

# 1. INTRODUCTION

## 1.1. East Asian economic integration and the role of ERIA

The Economic Research Institute for ASEAN and East Asia (ERIA) aims to make intellectual inputs in response to regional policy research needs for economic integration by conducting policy studies and capacity-building activities. This “Test-run” Roadmap Project is intended to support the initiative of the ASEAN Economic Community (AEC) and beyond by identifying research agendas to address various challenges in the region.

For decades, ASEAN and East Asia have achieved remarkable economic growth and have been one of the world’s leading growth centers. A notable feature of the East Asian economic growth is its effective utilization of globalizing forces. Corporate activities are conducted beyond national borders, international division of labor in terms of production processes has been extensively developed, and East Asia has created massive vertical intra-industry trade<sup>1</sup>.

Although the development literature often claims that globalization would aggravate internal and external income disparity, it is not necessarily the case in East Asia. Rather, the East Asian experience tells us that two objectives — the deepening of economic integration and the narrowing of development gaps — can be pursued at the same time. We have often observed that the economic dynamism that comes from utilizing differences in location advantages and avoiding congestion in agglomeration has resulted in numerous economic activities being shifted to relatively undeveloped regions or countries in East Asia, which has resulted in relatively equitable socioeconomic conditions.

Recent academic studies have analyzed the entangled mechanism of such favorable links of economic integration to development. Newly developed fields of research, such as the fragmentation trade theory and the New Economic Geography (NEG), seem to work as powerful analytical tools for investigating the mechanism. To draw concrete policy recommendations for deepening economic integration and narrowing

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<sup>1</sup> In this report, “East Asia” is defined as the region of East Asian Summit (EAS).

development gaps, a robust analytical foundation must be established.

In addition, as an essential prerequisite, conditions for sustainable economic growth must also be realized. There are increasing concerns in the region about issues relating to energy and the environment, as well as macroeconomic stability and the need for structural reforms; these matters should be subjected to rigorous policy studies.

There have been a number of efforts made to foster economic integration in East Asia. Notably, the AEC and some bilateral/plurilateral free trade agreements (FTAs) have proposed a policy framework for deeper economic integration with concrete time schedules. These efforts at the policy level, however, have not yet been fully supported by academic input. For steady and effective implementation, rigorous policy studies are urgently required, the topics of which include the evaluation of the current status of integration, economic justification and prioritization of various policy modes, the streamlining of multiple integration efforts, etc.

East Asian economic integration is no doubt very challenging since the countries have large differences in terms of economic development, political system, and historical and cultural background. However, we would like to turn these differences into a source of dynamism and pursue economic integration for a more prosperous future of the region.

## **1.2. Organization of ERIA research projects and this report**

This project entitled “Developing a Roadmap toward East Asian Economic Integration” was launched as a test-run project in the ERIA Expert Group Meeting (EEGM) on April 1, 2007, in Manila, aiming to establish a strategic framework for constructing a comprehensive roadmap toward the AEC and beyond that meets three objectives: a) deepening economic integration, b) narrowing development gaps, and c) sustainable economic growth<sup>2</sup>.

Under the umbrella of this project, five research projects were launched in the subsequent EEGM in Kuala Lumpur in May 2007, to conduct in-depth research on

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<sup>2</sup> Another test-run project on “Energy Security in East Asia” was launched in the meeting as well. This test-run project comprises of three specific research projects, namely, (1) *Analysis on Energy Saving Potential in East Asia Region*, (2) *Investigation on Sustainable Biomass Utilisation Vision in East Asia*, and (3) *Standardization of Biodiesel Fuel for Vehicles in East Asia*. Reports from these projects are being published separately.

specific issues:

- (1) *Deepening Economic Integration*, led by Dr. Hadi Soesastro, Executive Director, Centre for Strategic and International Studies (CSIS), Indonesia;
- (2) *Infrastructure Development in East Asia: Towards Balanced Regional Development and Integration*, led by Dr. Nagesh Kumar, Director General, Research and Information System for Developing Countries (RIS), India;
- (3) *Analyses of Industrial Agglomeration, Production Networks and FDI Promotion: Developing Practical Strategies for Industrial Clustering*, led by Dr. Mohamed Ariff, Executive Director, Malaysian Institute of Economic Research (MIER), Malaysia;
- (4) *Development Strategy for CLMV in the Age of Economic Integration*, led by Dr. Chap Sotharith, Executive Director, Cambodian Institute for Cooperation and Peace (CICP), Cambodia; and
- (5) *Asian SMEs and Globalization*, led by Dr. Hank Lim, Research Director, Singapore Institute of International Affairs (SIIA), Singapore.

Part I of this report is organized as follows: Chapter 2 provides overviews on the nature and characteristics of the East Asian economy. Chapter 3 investigates links among the three objectives using the framework of the fragmentation trade theory and New Economic Geography. The required policy environment is also discussed in this chapter. Chapters 4 to 9 are devoted to demonstrating the findings and policy recommendations of the five other ERIA research projects.

Part II comprises perspectives on East Asian economic integration from the 16 countries in the ERIA initiative.

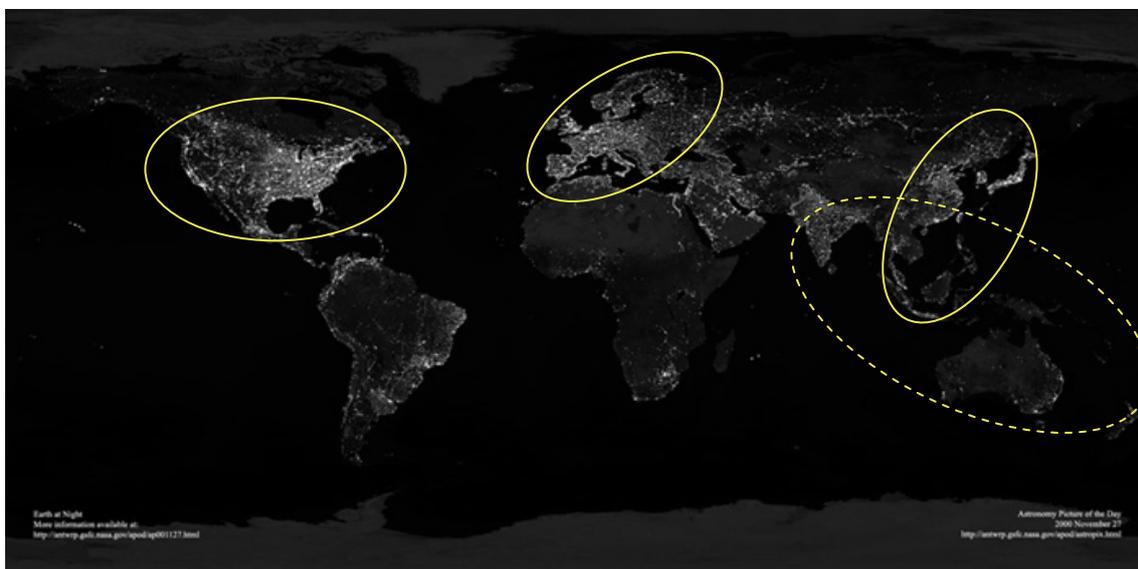
## 2. NATURE AND CHARACTERISTICS OF THE EAST ASIAN ECONOMY

### 2.1. Economic growth and income disparities

ASEAN and East Asia have achieved remarkable economic growth and have led dynamism among developing economies in the world. Since the late 1980s, in particular, East Asia has successfully attracted foreign direct investment (FDI) and has effectively taken advantage of globalizing forces for its development.

Figure 2-1 is a night photo of the earth taken from NASA's satellites. It utilizes a bird's-eye view of the world to show where economic activity is concentrated in 2000. We can identify the distribution of economic activities on the earth by the density of the lights in the night.

