reside and work anywhere in ASEAN for the eligible skilled workers, the right to provide services temporarily or permanently anywhere in ASEAN for firms and self-employed persons, the establishment of a regional institution to oversee standards harmonisation and conformance assessments (CARICOM), legislated harmonisation on essential requirements where member countries must accept products proven to meet the essential requirements (EU) , harmonisation of social policies or transportability of social security benefits, and the removal of legally binding restrictions to any discriminatory duty, fee, tax or requirement directly or indirectly against imports or provider from another member state.

It is not clear if ASEAN would want to go as deep in economic integration as is demanded by the essence of a single market with the implied major policy and institutional changes needed as discussed above. ***ASEAN differs substantially from EU or CARICOM***, making it much more difficult to go completely on single market so soon. The levels of development differ so much among AMSs than among the original EU members which also had much greater impetus for political integration. AMSs are so much bigger compared to the small island nations of the Caribbean where integration into a single market and economy is almost an imperative.

Indeed, it is apparent that at present, there is great hesitancy in ASEAN to go all the way. ***Pending clear political decisions in ASEAN to go for a truly single market***, ***the phrase "single market and production base" is really, at least for now, essentially one of "integrated and highly contestable ASEAN"[1].*** As will be pointed out in the Report later, ensuring "integrated ASEAN as a production base" would be a productive way towards the eventual

[1] In effect, given the popular usage of "single market and production base", it can still be used in official announcements but liberally interpreted as "integrated and highly contestable" in the transition.

establishment of a “single market” in outcome as well as likely in process. And a “highly contestable ASEAN” is an important support to an “integrated ASEAN as a production base”. Contestability is the ease of entry to and exit from an industry or activity either through market competition or through the prudent application of competition policy in the face of sunk costs and network costs.

Many of the elements towards an “integrated and highly contestable ASEAN” are familiar in the AEC Blueprint; as follows:

- streamlined and non-protective non-tariff measures (NTMs);
- standards and conformance regime that is facilitative of trade;
- greater contestability (and liberalisation) of the services sector and of investments;
- more efficient trade, investment and transport facilitation;
- competition policy;
- greater infrastructure connectivity; and
- greater mobility of skilled labour

Most of the above are in Pillar 1 of the AEC Blueprint 2009-2015. Indeed, most of the suggested actions beyond 2015 are further deepening of the initiatives that are in the AEC Blueprint, on the presumption that it would be unrealistic to expect full implementation of the measures by 2015. Moreover, there is a need to widen the industry reach or deepen the degree of facilitation towards deeper economic integration than what is expected in the AEC Blueprint. The details are discussed in **Chapter 3** of the Report.

An integrated ASEAN as a production base necessitates greater infrastructure connectivity in terms of roads, bridges, seaports and airports, telecommunication facilities, etc. It also calls for more efficient transport and logistics services as well as transport facilitation policies. Hence, the critical importance of contestability and a pro-competitive policy on logistics and transport-related services. Although Pillar 2 of the AEC Blueprint has infrastructural connectivity measures, it is the *Master Plan on ASEAN Connectivity (MPAC)* that presents the more cohesive and compelling strategy of ASEAN to deepen connectivity within the region.

The importance of the complementarity among physical infrastructure, contestable markets (including those of transport and logistics services), and of efficient and coherent regulations and procedures in ensuring an integrated ASEAN as a production base is perhaps best expressed by Indonesia's Ambassador to ASEAN H.E. Ngurah Swajaya's keynote address during the EAS Regulatory Roundtable in Bangkok on 18 July 2013, when he said:

> "*Good physical infrastructure does not guarantee seamless connectivity if they are not supported by good institutional and people-to-people connectivity…*
> *The good physical infrastructure combined with regulatory policy coherence has enabled the EU to establish seamless connectivity, effective Single Market and a more competitive production base".*

Chapter 3 discusses in greater detail the key elements needed to have an integrated and highly contestable ASEAN beyond 2015.

Pillar Two: Competitive and Dynamic ASEAN

The fundamental strategy for ASEAN to become a globally competitive region relies on deepening and expanding the network of industrial clusters locally and regionally facilitated by regional connectivity and by ASEAN becoming a major cog of East Asia and global production networks of goods and services. In the forefront would have to be ASEAN-based firms, both local and multinationals, that are increasingly relying on innovation and creativity to become and remain internationally competitive. Ensuring a dynamic and competitive ASEAN involves pushing the frontier of production networks forward, both outward through increased linkages globally as well as inward through the development of industrial clusters and SMEs.

