

EXECUTIVE SUMMARY

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1. BACKGROUND AND OBJECTIVES

For the last decades, East Asian countries have been exploring and exploiting the potential benefits of regionalization, taking advantage of geographical proximities and diversities. Although intraregional trade has been intensified during the process, the East Asian economy continues to rely heavily on the rest of the world, such as the United States (US) and the European Union (EU). In view of the increasing concerns over the world economy, triggered by soaring crude oil prices and financial instability spreading worldwide from the US, there are reasons to suggest that the region strengthens its self-reliant efforts to address further trade and investment policy arrangements that will be beneficial to the East Asian region as a whole, while continue to adhere to the concept of open regionalism. The proliferation of free trade agreements (FTAs) in East Asia has been seen largely in this context.

This proliferation, however, has failed to provide a seamless regional market and production base that benefits the whole region. In an effort to correct this, ASEAN has moved beyond the ASEAN Free Trade Area (AFTA) to achieve a higher degree of economic integration. It has recently formulated a Blueprint to realize the ASEAN Economic Community (AEC) by 2015. The successful implementation of the AEC Blueprint will give a boost to deepening economic integration in East Asia.

Recognizing the above, this “Deepening Economic Integration” project aims at developing a policy framework to strengthen the AEC and its role in deepening economic integration in the wider East Asian region. The policy framework will be based on further conceptualization of critical issues and is supported by evidence-based analysis and rigorous empirical studies.

2. APPROACH

The research project begins with a careful review of the AEC Blueprint. The AEC Blueprint envisages the following four key characteristics: (a) a single market and production base, (b) a highly competitive economic region, (c) a region of equitable economic development, and (d) a region fully integrated into the global economy. It also provides a useful guide to the deepening of economic integration in East Asia as a whole.

The first phase of this research has focused on the following four areas: (i) an in-depth examination of East Asia's development and challenges, (ii) critical issues in implementing the AEC Blueprint, (iii) key investment issues, and (iv) key trade issues.

In the first area, the research identifies the primary factors that have led to the *de facto* economic integration in East Asia. It presents a strategic framework to pursue deepening economic integration that at the same time will contribute to narrowing development gaps by further reinforcing those factors through cooperative, collaborative, and collective efforts. This strategic framework also provides a useful theoretical underpinning that helps structure and prioritize the wide-ranging policy actions stipulated in the AEC Blueprint.

In the second area, the research has focused on several key issues: rules of origin, trade facilitation, services liberalization, investment liberalization and facilitation, competition policy, equitable economic development, and coherent external economic policy. The study is meant to supplement the efforts of the ASEAN Secretariat by providing an analytical framework and further elaboration on as well as potential expansion of the scope of the policy measures. It also gives attention to the important aspects of implementation. Specifically on services liberalization and competition policy, in-depth studies have been undertaken (joint research projects).

In the third area, the key determinants of foreign direct investment (FDI) inflows in East Asia are reviewed by using two types of gravity models. A notable feature of the research is its focus on intra-developing Asian flows of FDI. On the fourth area, the

research evaluates the existing FTAs in the region, focusing on the impact of multiple rules of origin and overlapping FTAs.

3. FINDINGS AND CONCLUSIONS

3.1. Development and challenges

The remarkable economic growth in East Asia has been accompanied by *de facto* economic integration in the region through the development of international production and distribution networks. International trade statistics vividly illustrate this process. The share of East Asia in world trade has steadily increased from 15.0 percent in 1980 to 23.5 percent in 2006. Intraregional trade in East Asia has been intensified from 33.3 percent in 1980 to 43.1 percent in 2006, driven particularly by parts and components, the share of which has multiplied from 6.0 percent in 1980 to 28.1 percent in 2005. As a result, intraregional trade in parts and components in East Asia has exceeded those in the North American Free Trade Agreement group and EU by 2005, in terms of both share and value. Moreover, the share of capital goods in intraregional trade in East Asia has doubled during the same period from 9.0 percent to 18.9 percent.