**Figure 2-1: Three sparkling regions (November 27, 2000)**



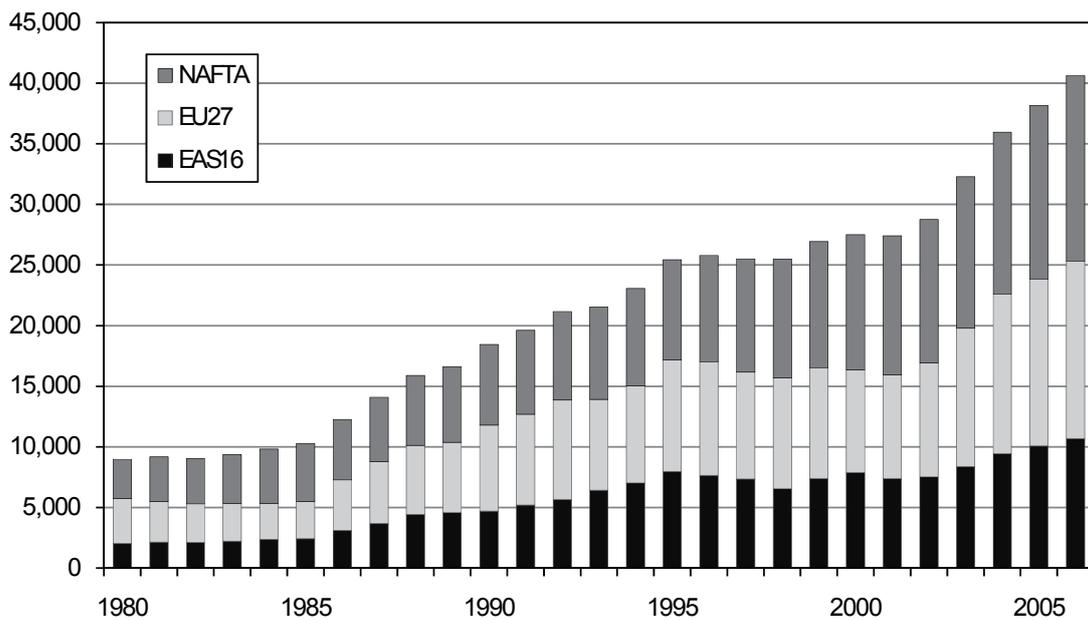
*Credit:* C. Mayhew & R. Simmon (NASA/GSFC), NOAA/ NGDC, DMSP Digital Archive.

*Source:* Downloaded from NASA website (<http://apod.nasa.gov/apod/ap001127.html>).

We can readily recognize three sparkling regions (circled in the photo), each extending across national borders. The brightest region is the core area of the North-American Free Trade Agreement (NAFTA), which consists of the US, together

with the southern part of Canada and the northern part of Mexico. The next brightest region is Europe, containing the European Union (EU). The third is East Asia, extending along the East China Sea and South China Sea from Japan to Indonesia. India also has a large sparkling area.

**Figure 2-2: GDP of East Asia, EU27 and NAFTA (billion US\$, current prices)**



Source: IMF, *World Economic Outlook Database*, October 2007.

In fact, as Figure 2-2 shows, the GDP of enlarged East Asia, consisting of ASEAN 10, plus three (China, Japan, and Korea), and plus three (Australia, India, and New Zealand), is rapidly approaching to the GDP of the other major regions of NAFTA and EU-27. To be precise, in 2006, the GDP of enlarged East Asia was US\$ 10,699 billion, which was slightly lower than those of EU-27 (US\$ 14,610 billion) and NAFTA (US\$ 15,310 billion).<sup>3</sup> Figure 2-2 also indicates that over the 26-year period from 1980 to 2006, the GDP of enlarged East Asia grew the fastest (5.3 times), compared to those of EU (4.0 times) and NAFTA (4.7 times).

<sup>3</sup> In this report, East Asia includes Brunei, Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand, Vietnam, Australia, China, Japan, Korea, and New Zealand. EU27 consists of Austria, Belgium, Bulgaria, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the United Kingdom.

In terms of the share in the world total GDP in 2006, the enlarged East Asia accounted for 22.2% of global GDP, while the EU-27 generated 30.3%, and NAFTA 31.7%. In sum, 84.2% of global GDP was concentrated in the three regions. In 1980, the corresponding shares were 17.2% for the enlarged East Asia, 31.4% for EU-27, 27.7% for NAFTA, with the three regions combining for 76.2%. Hence, the concentration of the world GDP in the three regions has recently been intensifying, with East Asia growing the fastest.

The geographical size of NAFTA is about the same as that of East Asia, as we can see in Figure 2-1. In fact, the flight distance between New York and Los Angeles is equivalent to the distance between Tokyo and Bangkok. This means that, given today's technologies, the geographical area of NAFTA or East Asia represents a natural spatial unit of economic activity that extends far beyond traditional nation-states, though much smaller than the whole world. Also notice that East Asia contains the East China Sea and South China Sea in the middle, a geographical circumstance that renders cargo transport costs cheaper in East Asia than in NAFTA. Thus, East Asia is not as big as commonly thought. In contrast, the geographical size of the EU is considerably smaller than that of NAFTA and of East Asia. This suggests the possibility of further expansion of the EU in the future.

**Table 2-1: FDI inward stocks in East Asia**

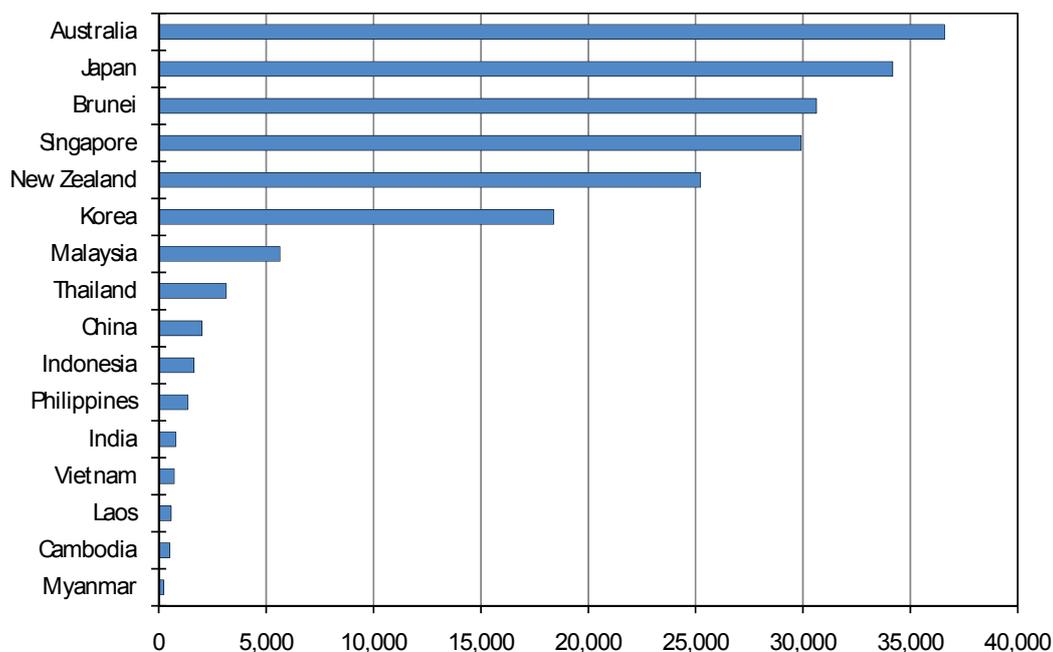
	FDI Inward Stocks (million US\$)				As a Percentage of GDP (%)			
	1980	1990	2000	2006	1980	1990	2000	2006
Australia	24,776	73,644	111,138	246,173	14.9	23.7	27.8	32.6
Brunei	19	33	3,868	9,861	0.4	0.9	89.6	86.2
Cambodia	38	38	1,580	2,954	5.1	2.2	43.1	41.6
China	1,074	20,691	193,348	292,559	0.4	5.4	17.9	11.1
India	452	1,657	17,517	50,680	0.2	0.5	3.8	5.7
Indonesia	4,680	8,855	24,780	19,056	5.9	7.0	15.0	5.2
Japan	3,270	9,850	50,322	107,633	0.3	0.3	1.1	2.5
Korea	1,327	5,186	38,086	70,974	2.1	2.0	7.4	8.0
Lao PDR	2	13	556	856	0.7	1.4	32.1	24.9
Malaysia	5,169	10,318	52,747	53,575	21.1	23.4	58.4	36.0
Myanmar	1	281	3,865	5,005	0.0	5.4	53.1	38.5
New Zealand	2,363	7,938	24,894	63,116	10.3	18.2	47.3	60.8
Philippines	1,281	3,268	12,810	17,120	3.9	7.4	17.1	14.6
Singapore	5,351	30,468	112,633	210,089	45.7	82.6	121.5	159.0
Thailand	981	8,242	29,915	68,058	3.0	9.7	24.4	33.0
Vietnam	1,416	1,650	20,596	33,451	59.1	25.5	66.1	54.8
World	551,221	1,779,198	5,810,189	11,998,838	5.2	8.4	18.3	24.8

Source: UNCTAD, *World Investment Report 2007*.