Much remains to be done in the area of innovation as most AMSs, with the exception of Singapore, fall far short of countries like China in investments in research and development. Nonetheless, there are already successes in the region as best exemplified by Singapore, with the apparent model of targeted investment facilitation for innovative multinationals, relatively liberal immigration rules for highly skilled technical personnel, together with the strengthening of domestic R & D capacity in terms of human resources and infrastructures. Singapore could serve as a possible model for the rest of the region. Similarly, much remains to be done in the ASEAN to develop much more industrial clusters with SMEs in a larger number of commodities.

Dynamic shifts in comparative advantage in the region arising from significant changes in relative wages (in efficiency terms or adjusted for labor productivity) over time allow for ever increasing range of products of, and widening areas in the ASEAN engaged in, exports. Also facilitating the dynamic shifts in comparative advantage in the region is the easy movement of goods, services, people, and capital that an integrated and highly contestable ASEAN entails. This will also allow for the adoption of leapfrogging development strategies by the lagging regions, thereby accelerating further the shifts in comparative advantage in the region. Finally, connectivity, both institutional and physical, towards a seamless ASEAN is an important component of the drive towards a dynamic and competitive ASEAN Economic Community**.**

Chapter 4 elaborates on the regional production networks under the so-called 2nd unbundling as well as on industrial clusters and how ASEAN can get more integrated in it. The chapter also discusses the dynamics of technology transfer and innovation and the concomitant human capital development that are so central to ASEAN moving up the value chain and maintaining its competitiveness and dynamism. In short, at the core of the challenge towards ASEAN's competitiveness and dynamism is how ASEAN can get firmly plugged into the networked and innovative future that the world would be in.

Pillar Three: Inclusive, Resilient and Green ASEAN

One major characteristic of ASEAN relative to other regions is the very wide gap in the levels of development among the members as compared to, say, EU or even the Latin American Integration Area (LAIA). In some AMSs, income inequality is also large even if it is not as serious as in a few Latin American countries as **Chapter 1** showed. Thus, ASEAN needs to give special attention to inclusiveness in its regional integration program, as evidenced in Pillar 3 of the AEC Blueprint 2009-2015.

Engendering inclusiveness. At the same time, the wide gap in development levels can be used by itself as a growth opportunity since there is a corresponding wide difference in wages across countries. Specifically, the wide gap in wages allows for the expansion and deepening within ASEAN of regional production networks which have been a central feature of industrialisation and economic transformation of a number of East Asian countries, most notably China. Indeed, the opportunity for ASEAN given the diversity of levels of development of the members is that deeper economic integration allows for strengthening synergies among AMSs and East Asian countries, "…bringing the capital and know-how of the more mature economies together with the competitive costs and abundant labor and resources of the less-developed member countries" (Hansakul and Keng, 2013, p.1). The drive towards inclusive growth or equitable development in this Report is biased precisely towards the harnessing of dynamic economic forces rather than through heavy dependence on direct income distribution mechanism based on social considerations.

There are three aspects of inclusiveness for ASEAN; namely, geographic, industrial and societal. There remain significant development gaps in these three aspects of inclusiveness in many AMSs. The more important geographic development gaps involve those between the richer AMSs and the poorer AMSs as well as the richer regions and poorer regions in most AMSs. Industrial inclusiveness concerns multinationals vs. local firms, large firms vs. SMEs, manufacturing vs. agriculture, and others. Societal gaps, meanwhile, pertain mainly to rich vs. poor households as well as differential treatments by age, gender, ethnicity, and others. Note however that engendering geographic inclusiveness and industrial inclusiveness would actually also contribute to societal inclusiveness because the poor tends to be in the rural areas and places with poor physical and institutional connectivity with the growth centers in the countries and region. Moreover, one of the best ways of reducing poverty and income inequality is by raising employment---better still, better paying employment—primarily in the non-agricultural sector, and most of the employers in the non-agricultural sector would be small and medium scale enterprises (SMEs).

Engendering geographic and industrial inclusiveness would largely involve addressing structural problems, policy issues and market failures that lead to segmented markets geographically, sectorally, and technologically. Thus, for example, an integrated and highly contestable ASEAN would encourage the expansion of regional production networks to the less developed areas as it becomes easier to invest and move goods, on the one hand, and accentuate the potential benefits of lower labour costs and natural resources to investors, on the other hand. This surge in regional production networks-related production in the poorer areas engenders geographic inclusiveness. Similarly, by improving SMEs' access to finance, technology and market information, SMEs would grow, become more linked to production networks and lead to denser industrial clusters that add further avenues for productivity growth. The result is greater industrial inclusiveness, higher employment, and greater domestic production capability to meet market demands from home and abroad.