FDI flows have been another channel through which East Asian economies integrate with one another. It is noteworthy that intra-Asian FDI flows are no longer a North-South phenomenon but increasingly a South-South one as well, and a substantial portion of FDI from Asia is intraregional in nature. Developing countries in Asia have been emerging as the sources of FDI outflows as well as the destinations of FDI. As a result, around 35 percent of FDI inflows to Asian developing countries between 1997 and 2005 have come from within the region. Compared to this, intra-ASEAN FDI flows accounted for a relatively small portion, just over 10 percent of FDI flows in Asia between 1997 and 2005.

De facto economic integration in East Asia has substantially advanced for some economic elements while being far from complete for other elements. That is, there remains ample room to promote international production and distribution networking through eliminating such gaps by devising a proper policy environment. This is the study's main rationale in developing a framework for deepening economic integration.

In addition, since “narrowing development gaps” is one of the most important regional commitments, policy measures toward deepening economic integration should be closely connected with development initiatives to which regional resources are devoted.

Our strategic framework suggests that the two objectives of deepening economic integration and narrowing development gaps can be pursued at the same time, by effectively utilizing production fragmentation and agglomeration forces. This theoretical claim is supported by our empirical studies. This clearly implies that reduction of service link costs and network set-up costs, coupled with congestion effects in more developed economies, have promoted the shifts of production blocs to less developed economies. The key strategy, therefore, is to reduce service link costs and network set-up costs.

In the context of East Asian economic integration, ASEAN has been gaining its importance as the hub of regional FTA networks as well as the forerunner to deepen economic integration. Therefore, the ASEAN’s initiatives toward the AEC should be supported by the collective action of East Asia as a whole, because deepening economic integration in East Asia largely depends on the successful implementation of the AEC.

3.2. Implementing the AEC Blueprint

3.2.1. The AEC Blueprint

The ASEAN Economic Community (AEC) Blueprint is a very significant development in ASEAN’s efforts toward deepening regional economic integration. The AEC Blueprint is a clear departure from ASEAN’s tradition. With the adoption of the Blueprint, ASEAN has moved from an integration driven by the process to an integration driven by clearly defined end goals and timelines. The AEC Blueprint is also a binding document of commitments by the members.

The Blueprint is organized along the AEC’s four main characteristics, namely: (a) a single market and production base; (b) a highly competitive economic region; (c) a region of equitable economic development; and (d) a region fully integrated into the global economy. The fourth characteristic indicates the “open” nature of ASEAN’s pursuit of regional economic integration (*open regionalism*). The AEC Blueprint,

therefore, provides a useful, operational basis for developing the agenda of deepening economic integration in the wider East Asian region as well.

The Blueprint is comprehensive. It identifies 17 “core elements” of the AEC and delineates 176 priority actions to be undertaken within a strategic schedule of four implementation periods (2008-2009, 2010-2011, 2012-2013, and 2014-2015). It should be noted that some goals in the Blueprint remain vaguely defined and “milestones” are still missing, but these can be rectified in the process, if effective implementation mechanisms are established. Analysis can also make a useful contribution to overcoming this.

3.2.2. Rules of origin

Despite the proliferation of FTAs in East Asia, their potential benefits do not seem to be realized because of the lower-than-expected utilization of FTAs. Our ex post evaluation identified several reasons. First and foremost is the administration cost to satisfy rules of origin (ROOs), as ROOs are a necessary feature of any FTA to prevent “trade deflection” that would tend to erode the trade preference offered by the FTA. Second, due to the so-called “spaghetti-bowl effects”, “proliferation” of FTAs has resulted in additional costs to utilize FTAs by forcing exporters to face various ROOs according to the goods and the destinations. Third, other provisions in FTAs, such as the one on direct shipment, can discourage the utilization of FTAs.