ASEAN and the surrounding region have aggressively targeted inbound FDI. Since the mid-1980s, a large amount of FDI has flowed into East Asia, which has brought about massive positive impacts on economic growth of the host countries. Table 2-1 presents the FDI inward stock data in the enlarged East Asian countries, as compiled by the United Nations Conference on Trade and Development (UNCTAD). Although there are many problems with the reliability of FDI-related data and their international comparability, we can at least confirm that most of the East Asian countries have been successful in attracting FDI and have tried to effectively utilize globalizing forces for their development. In particular, FDI has played a leading role in the formation of international production/distribution networks in ASEAN and East Asia.

FDI in East Asia has wisely been utilized in the overall framework of countries' development strategies and has resulted in expanded exports, income, and eventually consumption. The virtuous FDI-led cycle has built in host countries, which has provided opportunities for indigenous entrepreneurs/firms to develop and has raised the welfare level of people in East Asia.

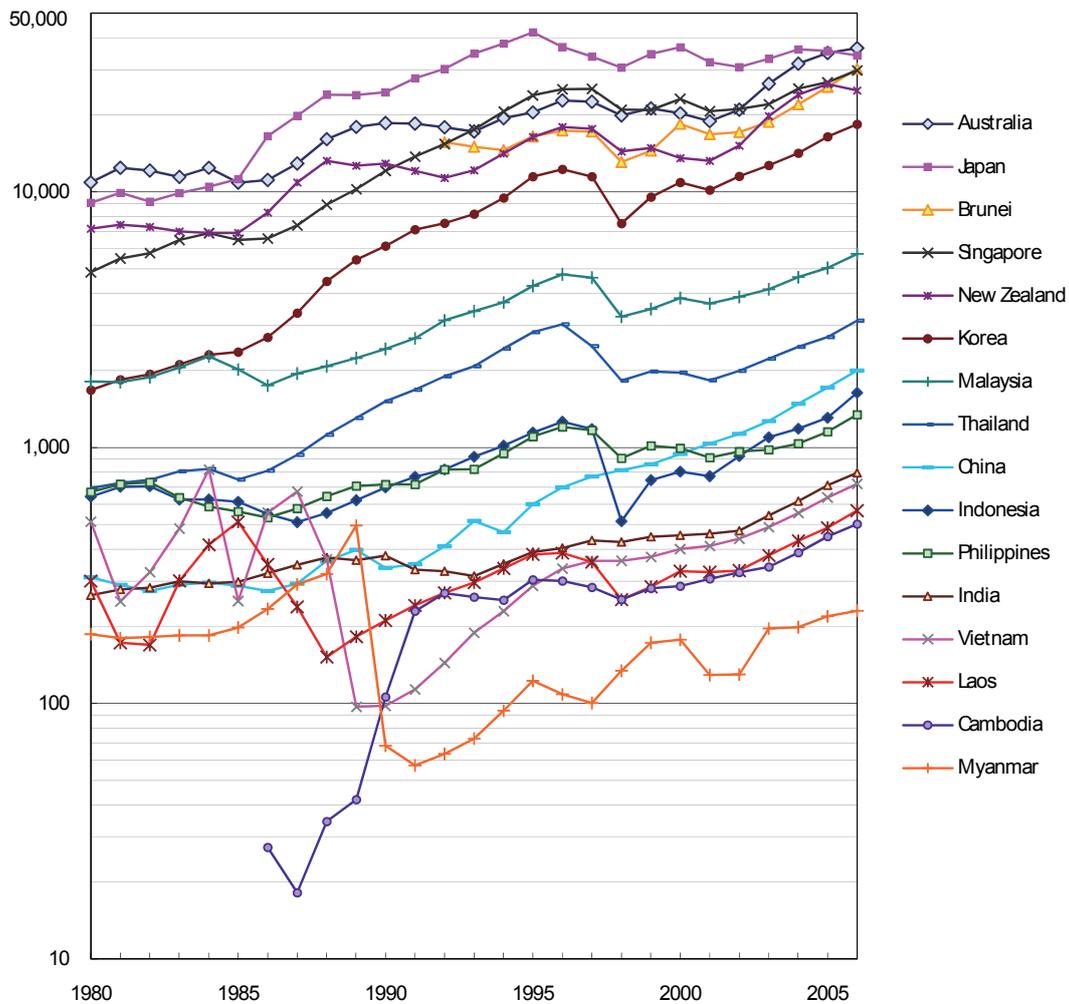
**Figure 2-3: GDP per capita in East Asia (US\$)**



Source: IMF, *World Economic Outlook Database*, April 2007.

The high levels of economic growth have been attributed to not only the competitive edge of East Asian firms but also the overall improvement of the business environment in East Asian countries. The latter includes unilateral tariff reduction, improvements in customs procedures, investment incentive and facilitation measures, such as exemptions of tariffs on intermediate goods and corporate taxes, the provision of one-stop services for FDI, infrastructure building, human resource development, enhancement of capabilities of SMEs, etc. These policy measures reduce trade costs as well as production/investment costs. Free trade agreements (FTAs) are also working as an effective policy measure to reduce trade and production costs.

**Figure 2-4: Changes in GDP per capita in the enlarged East Asia (US\$)**



Source: IMF, *World Economic Outlook Database*, April 2007.

Although the remaining development gaps in the region are still substantial, the wave of economic dynamism starts to cover all over the region. Figure 2-3 depicts GDP per capita by country (in terms of US dollars) in the enlarged East Asia. In 2006, GDP per capita in Australia, Japan, Singapore, Brunei, and New Zealand were more than 100 times higher than in Myanmar, and more than 10 times higher than in China. In contrast, among the EU-27 countries in 2006, GDP per capita in Luxembourg (the highest) was about 20 times that of Bulgaria, and 5 times that of Portugal. Obviously, the income disparity in East Asia is far greater than that in Europe.