The pursuit of industrial inclusiveness in the ASEAN will be mainly through the robust growth of SMEs in the region. The robust growth of SMEs is due to two important channels; namely, the expansion in the participation of SMEs in the growth and increase in number of industrial clusters and production networks in the region, and the robust growth of domestic and regional markets themselves that are mainly serviced by SMEs. At the same time, the robust growth of SMEs is in itself an important vehicle for the growth of the middle class in the region, thereby raising domestic and regional demand that further feeds the growth of the region's SMEs.

For the ASEAN latecomers as well as Indonesia and the Philippines which still have large agricultural population, the pursuit of industrial inclusive growth includes not only robust growth of SMEs but also the robust growth and productivity of agriculture. Given that most AMSs have comparative advantage in agriculture and natural resources, the robust growth of agriculture reduces poverty and increases the middle class, thereby contributing further to the growth of domestic and regional demand and therefore to the growth of SMEs (as well as agriculture and farmers' incomes). The robust growth of SMEs and agricultural productivity contributes significantly to high economic growth rate needed to reach at least an upper middle income status and thereby narrow the development gap in the region.

As noted earlier, there is quite a bit of complementarity and overlap in the main strategies to address industrial, geographic and societal inclusiveness gaps.

Thus, for example, the robust growth of SMEs does not only engender industrial inclusiveness but also societal inclusiveness. This is because employment and enhanced labour income flow, mainly from the non-agricultural sector, is one key means of moving out of poverty. And much of the additional employment in the non-agricultural sector comes from robust growth of SMEs. Similarly, agricultural development also engenders geographic inclusiveness as well as societal inclusiveness since the poverty incidence in the rural areas and among agricultural-based households tends to be substantially higher than the national averages and the urban households in many AMSs.

Nonetheless, economic processes would not all address poverty and income inequity. Income mobility requires employability and the latter invariably requires access to good education. Health emergencies can lead to poverty while serious malnutrition adversely affects education capability and therefore hurts inter-temporal income mobility. Thus, there is also scope for targeted basic safety nets that allow the poor to gain greater opportunities for employment and profitable livelihood.

In summary, the four key strategies towards an inclusive ASEAN are the following:

- deeply link peripheries to growth centers;
- raise agricultural productivity and support rural industries; deeply integrate SMEs with other SMEs, large enterprises and multinational firms in domestic industrial clusters and regional production networks; and
- ensure that targeted safety nets are consistent with fiscal capacity (at the national level).

More discussion on engendering inclusiveness in ASEAN is found in **Chapter 5A** of this Report.

Towards resilient and green ASEAN. The first element of enhancing resiliency is energy, food, and resource security. With growing population, expanding industrial sector, advancing urbanisation, and rising standard of living, the demand for energy, food, and resources will surely increase so that stable and ample supply must be secured. In addition, unstable markets of energy, food, and resources have recently been experienced, and more turbulence is expected in the medium and long run. These shocks are aggravated partially by insufficiently harmonised policies of exporting and importing countries, unwarranted speculation, and insufficient research and development to enhance productivity and develop alternative sources.

There is thus ample room for regional and global cooperation. Such effort may include the following: to secure ample and stable supplies with enhancing efficiency and productivity to meet demand; to keep healthy market mechanism work against speculation; to develop regional inventory stock system for emergency; and to promote regional and global cooperation among exporting and importing countries.

Food security has been a particularly important concern for ASEAN. ASEAN has in fact built one key mechanism for emergency food reserve, i.e., the *ASEAN Plus Three Emergency Rice Reserve* (APTERR). ASEAN has also crafted the ASEAN Integrated Food Security (AIFS) Framework and the Strategic Plan of Action on Food Security (SPA-FS). ASEAN also has the ASEAN Food Security Information System (AFSIS). Nonetheless, it is important for ASEAN to craft an integrated approach to food security, addressing farm-level factors, demand and price factors, policy and trade factors, as well as environmental factors. All of the abovementioned factors constitute the so-called ***Rice Bowl Index***. These factors, the index and the framework for food security in ASEAN beyond 2015 are discussed in **Chapter 5A** of this Report.

On energy security, urgent and bold policy measures are required both at the national level and at the regional cooperation aspect. On the supply side, ASEAN should diversify sources of energy and origins of imports and encourage investment in domestic exploration, production, and infrastructure for both fossil energy and alternative energy such as biomass. On the demand side, the efficiency of energy use should drastically be improved. The efficacy of domestic and regional energy markets by removing inappropriate government intervention is also important to improve energy security. There is ample room for reinforcing mechanism to counter emergency situations as well as for keeping sea-lane security. The existing energy cooperation forums under ASEAN, ASEAN+3, and EAS should be strengthened to invigorate dialogue and cooperation. It is worth noting that the results of ERIA project simulations on the impact of energy conservation on economic growth show that improving energy efficiency in East Asia would raise the economic growth rate of many of the ASEAN member states. The issue of energy for ASEAN and East Asia is tackled in greater detail in **Chapter 5B** of this Report.