In order to exploit the potentials of existing FTAs, including AFTA, it is necessary to improve ROOs to become less restrictive, simpler, and more flexible. The findings suggest that the change of tariff code (CTC) rule is more business-friendly than the value content (VC) rule, and that less demanding administration such as the self-certificate system may encourage the utilization of FTAs. There is also a need to streamline ROOs in overlapping FTAs. It is most important to keep in mind that FTA provisions should be in line with the multilateral nature of production and distribution networks in East Asia. Finally, it is crucial to conduct ex post evaluation of existing FTAs to pinpoint key bottlenecks and on that basis to draw more detailed prescriptions to eliminate them.

3.2.3. Trade facilitation

International interest in trade facilitation has increased noticeably in the last few years reflecting the progress of trade liberalization and the development of international production and distribution networks. Recent studies suggest that there can be significant economic gains from trade facilitation measures, specifically in areas that increase the overall reliability of the supply chain; overcoming the weakest link in the supply chain; better coordination of border procedures between customs and other agencies; increasing the availability of quality and competitive services such as trucking, custom brokering and warehousing; as well as reforming the logistic service markets.

The AEC Blueprint on trade facilitation, such as the establishment of the ASEAN Single Window and customs integration, is in the right direction. It is important to ensure that current policy intentions are translated by the various governments and agencies into action and implemented. Attention should be given to finding the most effective means to do so, together with monitoring progress in implementation.

3.2.4. Services liberalization

Equally importantly, services liberalization can generate benefits beyond the service sector itself by facilitating further development of international production and distribution networks through the reduction of service link costs and network set-up costs.

Judging from the importance to facilitate fragmentation through international production and distribution networking, detailed studies on services liberalization in East Asia have been conducted in the following six subsectors: business services, postal/courier services, ports/maritime services, financial services, distribution services, and logistic services. These are important subsectors and compliment the Priority Integration Sectors (PIS) set out in the AEC Blueprint. In the effort to develop subsectoral scorecards, taking all the four modes of services liberalization into consideration, the study has compiled subsectoral “restrictiveness indices” that can eventually be used to conduct quantitative analyses on the impact of services liberalization.

The most important implication from the study is that gains are much larger from reducing nondiscriminatory barriers than from reducing the discriminatory barriers that are typically the focus of trade negotiations. The reason for this is that most of these

barriers are of the cost-raising (i.e., productivity reducing) type rather than the price-raising (or tax) type, although it is not yet clear exactly which type of barriers has which type of effect in all the major services sectors. It is important, therefore, to identify the costs of specific barriers in specific sectors and to clearly spell out the costs of these restrictions to the domestic economy and not just to foreign trading partners.

3.2.5. Investment liberalization and facilitation

FDI has been a key driver of regional economic integration through the emergence of dynamic production networks. Intra-Asian FDI has been far more critical than intra-ASEAN investment in this process. Therefore, it is necessary to re-examine the concept of the ASEAN Investment Area (AIA) to establish the ASEAN Comprehensive Investment Agreement (ACIA) by expanding the scope and measures.

More specifically, the study shows that AIA reform should be accompanied by improvement in the domestic business environment, particularly economic regulations, tax regimes, competition policy, and corporate and labor laws, although some of these have not been well addressed in the AEC Blueprint because they are usually viewed as “behind-the-border” issues. However, it should be stressed that investment liberalization and the accompanying domestic reforms can generate significant positive synergy and the narrowing of development gaps in ASEAN.

The empirical study shows that distance, which is a widely used proxy of service link costs, and wage differentials are significant determinants of intra-Asian FDI flows. This further signifies the importance of investment liberalization and facilitation as one of the main policy pillars of the strategic framework to pursue deepening economic integration and narrowing development gaps.

3.2.6. Competition policy

The AEC Blueprint intends to develop a regional guideline on competition policy by 2010, and the introduction of competition policies in all member countries by 2015. Today, only four ASEAN countries (Indonesia, Philippines, Thailand, and Vietnam) have competition policies, although some others, including Malaysia, have enacted laws and regulations aimed at curbing monopolistic and restrictive business practices.