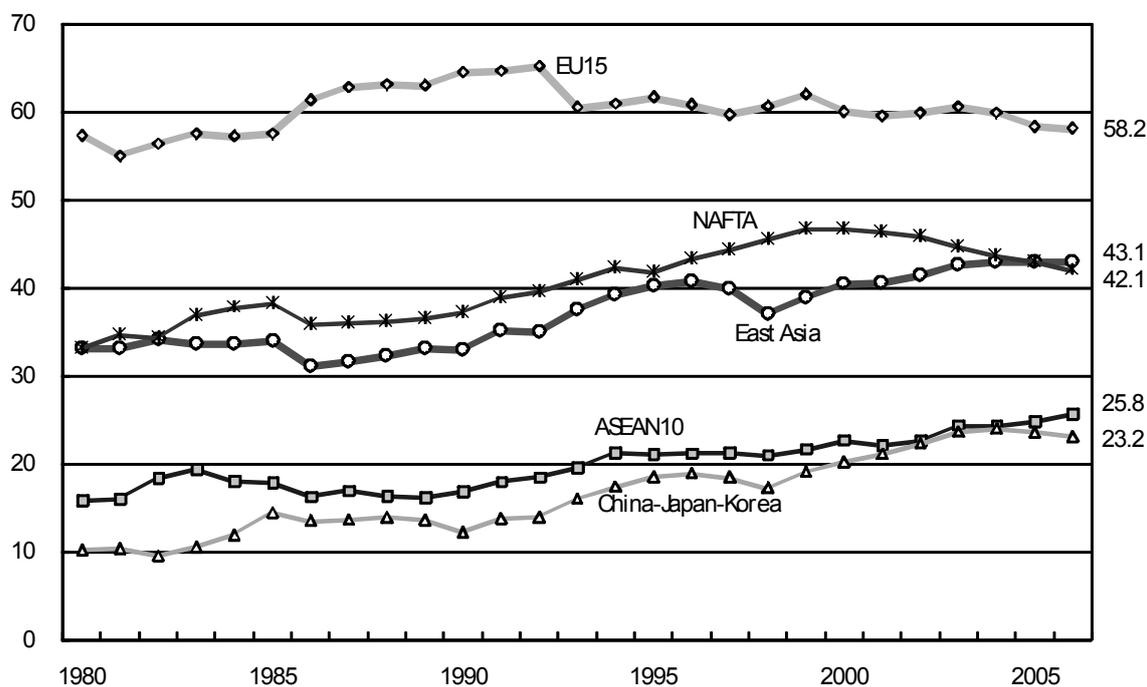
Such big disparities in GDP per capita reflect productivity differences among countries, which in turn reflects differences in both the level of human capital development, and the degree of agglomeration economies enjoyed in each country. Large development gaps provide a big challenge. At the same time, when a proper policy environment is provided, differences can in turn become opportunities for utilizing globalizing forces. In fact, as Figure 2-4 shows, a number of countries in East Asia have been steadily catching-up in per capita GDP in Asian economic dynamism.

## **2.2. The formation of production networks**

Since the early 1990s, international production networks have developed in ASEAN and East Asia. Production-process-wise division of labor has been pursued, resulting in massive vertical intra-industry trade in parts and components within the region.

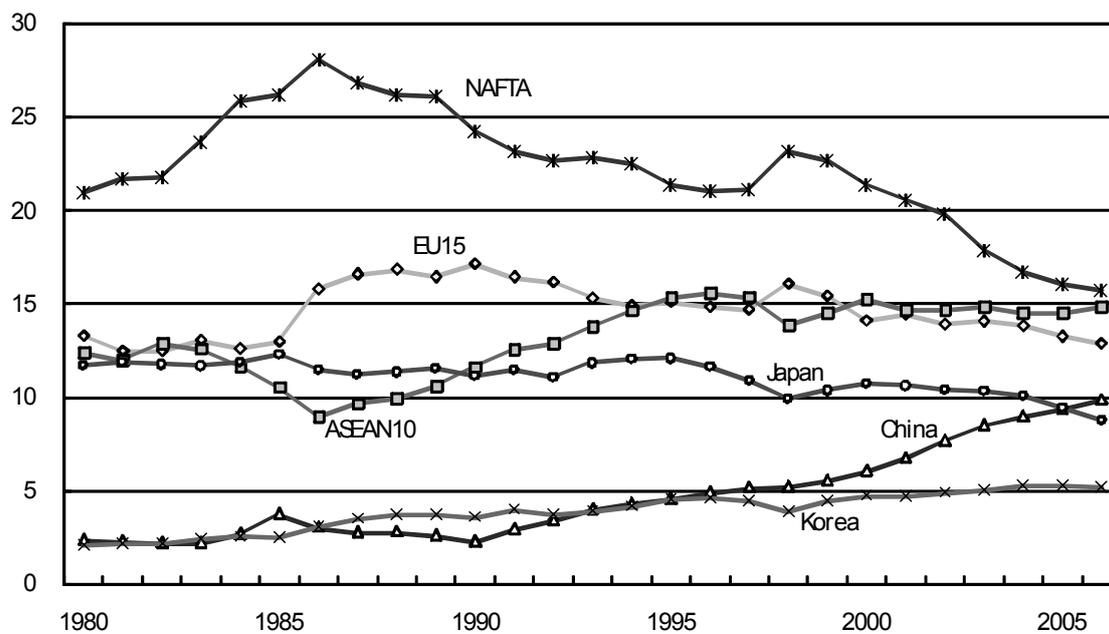
The international trade statistics clearly presents the recent advancement of *de facto* economic integration in East Asia. Figure 2-5 shows the share of intra-regional trade (exports and imports) within several economic areas. The share of intra-regional trade in enlarged East Asia rose steadily from 33.3% in 1980 to 43.1% in 2006. Surprisingly, in 2006, this figure was higher than that of NAFTA (42.1%) though lower than that of the EU (58.2%). East Asia has no doubt achieved a high level of *de facto* economic integration in terms of international trade transactions within the region. The integration process has not been seriously interrupted, even by the Asian currency crisis in the late 1990s.

**Figure 2-5: Intra-regional trade (export and import) ratio by region (%)**



Source: IMF, *Direction of Trade Statistics*, CD-ROM, May 2007.

**Figure 2-6: Trade share of the enlarged East Asia with partner country (%)**



Source: IMF, *Direction of Trade Statistics*, CD-ROM, May 2007.

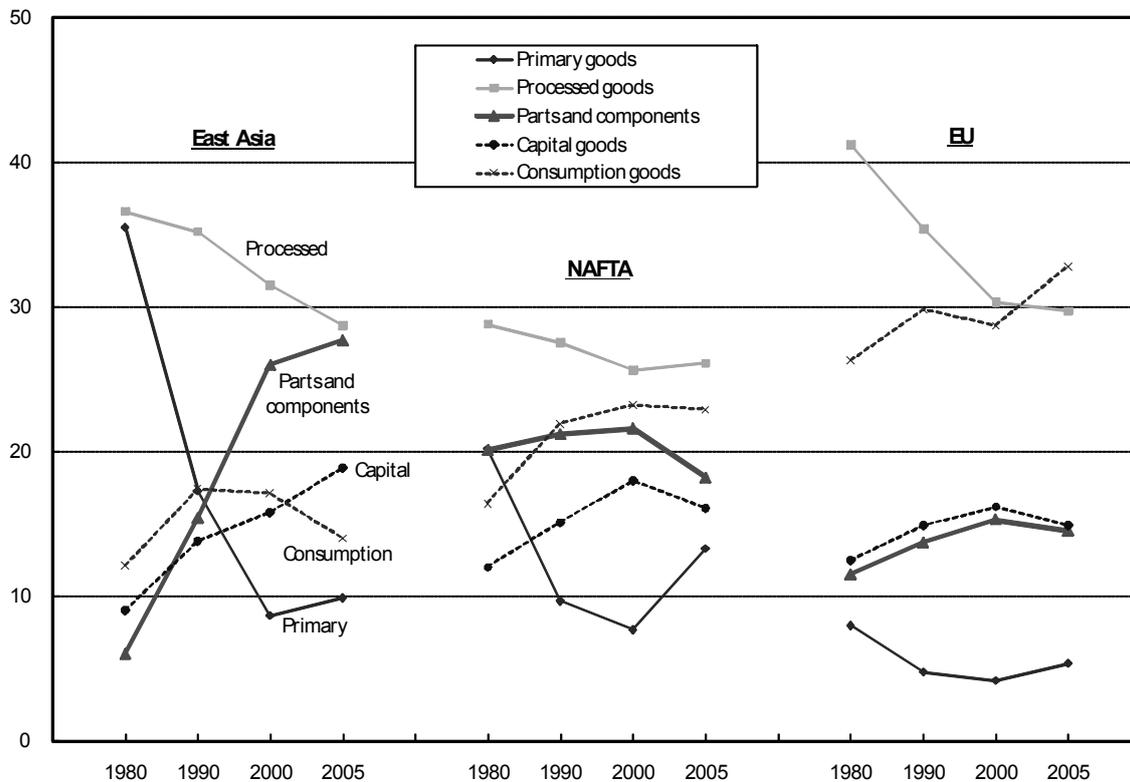
However, economic integration in East Asia does not appear to have developed in an even manner. The share of intra-regional trade of the ASEAN 10 and China–Japan–Korea in 2006 was only 25.8% and 23.2%, respectively, against that of the enlarged East Asia (43.1%), which suggests that economic activities require a large space in which to expand, i.e., the whole East Asia, as the spatial economists argue (Fujita, 2004). Moreover, in Figure 2-6, which shows trade shares of East Asia by partner countries/regions, we can see that China and the ASEAN 10 increased their shares in East Asian trade, in contrast to the gradual decline of Japan. This suggests that countries at relatively low income levels have played a significant role in the expansion of intra-regional trade in East Asia.