Effective disaster management is also important for a resilient ASEAN. ASEAN and Asia as a whole are particularly prone to various kinds of disasters such as typhoon, earthquake, tsunami, drought, flood, volcano activities, and others. Not only natural factors but also human factors affect the frequency and seriousness of damages. Better organisation is required for disaster management in terms of risk identification, emergency preparedness, institutional capacity building, risk mitigation, and catastrophe risk financing. Such effort may include developing a regional cooperation scheme for quick and effective action, exploring a possibility of regional insurance mechanism against disasters, and establishing a comprehensive inter-disciplinary laboratory for disaster management.

The last element of resilient ASEAN is safety nets and social protection. This is also related to inclusiveness pathway. The fruit of economic growth should reach all parts of the society. As economic growth pushes up income and urbanisation proceeds, shifts from traditional types of social protection to modern formal types of social protection are inevitable. Formal social protection becomes essential even for political stability along the path of economic development; otherwise, economic development would not be sustainable. At the same time, because social protection is often accompanied by huge fiscal burden, the development of an efficient system with proper prioritisation and scheduling is needed. This is discussed further in **Chapter 5A** of the Report.

Global warming and other environmental problems have become a big concern shared by a wide range of people in the world, including ASEAN citizens. But because developing countries, including ASEAN, naturally have a strong wish to grow more, there may be a tradeoff with the protection of the environment, particularly in terms of CO2 emission. Economic growth, industrialisation, and urbanisation, however, have to be prioritised at least in the coming decade in ASEAN. A comprehensive, consistent scenario of how economic growth can reconcile environment is not well established yet. This is the reason why developing countries, including ASEAN, have only taken a relatively passive stance in promoting green development. However, beyond 2015, ASEAN would have to be an active player in promoting green development by establishing a solid and convincing strategy of reconciling green development with economic growth, industrialisation, and urbanisation.

In the coming decade, CO2 emission seems to inevitably increase with our strong economic growth. Nonetheless, there are many things that can still be done for better environment without sacrificing economic growth. Some measures would even strengthen competitiveness by enhancing efficiency and responding to a surge of resource costs. As the world increasingly emphasises environmental sustainability, thinking green and sustainability can be an economic opportunity for ASEAN to capitalise on. Examples of likely win-win areas for ASEAN include the promotion of green industries such as renewable energy industries and recycling industries, greening existing industries with better process technologies, promoting energy efficient products, and establishing energy market integration in the region. In the long run, harnessing further technological progress would also be of help. A number of these energy-related initiatives are discussed in **Chapter 5B** of the Report.

Pillar Four: Global ASEAN

Pillar 4 of the AEC Blueprint, *Towards Full Integration into the Global Economy*, is a reflection of ASEAN's deep appreciation that it must be well integrated with the rest of the world just as it works towards a fully integrated and competitive economic region. This is because most of the ASEAN member states trade more with the rest of the world than with the rest of the ASEAN region. Simulation results using a dynamic GTAP model suggest that the benefits to AMSs from economic integration within East Asia are greater than the benefits from economic integration within ASEAN alone (Itakura, 2012).

Of course, ASEAN has been the facilitator and hub of East Asian economic integration as best exemplified by the ASEAN + 1 FTAs that ASEAN has with Australia and New Zealand, China, India, Japan and South Korea. That ASEAN is the facilitator and fulcrum of such economic integration initiatives in the region is remarkable in itself since in the EU and NAFTA, the dominant economic powers were the ones that led and drove the regional integration processes (see Fukunaga, *et al*., 2013).

Moving forward, the Regional Comprehensive Economic Partnership (RCEP) is ASEAN's most important initiative in stepping up further regional integration in East Asia as well as ASEAN's major expression of a global ASEAN. RCEP is also the critical complement to ASEAN's efforts to create a well performing ASEAN Economic Community. Especially in the light of the Trans-Pacific Partnership (TPP), a successful conclusion of the RCEP negotiations that effectively raises the regional integration initiatives in East Asia to a higher level while at the same time taking great consideration of the inclusiveness of RCEP in view of the wide gap in development levels of AMSs will be a major challenge for ASEAN. **Chapter 6** of the Report examines a number of issues and explores ways forward towards a credible and successful RCEP. It is important for ASEAN to utilise its strategic location at the geographic heart of the fast-growing developing Asia.