It is recognized that it would be impractical for ASEAN countries to have a uniform set of competition policies and laws, but the study lends support to the call for some convergence of competition laws. In its absence, there is the danger that the competition law in one country will be challenged under the existing laws in other countries. Conversely, a convergence of competition policy will contribute to the creation of “level playing fields”, where economic resources will be utilized more efficiently.

3.2.7. Equitable economic development

In the era of globalization, the development strategy of each country should be designed to effectively utilize fragmentation and agglomeration forces in production and distribution networking. Along this development path, the key issues to be addressed should begin with devising the strategy to participate in networks, and then move to formulating industrial agglomeration, and subsequently to efforts to upgrading industrial structures.

The AEC Blueprint entrusts ASEAN to address development gaps by enhancing its existing frameworks¹ to achieve equitable economic development. In view of the continuously expanding production and distribution networks, this issue can be addressed more effectively by the collective action in East Asia as a whole.

3.2.8. Coherent external economic policy

The AEC Blueprint stipulates the importance of developing coherent external economic policy by ASEAN because of its critical role in the economic integration of East Asia as a whole. Incoherence can be found in the areas of trade policy, including FTA policy, and investment policy. These incoherences can be detrimental to ASEAN economic integration in particular and to the wider region’s economic integration in general.

As for the trade policy, ASEAN members still maintain wide differences in levels of trade protection in several sectors. They have also concluded a number of FTAs without sufficient consultation with one another. Similarly, in the area of investment policy, not all members have adopted the universal principle of national treatment. They also need to give greater attention to jointly reviewing and revising their domestic

laws and regulations that are critical for promoting investment flows into the region. In establishing a system to enhance regional coordination to formulating coherent external economic policy, it is crucial to address the issue of cooperation and competition among member countries.

ASEAN members should realize that bilateral FTAs are not sufficient to promote the growth of production and distribution networks that are multilateral in nature as well as to strengthen their role in these networks. Moreover, empirical studies continue to bring out the fact that bilateral FTAs are far inferior to unilateral trade liberalization on an MFN (most favored nation) basis.

Therefore, ASEAN members should focus on the timely completion of comprehensive economic partnership agreements (including FTAs) with their main partners in East Asia (China, Japan, Korea, Australia and New Zealand, and India). ASEAN members should have a common template to be used in concluding the above agreements. A common template in the area of investment, competition policy, and intellectual property rights can avoid distortions and deflections that would be detrimental to the further promotion of dynamic production and distribution networks in the region.

3.2.9. Implementation issues

ASEAN member countries must give serious attention to the effective implementation of the Blueprint. In essence, each member country will have to begin this process by preparing more detailed national action plans.

The Blueprint suggests that at the regional level, ASEAN sectoral bodies will be involved in the coordination of the implementation of the Blueprint, but related government agencies are responsible for overseeing the implementation. Partnership arrangements involving government agencies, sectoral bodies, and business associations as well as the civil society will need to be formed to ensure participation of all stakeholders in the preparation of national action plans, as well as in regular consultations on their implementation. The above nongovernment stakeholders need to be identified and clear criteria should be set for their involvement.

The implementation mechanism as envisaged in the Blueprint consists of the following elements: (a) relevant sectoral Ministerial bodies to be responsible for

implementation of the Blueprint and for monitoring of commitments under their respective purview; (b) the ASEAN Economic Ministers (AEM) to be in charge of economic integration in the newly established Council of ASEAN Economic Community (as stipulated in the ASEAN Charter) are also accountable for overall implementation; (c) the High Level Task Force (HLTF) to assist the AEM; (d) regular consultation meetings with stakeholders to be organized by the AEM; (e) a progress report on the implementation of the AEC to be prepared by the ASEAN Secretary General for relevant Ministerial meetings and the Summit; and (f) the ASEAN Secretariat to review and monitor compliance of the implementation of the Blueprint. Of key importance to the successful implementation of the Blueprint is the clear separation between policymaking (HLTF and AEM) and the monitoring of implementation (ASEAN Secretariat). ERIA research will pay particular attention to developing evidence-based analysis that will aid in the meaningful monitoring of the implementation of the Blueprint.