It should be noted that trade patterns inside the enlarged East Asia have changed, from the traditional pattern in which final products had been traded based on traditional comparative advantages to a pattern in which there is massive amount of trade in parts and components. To put it differently, intermediate goods in the same industry have actively been traded among the Asian countries, expanding intra-industry and intra-regional trade.

This can be confirmed observing that the import shares of parts and components within East Asia, including Hong Kong and Taiwan, increased from 6.6% in 1980 to 29.5 % in 2004, while the shares of imported processed goods decreased from 38.2% to 27.9% over the same period (Figure 2-7). Surprisingly, the import value of parts and components in East Asia is larger than in NAFTA and EU. East Asia is the largest import region for parts and components, indicating that East Asia has emerged as a region with the most developed machinery industry in the world (Figure 2-8).

Two points should be addressed here. First, East Asia, in particular ASEAN 10 and China, mutually trade parts and components for final products that are assembled within the region. Second, East Asia's production networks are deeply linked with NAFTA and EU (Figure 2-9). NAFTA and EU export much of their parts and components to ASEAN 10 and China, meanwhile China and ASEAN 10 export parts and components, as well as consumer goods, to those advanced regions.

**Figure 2-7: Trade pattern inside East Asia (%)**

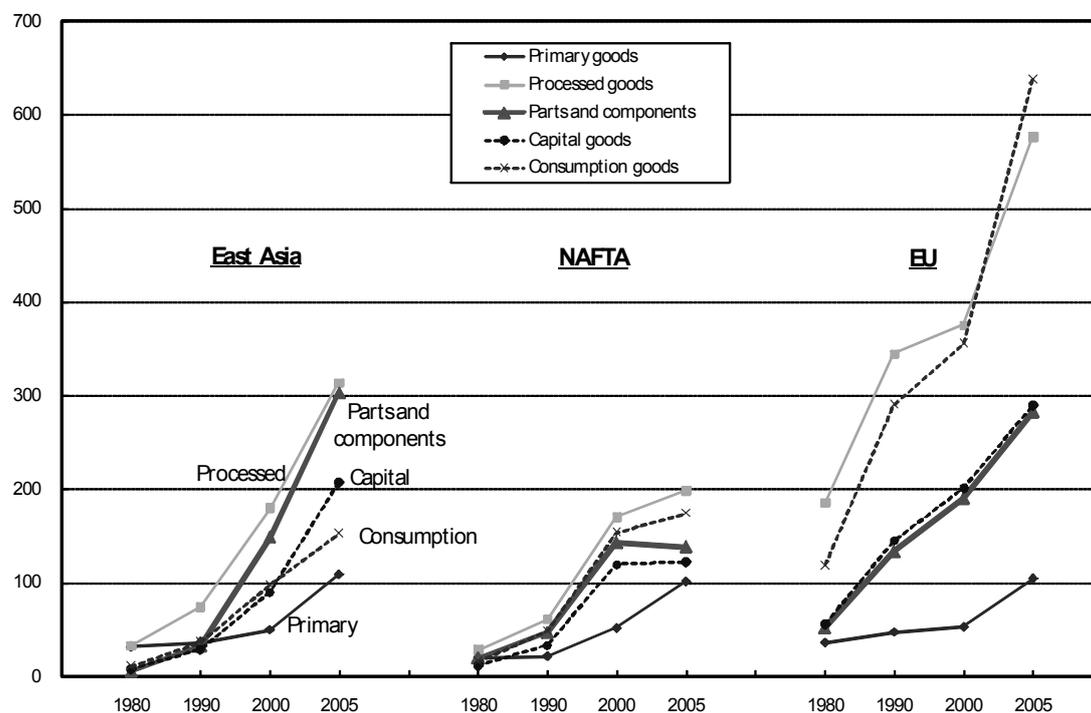


*Notes:*

1. East Asia includes ASEAN 10 (Brunei Darussalam, Indonesia, Cambodia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam), Australia, India, China, Japan, Korea and New Zealand. NAFTA includes Canada, Mexico and United States. EU is calculated on a 15-country basis. Although the official members of each region may change over the years, calculations have been conducted on the same country basis.
2. Because of data availability, the data on China (1980) and Brunei Darussalam (2000 and 2005) are not included. Data on Laos and Myanmar are substituted by their trade partners', while the data on Cambodia and Vietnam for the years not covered by the UN Comtrade database are also substituted by their partners'. It implies the data may be missing for trade between those countries, because their partners' data may be unavailable as well.
3. This graph is based on BEC-basis data, which are recalculated from SITC-basis using a long-term perspective (1980-2005). The trade goods by production stage include the following items: Primary goods — items under BEC codes 111, 21 31; Processed goods — BEC codes 121, 22, 32; Parts and components — BEC codes 42, 53; Capital goods — BEC codes 41, 521; Consumption goods — BEC codes 112, 122, 51, 522, 61, 62, 63.
4. The values of trade goods are measured by import value on a US dollar basis.

*Source:* Ozeki (2008). Compiled by IDE-JETRO based on the UN Comtrade database.

**Figure 2-8: Trade pattern inside East Asia (billion US\$)**



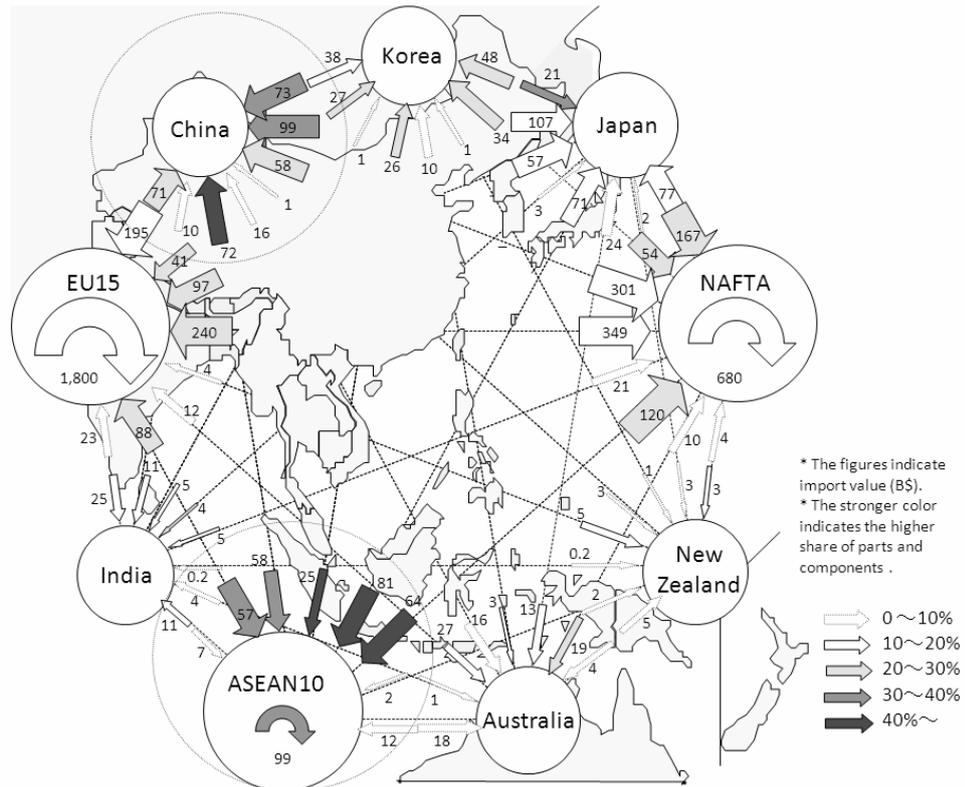
Notes and Source: Same as Figure 2-7.