As ASEAN moves up economically, ASEAN may need to step up in the global community of nations, accelerating cooperative relationships with interested dialogue and non-dialogue countries and international organisations. This can foster greater mutual understanding on issues that will influence the region's stability, security and prosperity. By maintaining open and equal relations with various partners, ASEAN can bring in various resources and solidify its position as a leading growth center of the world. ASEAN can also provide inputs to international forums based on its experiences and lessons gained in the process of the AEC establishment and deepening. Based on its issue-oriented approach, especially in the promotion of wider regional FTAs and EPAs, ASEAN can be a central building block for other wider cooperation schemes and can establish balanced relations with other parts of the world.

The challenge is for ASEAN to have a common and artful stance on issues common to the region, when ASEAN itself consists of 10 countries of widely varying levels of development and interests. As Tay (2013) points out, this is not easy but there have been some successful cases for ASEAN. Growing ASEAN voice in the international arena is discussed further in **Chapter 6** of the report.

ASEAN stepping up and raising its voice internationally as well as managing well the challenges of deeper integration post 2015 may call for the peoples of ASEAN to gain a deeper sense of community among themselves in the region. Moreover, it may call for the strengthening of the ASEAN regional architecture in order to facilitate cohesiveness. As the ASEAN Leaders voiced out in the 1997 ASEAN vision 2020 (p. 5):

> "*We resolve to develop and strengthen ASEAN's institutions and mechanisms to enable ASEAN to realize its vision and respond to the challenges of the coming century. We also see the need for a strengthened ASEAN Secretariat with an enhanced role to support the realization of our vision.*"

Chapter 6 discusses the imperatives for further institutional changes in ASEAN beyond 2015. The chapter also highlights the role that the Track 2 and Track 1.5 mechanisms can play towards the more effective management of the integration process in ASEAN.

Foundation: Responsive ASEAN

In addition to the four pillars articulated above, the framework put forth in **Figure 2B.1** indicates that the four pillars need to stand on a strong foundation of a **responsive ASEAN**. There are two elements of a responsive ASEAN that are of particular interest for ASEAN moving forward beyond 2015.

The first element is something prosaic; e.g., the individual ASEAN member states and ASEAN itself being responsive to the concerns of the business sector, for the simple reason that it is the private sector which is the key motor of a sustained high and equitable growth in ASEAN. The private sector is not monolithic and various segments have different interests. Nonetheless, there are likely areas of commonality among them primarily with respect to issues of corruption, bureaucratic inefficiency, the need for greater inter-agency coordination and policy consistency, and the quality of infrastructure and human capital. In many ways, being responsive to their general concerns involves working closely with them to improve economic governance and to create a conducive and attractive business and investment environment in the region.

The second element, although related to the first one, is less prosaic and more elemental; i.e., ***responsive regulations and regulatory regime***. Regional economic integration necessitates policy and regulatory changes and refinements in most, if not all, AMSs. Indeed, in many ways, the ASEAN Economic Community is a concerted regulatory and institutional improvement process for AMSs. Responsive regulations and regulatory regime involve active listening and engagement of the government with various stakeholders, giving them voice, fair hearing of the dissenters, and building commitments from them. It would involve informed regulatory conversations with the stakeholders that encourage the identification of better solutions to regulatory problems as well as engender the building of coalitions for regulatory improvement and reform.

Responsive regulatory regime involves the design of regulations that are "… responsive to the moves [that] regulated actors make, [and] to industry context and to the environment…" (Braithwaite, 2011, p.475). As such, the challenge is to develop partnerships with stakeholders that engender collaborative capacity building as well as agreements on the pyramid of sanctions in tandem with the pyramid of support that shape the regulatory regime. The end result of all these is supportive in building a high quality regulatory environment wherein the concepts of non-discrimination, transparency and accountability are embedded in the regulatory cultures of ASEAN, similar to the goals of the APEC Leaders when they signed the Implementation of Good Regulatory Practices across APEC Countries (APEC, 2011).

Responsive regulatory regime contributes to efficient regulations and regulatory coherence within a country. "Efficient regulation is no more burdensome than it needs to be to achieve its desired objective. Coherence means that different regulations and procedures do not duplicate each other or work at cross purposes" (Dee, 2013b, p.2).