3.3. Future research

3.3.1. Developing ERIA scorecards of services liberalization

The study has begun to develop analytical scorecards of services liberalization for six subsectors, namely, business services, maritime/port services, courier/postal services, financial services, distribution services, and logistic services. In order to support ASEAN's efforts to achieve "free flow of services", the study will need to be extended to cover other subsectors. What can be called "ERIA scorecards" to assist and supplement similar efforts by the ASEAN Secretariat can be an essential tool to facilitate the implementation of services liberalization in accordance with the AEC Blueprint and its strategic schedule as well as in crafting the services chapter of the various ASEAN agreements with its East Asian partners.

3.3.2. In-depth studies on trade facilitation

ASEAN already has well-developed proposals on what needs to be done in the area of trade facilitation. However, the motivation to carry out the changes and the most effective means to do so are less clear and it is on these aspects together with

monitoring progress in implementation that research will focus on. This study will also be incorporated into the ERIA scorecards exercise as well. They will also be useful in defining the trade facilitation agenda for the wider East Asian region.

3.3.3. Post evaluation of existing FTAs

In order to optimize the utilization of the existing FTAs in East Asia, the first step is to identify the reasons for their low utilization. A large sample survey can be a useful tool for this purpose. A preliminary survey of responses by the corporate sector has been undertaken in relation to FTAs involving Thailand and Japan. In addition, this exercise can be extended to monitor the implementation of FTAs along with the provisions in the agreements.

3.3.4. Enhancing ASEAN's participation in regional production networks

ASEAN's intention to enhance its participation in "global supply networks" is very much consistent with the strategic framework developed by this study. By incorporating the findings of other ERIA research projects (infrastructure development, industrial clustering, SMEs, and CLMV), a set of practical policy measures to achieve this objective can be elaborated within a comprehensive and unified framework to pursue deepening economic integration and narrowing development gaps at the same time.

4. POLICY RECOMMENDATIONS

The process of deepening economic integration in East Asia will largely depend on the successful implementation of the AEC. The present study has identified crucial policies that will significantly contribute to the establishment of the AEC. Three major aspects are to be given priority.

4.1. Developing AEC scorecards

AEC scorecards, based on solid analysis of the key obstacles to integration, will assist in tracking the progress of implementing the AEC Blueprint. They will also provide necessary benchmarks, particularly in the areas of trade facilitation and services liberalization. This will enable policymakers to craft more appropriate and effective measures.

4.2. Streamlining ROOs in the Region

ROOs of the various regional FTAs are inconsistent and cumbersome. This has complicated and limited the use of FTAs, especially by SMEs. ROOs therefore have to be streamlined and AFTA is a useful benchmark on which to establish a common rule of origin for East Asia.

4.3. Re-examining the ASEAN Investment Area Initiative

Investment has been a key driver of regional economic integration through the emergence of dynamic production networks. Intra-Asian investment has been far more critical than intra-ASEAN investment in this process. Therefore, it is necessary to re-examine the concept of the ASEAN Investment Area (AIA). The study shows, however, that AIA reform should be accompanied by improvement in the domestic business environment, particularly economic regulations, tax regimes, competition policy, and corporate and labor laws. Free investment flows and the accompanying domestic reforms can contribute to narrowing the development gaps in ASEAN.

NOTE

1. “The ASEAN Policy Blueprint for SME Development: 2004-2014” for the development of small and medium enterprises (SMEs), and “the Initiative for ASEAN Integration (IAI)” to

narrow development gaps between ASEAN-6 (Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore, Thailand) and CLMV (Cambodia, Laos, Myanmar, Vietnam) countries.