What we observe in East Asia is an explosive increase in trade in intermediate goods, particularly in machinery industries, based on production-process-wise international division of labor among countries at different income levels and development stages. Trade patterns in today's global competition, where economies of scale strongly work, are quite different from the traditional patterns that are based on static comparative advantage. The entire production processes now involves sequential production blocks that are located in various countries. Different stages of production are performed by suppliers located in different countries. Products traded between firms in different countries are components, rather than final products. Figure 2-10 is an example of production-process-wise division of labor in the hard disc drive manufacturing in East Asia.

This phenomenon is known as cross-border production sharing or fragmentation of production. Production processes are finely sliced into many stages and located in different countries in East Asia. It is theoretically confirmed that, in such vertical specialization, a slight decline in trade costs induces large trade in intermediate goods since goods may move across national borders multiple times. For example, an

intermediate good is exported from country A to country B and is imported back to country A again after processing in country B. In this case, the good goes through customs offices four times. This is what actually happens in East Asia; as trade costs go down, the competitiveness of the entire East Asian region increases greatly.

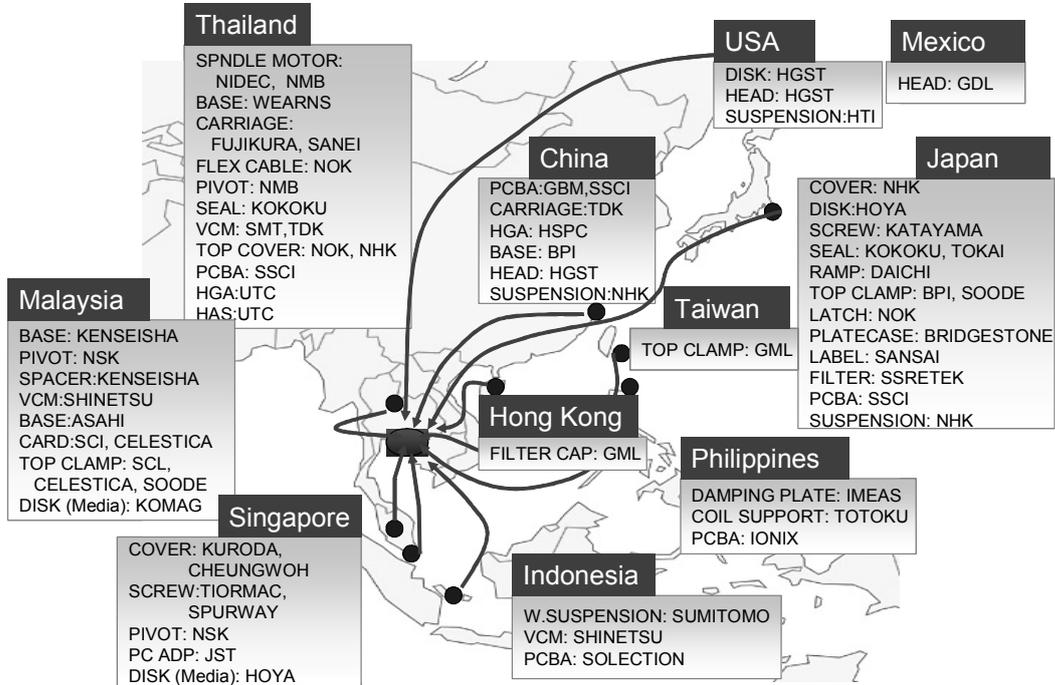
**Figure 2-9: Trade map centering on the enlarged East Asia**



Notes and source: Same as Figure 2-7.

Anderson and Wincoop (2004) estimated trade costs in developed countries by using a gravity model. They found that the total trade cost was 170%, out of which 21% was for transportation of goods, 44% for border-related trade barriers, and 55% for retail and wholesale distribution costs ( $2.7 = 1.21 \times 1.44 \times 1.55$ ). A breakdown of the 44% border-related trade barriers is 8% for policy barriers, 7% for language barriers, 14% for currency barriers, 6% for information barriers (use of different currencies), and 3% for contract enforcement and securities barriers in industrialized countries ( $1.44 = 1.08 \times 1.07 \times 1.14 \times 1.06 \times 1.03$ ). The study suggests that elimination of border barriers other than tariff is also an important issue.

**Figure 2-10: International procurement: An example of a hard disc drive assembler in Thailand**



Source: Hiratsuka (2006).

### **3. POLICY FRAMEWORK OF DEEPENING ECONOMIC INTEGRATION AND NARROWING DEVELOPMENT GAPS**

#### **3.1. Reduction of service link and network set-up costs**

One of the prominent features of the East Asian economy is the prevalence of production fragmentation, in which production processes are sliced into several sequential stages and the separated production blocks are located across countries. The resulting production and distribution networks constitute the framework of *de facto* economic integration in the region. In the age of globalization, development strategies should be designed to utilize globalization forces by effectively participating in the still-growing production and distribution networks.

In East Asia, business environments have been improved through the accumulation of ad hoc policy responses, rather than comprehensively designed policy packages. The remarkable economic growth in East Asia lends strong support for this approach. However, the rise of global competition has been urging the region to take collective actions to maintain and reinforce the resilience of the regional economy by further developing existing production and distribution networks. In order to do so, East Asia needs to share a comprehensive policy framework to design viable, effective and practical policy measures.

The key elements of the policy framework can be drawn from the New Economic Geography and fragmentation trade theory, which claim the importance of reducing the costs of fragmentation, namely service link costs and network set-up costs. The former are the recurring costs to link fragmented production blocks, and the latter are one-time costs to establish new production blocks in production networks. The reduction of these costs provides private firms an expanded window of opportunities to explore efficiency by making production fragmentation less costly. To put it differently, if service link costs and network set-up costs are reduced in a less-developed country (LDC), some manufacturing processes in relatively advanced countries will be moved to the LDC, while the remaining processes will be expanded in the advanced country. As a result, the combined production in both countries will be larger than

before fragmentation. Congestion in the advanced countries will encourage the movement.

Greater disparities in factor prices encourage production fragmentation. Development gaps can be transformed into a source of economic dynamism of the region if service link and network set-up costs are reduced by a well-prepared policy package. A policy package to reduce service link and network set-up costs can be realized by deepening economic integration, which contains elements of liberalization and facilitation of trade in goods and services and investment. Therefore, it is possible to pursue deepening economic integration and narrowing development gaps at the same time.

### **3.2. The mechanism of agglomeration and fragmentation**

In the process of industrialization in ASEAN and East Asia, international trade in parts and components has been dramatically expanded. At the background, international division of labor in terms of production processes (fragmentation) has developed to an unprecedented degree. At the same time, economic agglomeration or industrial clusters have grown in several notable places where dense vertical supply chains are formulated. In even higher development phases, economic agglomeration is beginning to nurture more sophisticated industrial structure of the knowledge economy. These fundamental transitions are rather new phenomena, starting from the late 1980s or the early 1990s. To understand the mechanism of agglomeration and fragmentation, two novel theories, new economic geography and the fragmentation theory, are extremely useful.