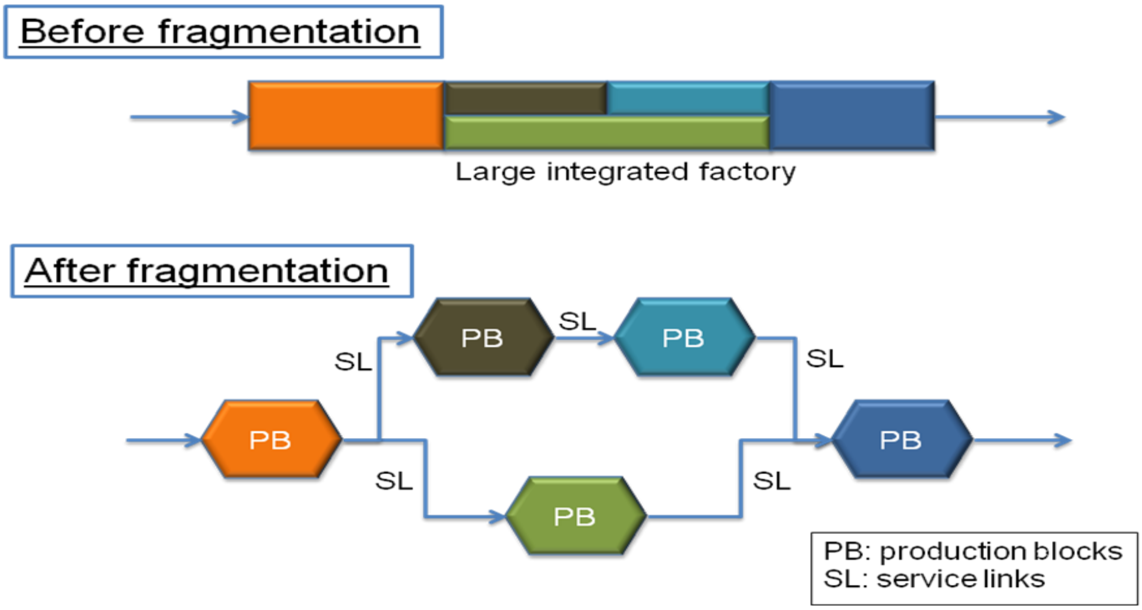
The nature and importance of responsive regulations and regulatory regime, and the corollary initiative of informed regulatory conversations and regulatory coherence are discussed further in **Chapter 7** of the report.

AEC and the Model of Regional Integration and Development in ASEAN

The ASEAN Economic Community is best seen not solely as a regional integration initiative per se but also as a critical cog of a novel East Asian model of development and integration in which ASEAN has been playing a significant role. This model of integration and development is anchored on the formation, expansion and deepening of regional production networks in East Asia driven by flows of direct investment, technology diffusion and trade, and facilitated by more open economic policies in much of the region. At base, this model is anchored on the cost reduction and flexibility and productivity increasing potentials of fragmented production, agglomeration, and firms' decisions in finding the balance between internalisation of production activities and outsourcing them from affiliates and subsidiaries or as arms-length transactions. (See e.g., Ando and Kimura, 2005; Ando and Kimura, 2009; and ERIA, 2010a.)

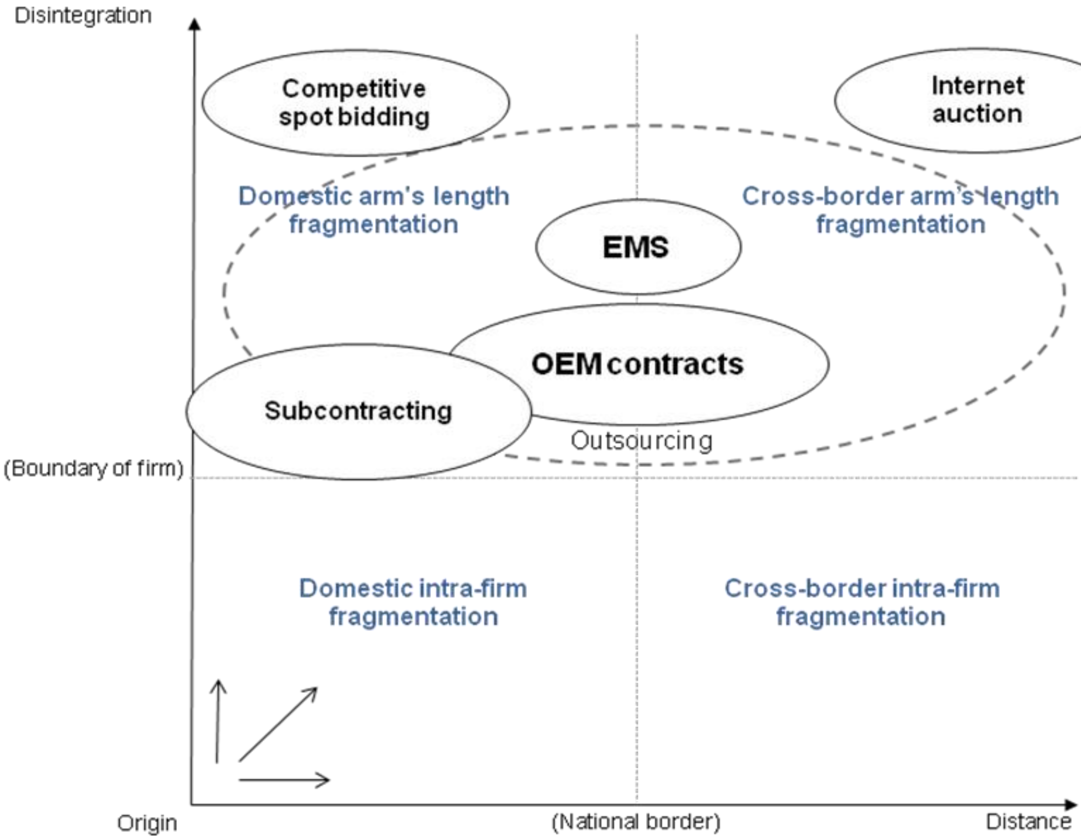
The formation of regional production networks starts with the replacement of vertically integrated production with production fragmented into "production blocs" which are tied together by "service links" provided by the private sector and the government (see **Figure 2B.2**). When the cost saving from lower production costs in the production blocs are large and the service link costs are small, then production fragmentation is viable and can occur if the production processes could be separated technically (ERIA, 2010a). (The separability of processes is a major reason for the popularity of fragmented production in, say, machinery industries but not in, say, chemical industries.) Service link costs are affected by coordination costs, transport costs and trade barriers, including the efficacy of customs and import/export clearances.