New Economic Geography explains agglomeration and dispersion of economic activities in geographical space. The spatial structure of economic activities is considered to be the outcome of a process involving two opposing types of forces, that is, agglomeration forces and dispersion forces. The theoretical formulation analyzes the balance of these two opposing forces that generate a variety of location patterns of economic activities.

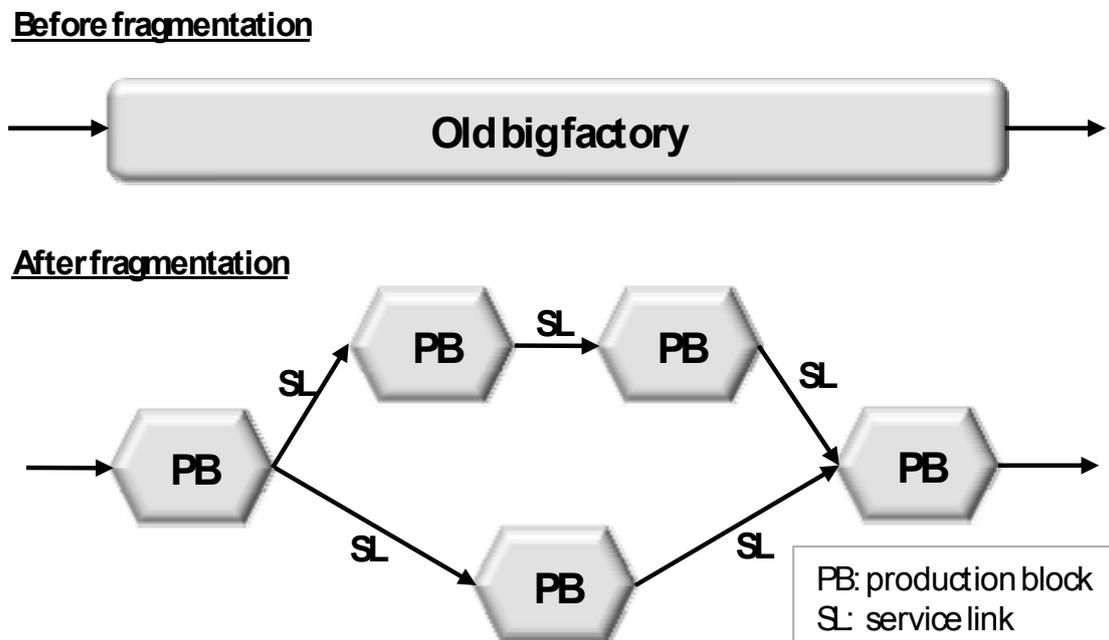
A key property of agglomeration forces resides in the circular causality of economic activities. For example, if an automobile assembler would attract a number of upstream suppliers, the resultant productivity enhancement and market expansion

might in turn attract another assembler. Such circular causality would generate a sort of economies of scale in a geographical sense. This mechanism would make agglomeration attract more and more economic activities.

The growth of economic agglomeration would enhance dispersion forces at the same time. Concentration of economic activities would increase land prices and wage rates, bring severe price competition among firms, and cause traffic congestion and air pollution. Due to such congestion effects, dispersion forces would be intensified, and less developed countries in the region could take advantage of it in attracting economic activities.

One of the most important factors that delicately affect the balance between agglomeration forces and dispersion forces is broadly-defined transport costs, which include freight costs, tariffs, non-tariff barriers, and risk of exchange-rate variation. New Economic Geography analyzes the factors, some of which are policy variables that determine industry location among countries or cities of different size.

**Figure 3-1: The original idea of fragmentation: an illustration**



Source: Kimura (2006).

The other novel line of thought, the fragmentation theory, focuses on the location of production processes. Production processes are fragmented into multiple slices and

located, say, in different countries in East Asia. The original idea of fragmentation is illustrated in Figure 3-1. Suppose that a firm in the electronics industry originally has a huge factory in a developed country that takes care of all its production processes from upstream to downstream. If the firm can separate its production processes and locate them in appropriate places, the total production cost may be reduced.

There are three elements that make fragmentation possible. First, there must be production cost saving in fragmented production blocks; the firm must take advantage of differences in location advantages between the original and new production sites. Second, the cost of service links that connects remotely located production blocks, i.e., costs of transportation, telecommunication, and various types of coordination, must not be too high. Third, the cost of network set-ups is small. The theory suggests that diversity or differences in development stages may accelerate fragmentation and FDI at the production process level if proper policy environment is prepared to reduce service link and network set-up costs.

New Economic Geography and the fragmentation theory provide insights on important factors that determine the location of economic activities in the globalizing era.

### **3.3. Policy environment that enables utilizing globalizing forces**

International production/distribution networks in ASEAN and East Asia are, at this moment in time, the most advanced and sophisticated in the world. As a background, East Asia has developed a favorable policy environment suitable for globalizing corporate activities. However, this policy environment is the result of accumulated trouble-shootings in response to claims and requests from the private sector, rather than being developed with well-designed strategic moves. Analytical evaluation of a policy environment that enables countries to take advantage of globalizing forces for economic development is yet to come.

New Economic Geography and the fragmentation theory provide rich implication for policy environment in the globalizing era. New Economic Geography suggests policies affecting the agglomeration forces and the dispersion forces, while the fragmentation theory identifies policies affecting production cost saving, service link costs, and network set-up costs. Combining these theories with careful consideration

related to policy needs, which will possibly differ by development stages, we can actually develop desirable policy packages in order to utilize globalizing forces. Some tentative arguments for initiating and accelerating industrialization are as follows:

1. At the early stage of development, prime concerns are how to attract the initial wave of production blocks by utilizing dispersion forces and how to participate in production networks to be able to utilize their location advantages, e.g. abundant unskilled labor. A country at this stage does not have to immediately improve the overall investment environment for the whole economy; such improvement is typically very difficult to implement. Rather, a minimal set of FDI facilitation, infrastructure services, and convenient service link arrangements should be provided at a specific industrial estate or a special economic zone.
2. After a successful start of industrialization, a series of policies helping the formation of agglomeration comes to the center of stage. It is crucial to host as many production blocks as possible by removing bottlenecks in location advantages and service link arrangements. For example, well-organized one-stop services and custom clearance services would be suggested. In particular, industrial estates are crucial for attracting FDI by foreign SMEs.
3. At a higher phase of industrialization, the participation of local firms as well as the strengthening of core ingredients of economic agglomeration, such as human resources and economic/social infrastructure, should be stressed. Due to the growth of economic agglomeration, a country quickly loses its advantage of low-wage unskilled labor. To keep massive economic activities and proceed to further economic development, it should acquire new strengths. Positive externalities from agglomeration should be fully utilized to stabilize the industrial base. Various actors in production networks, including both foreign and local firms, should be located there, attractive human resources to support higher levels of economic activities must be available, and efficient logistic arrangements should be developed to facilitate sophisticated value chain management. To reach the stage of a knowledge economy, well-balanced industrial structure, including a modern services sector, is required.

The recent wave of economic integration can be effectively utilized to promote proper policy reform and to further promote international production networks. Development strategies in the globalization era should be completely different from traditional strategies in which the domestic economy is insulated from foreign competition. Rather, national border barriers should be lowered, and international competition must be introduced. This is not, however, a simple-minded strategy of just free trade and investment but a deliberately designed strategy of utilizing globalizing forces to accelerate industrialization.

### **3.4. The economic development of latecomers**

The economic development of latecomers, in particular CLMV, is a very important agenda, not only for the countries concerned but also for ASEAN and the whole of East Asia. The relationship between the two objectives — deepening economic integration and narrowing development gaps — is extremely crucial in this context. This task is not a simple one, and efforts from various angles must obviously be taken. We however would like to claim that New Economic Geography and the fragmentation theory provide useful insights into development strategies to effectively utilize globalizing forces.