Figure 2B.2: The fragmentation theory: Production blocks and service links



The fragmentation into blocs allows for the differentiation in the location of the production blocs to different countries, for instance, based in part on significant differences in factor costs, efficiencies and capabilities. Fragmentation does not only have a geographic or spatial dimension but also an intra-firm/inter-firm dimension; that is, the firm decides which activities it will undertake itself and which activities it will rely on arms-length transactions with other firms located either nearby or in other countries.

Figure 2B.3: Two-dimensional fragmentation: An illustration



Source: Kimura and Ando (2005), reprinted from ERIA (2010a)

The geographic or spatial dimension and the intra-/inter-firm dimension leads to four sets of fragmentation and relationships as seen in **Figure 2B.3** taken from ERIA 2010c. They include:

- Domestic intra-firm fragmentation, e.g., two plants instead of one integrated plant
- Cross-border intra-firm fragmentation, e.g., foreign subsidiary plants
- Domestic arms-length fragmentation that can rely, for example, on domestic subcontracts or competitive bidding. Cross-border arms-length fragmentation, e.g., foreign subcontracts

Just-in-time operations or operations that require high level of supervision by scarce highly trained personnel would likely call for clustering of plants and firms, including firms in arm's-length transactions, within a reasonable short distance from one another. Activities that are not needed for just-in-time operations or are much more standardised could be located in geographically far countries with lower labour costs, the plants being either foreign subsidiaries or third party providers.

The fragmentation of production provides an avenue for developmental or growth strategies. Because firms have some flexibility on how to cut out their production blocs so as to exploit differences in location advantages in various areas, host countries may seek niches of location advantages for each production bloc. Note that the location decisions of the firms have corresponding implications on foreign direct investment as well as the potential for technology transfer and spillovers. The degree of technology spillover is affected by the technology absorption capability of host countries and their firms. It is this dynamic of investment-technology flow-trade nexus embedded in production fragmentation and regional production networks that has given East Asia a tremendous growth and industrialisation boost during the past three decades. In effect, this is the new developmental model spearheaded in East Asia.

There is a concomitant geographic layering in the involvement of various countries and areas because service link costs are sensitive to geographic distance. The CADP (ERIA, 2010a, p. 12) provides a three-tier classification of areas and countries in terms of their participation in regional production networks, vis:

- ***Tier 1 areas/countries:*** those that are very much in the production networks and where there are already industrial clusters that allow for high frequency production linkages (i.e., just-in-time operations).
- ***Tier 2 areas/countries:*** those that are not yet fully integrated in the production networks and domestic industry clusters are still nascent.
- ***Tier 3 areas/countries:*** those that will likely not participate in high frequency production networks linkages but where production networks can provide a basis for industrial development albeit of low-frequency linkages.

East Asia has the most sophisticated regional production networks in the world because the networks tend to cover a large number of countries involving both intra-firm and arms-length transactions, in contrast to the typical "back and forth, closed loop, intra-firm" (ERIA, 2010a, p.6) transactions in NAFTA between headquarters in, say, the US and its plant (s) in Mexico. The significant differences in factor prices in the different countries in East Asia (as compared to NAFTA) allow for the finer fragmentation that effectively utilises the differences in factor prices and productivities as well as location advantages.

What has given the regional production networks a development and growth significance is that economic activity involving regional production networks has been a significant segment of the economies of a number of East Asian countries. Equally important is that these countries have aggressively encouraged investment of firms, including SMEs, engaged in regional production networks.

What can facilitate the joining, expansion and deepening of a country's participation in regional production networks? **Table 2B.1** presents a matrix of policies supporting both fragmentation and agglomeration (Ando, 2013; ERIA, 2010a):

The policies in support of production fragmentation across firms and therefore encourage industrial agglomeration include:

- Reduce investment costs such as investment facilitation, easier start-up of firms, address corruption
- Overcome geographic distance and border effects, e.g., elimination of tariff and non-tariff barriers; improved trade and transport facilitation; improved physical connectivity; competition policy; standards and conformance
- Raise location advantages, e.g., upgrading of infrastructure and logistics services; liberalisation of production-supporting services

The policies in support of production fragmentation across countries are the policies that:

- Reduce network set-up costs of arm's length linkages: e.g., business matching between MNCs and local firms
- Reduce the cost of implementing arm's length transactions, e.g., strong legal protection of contracts, dispute settlement mechanism
- Strengthen the competitiveness of potential business partners, e.g., SME development; strengthening of innovation capacity and environment, including Intellectual Property Rights (IPR).

Table 2B.1: The 2x3 policy matrix fragmentation and agglomeration

	Reduction in fixed costs to develop production/distribution networks	Reduction in service link costs connecting production blocks	Further costs reduction in production cost per se in production blocks
Fragmentation along the distance axis	Policies to reduce investment costs	Policies to overcome geographical distance and border effects	Policies to strengthen location advantages
	1) improvement in stability, transparency, and predictability of investment-related policies; 2) investment facilitation in FDI-hosting agencies and industrial estates; and 3) liberalisation and development in financial services related to capital investment.	1) reduction/removal of trade barriers such as tariffs; 2) trade facilitation including simplification and improved efficiency in custom clearance/procedures; 3) development of transport infrastructure and improved efficiency in transport and distribution services; 4) development of telecommunication and ICT infrastructure; 5) improved efficiency in financial services related to operation and capital movements; and 6) Reduction in costs of coordination between remote places by facilitation of the movement of natural persons.	1) establishment of educational/occupational institutions for personnel training to secure various types of human resources 2) establishment of stable and elastic labour-related laws and institutions; 3) establishment of efficient international and domestic financial services; 4) reduction in costs of infrastructure services such as electricity and other energy, industrial estates services; 5) development of agglomeration to facilitate vertical production chains; 6) establishment of economic institutions such as investment rule and intellectual property rights; and 7) Various trade and investment facilitation.
	Reduction in fixed costs to develop production/distribution networks	Reduction in service link costs connecting production blocks	Further costs reduction in production cost per se in production blocks

Fragmentation along the disintegration axis	Establishment of economic environment to reduce set-up costs of arm's length transactions	Development of institutional environment to reduce the cost of implementing arm's length transactions	Policies to strengthen competitiveness of potential business partners
	1) establishment of economic system to allow co-existence of various business partners as well as making various types of contracts; 2) various policies to reduce costs of information gathering on potential business partners; 3) securing fairness, stability, and efficiency in contract; and 4) establishment of stable and effective institutions to secure intellectual property rights.	1) policies to reduce monitoring cost of business partners; 2) improvement in legal system and economic institutions to activate dispute settlement mechanism; and 3) policies to promote technical innovations in modulation to further facilitate outsourcing	1) hosting and fostering various types of business partners including foreign and indigenous firms; 2) strengthening supporting industries; and 3) Various policies to promote the formation of agglomeration.

Source: ERIA, 2010a.

The list of policies above clearly indicates how important the ASEAN Economic Community and its measures are for the full blossoming of regional production networks in ASEAN as a growth and development engine for the region. Virtually all the key measures in the AEC Blueprint are meant to reduce network set-up costs, reduce service link costs, improve location advantages, and encourage more arm’s length transactions among multinationals, between multinationals and local firms, and among local firms. It is also apparent from the list that there are policy areas that are not yet well captured or articulated in the current AEC Blueprint, 2009-2015. These are some of the unfinished business for AEC beyond 2015.

In short, there is congruence between the drive towards AEC and the new development and integration model discussed above. This synergy can be expected to catapult **RISING ASEAN** to further heights of development and international credence.