New Economic Geography suggests that latecomers may utilize the dispersion forces due to congestion in economic agglomeration. The theory analyzes two forces in economic agglomeration: the agglomeration forces and the dispersion forces. The agglomeration forces may enlarge disparities among the integrated countries (e.g., CLMV vs. other countries) as well as among domestic regions in each country (e.g., inland vs. coastal regions in China). At the same time, the dispersion forces may move manufacturing activities from forerunners to latecomers, and in doing so, narrow development gaps. The balance of these two forces would largely determine the overall effects of economic integration on industrial location patterns among the East Asian countries. From the viewpoint of CLMV, how to take advantage of the dispersion forces would become an issue.

There have, in fact, been signs of congestion in economic agglomeration in East Asia, and the dispersion forces have started working so as to influence industrial location. We have observed substantial increases in production costs in agglomeration

due to difficulties in securing labor and land, traffic jams, etc. Firms have had to find labor from far distances, and some of them eventually set up new factories in mid-sized cities or rural areas. In particular, labor-intensive or land-intensive production processes tend to shift. In recent years, many cities grew, with increasing numbers of residents, factories, and warehouses.

The fragmentation theory, on the other hand, suggests that differences in location advantages such as factor prices motivate fragmentation of production processes. Differences in wage levels between ASEAN forerunner countries and CLMV are still substantial, and thus, CLMV may rather have strengths, particularly for labor-intensive or natural-resource-intensive production processes. The important issue, then, for attracting FDI would be a proper investment climate that reduces network set-up and service link costs. Geographical proximity to growth centers would also be a strong point. Efforts for deeper economic integration are essential to preparing the necessary policy environment.

In sum, latecomers, particularly CLMV, have good opportunities for attracting economic activities in the globalizing era. By strategically improving their policy environments, they can simultaneously attain the two objectives — deepening economic integration and narrowing development gaps.

### **3.5. Fostering local firms/entrepreneurs**

How to foster local firms and local entrepreneurs in the competitive environment is a big concern of developing countries. In the past, direct or indirect protection for local firms and delaying the liberalization process were rather taken for granted in the infant industry protection argument. But, now in the globalization era, local firms must compete with gigantic multinational enterprises (MNEs) in the open market from the beginning. What sort of industrial policies or SME policies would be justifiable is one of the most controversial topics among development economists.<sup>4</sup>

The current wisdom, from theoretical literature, shows that MNEs may provide catalysis for fostering local firms. In support of this, we recently found that small and medium enterprises (SMEs), indeed, play pivotal roles in the functioning of

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<sup>4</sup> Hew and Nee (2004) present an excellent review on the current status of SMEs in ASEAN.

international production networks and economic agglomeration. There are certainly ways to foster local firms or SMEs by utilizing globalizing forces. Multiple market failures do exist in the development of local firms and entrepreneurship, and they would be mitigated by proper policy arrangements.

There is ample evidence that local firms are participating in production/distribution networks, particularly in machinery industries. An empirical study of Thailand, based on industrial surveys, revealed several interesting research findings (Yokota, 2008a). First, between MNEs and SMEs, there have been positive spillovers and linkage effects in the machinery industry, but not in other industries so far. Second, the impact of trade liberalization differs from industry to industry; trade liberalization has increased productivity in the machinery industry and labor-intensive industries. Third, in particular, local firms in the machinery industry have received the largest benefits from trade liberalization.

Another example of the link between MNEs and local firms can be found in Penang, Malaysia. In Penang, many indigenous enterprises have developed through linkages with foreign electronics companies. Indigenous enterprises are participating in producing not only parts and components but also industrial equipment. We also observed that foreign assemblers operating in Thailand have gradually expanded their outsourcing to indigenous suppliers. Most indigenous enterprises that have linked with MNEs are SMEs. Some have succeeded in the global marketplace, serving customers both in Asia-Pacific and around the world.

Economic integration has provided business opportunities not only in terms of participating in production/distribution networks but also in capturing enlarged markets. A Malaysian electrical appliance firm is expanding OEM production, outsourced from MNEs, as well as increasing direct sales of its original brand to the ASEAN integrated market. It is notable that in agricultural products, including food and beverages, ASEAN enterprises have demonstrated a big presence. A Philippine giant food and beverage manufacturer has extended its business overseas to Australia, China, Indonesia, and Vietnam. A leading Thai agro-based company has expanded its businesses in Cambodia, China, India, Indonesia, Malaysia, Myanmar, Singapore, Vietnam and other countries.

Trade liberalization may lead to market share reallocations towards more productive firms. The way to avoid this is to promote product differentiation. When

there are fewer substitutes among products, firms can enjoy sufficient margin. In other words, demand for the products is less sensitive to the changes in the broadly-defined transport costs. An empirical study clarified that the total value of transported goods declines dramatically before reaching 100 miles (Hillberry and Hummels, 2005). However, products differentiated enough can be sold in distant markets. Furthermore, moderate competition among firms under product differentiation can facilitate industrial agglomeration.

Industrial agglomeration or clustering has the potential to increase firms' productivity. For example, an enormous leather industry in Agra, India, provides various type of footwear (Knorringa, 1994). With large-scale production, many varieties are sustained by pooling skilled labor, co-operation among SMEs and specialized jobs, which bring with it backward and forward linkages. A study on SMEs in Indonesia show better performances by clusters of SMEs than by stand-alone SMEs (Hew and Nee, 2004).

Many indigenous enterprises have succeeded in improving their performance by establishing linkages with MNEs, expanding their businesses in integrated markets, or cooperating with other SMEs through the formation of industrial clusters. We should conduct serious research on successful cases among local firms/entrepreneurs in ASEAN and the surrounding region and contemplate necessary policy support.

### **3.6. New policy challenges:**

#### **The widening scope of integration and sustainable economic growth**

The economic integration process in ASEAN and East Asia has, so far, been somewhat biased toward trade liberalization and facilitation. In forerunners of ASEAN and China, the policy environment for international production/distribution networks in the manufacturing sector has demonstrated good progress, although there is still a lot of room for further improvement of the business environment. Some other aspects of economic integration, including services sector, are still largely premature. A well-balanced industrial structure and a solid knowledge base should be established in order to further climb up the development ladder. Some policy fronts may require explicit comprehensive initiatives of *de jure* economic integration, rather than depending on the accumulation of incremental policy improvements.

It is also crucial as prerequisites to meet conditions for sustainable economic growth relating to energy, environment, macroeconomic stability, and structural reform. Well-balanced growth over a long period of time is indispensable to the ultimate goal of economic growth and development. In particular, growing energy demand has increased the risk of a shortage of energy supply. Indeed, the emergence of China and India has provided dynamism in the global economy, but at the same time, has increased energy consumption.

East Asia has enjoyed high economic growth for decades. At the same time, economic growth has been accompanied by serious environmental problems, some of which have become trans-boundary issues. Forest fires and the resulting smoke haze that periodically blanketed Southeast Asia have existed for more than a decade, notwithstanding the ASEAN agreement on the trans-boundary environmental protocol in 2003. There is urgent need for making economic growth compatible with the preservation of the regional and global environment.

## **4. DEEPENING ECONOMIC INTEGRATION: THE ASEAN ECONOMIC COMMUNITY AND BEYOND**

The policy framework toward East Asian economic integration should be designed to support production fragmentation and networking by reducing the accompanying costs, namely service link and network set-up costs.

For this purpose, trade facilitation is particularly important since one additional occurrence of production fragmentation across countries generates four additional border controls, which is a key determinant of service link costs. In fact, while time and costs of international trade varies significantly by countries, it is still very high in several countries in the region (Layton, 2008). By the same token, services liberalization is equally important, not only for the services sector itself but also for the industrial sector by directly reducing service link costs. It is theoretically confirmed that trade in goods will be facilitated by efficient inputs from the service sector, such as transportation, logistic, finance, and insurance (Deardorff, 2000). Moreover, a recent survey reveals that the time required to start up new businesses, which is a main component of network set-up costs, varies significantly by country (World Bank, 2007).

These observations imply that there remains ample room to reduce services link and network set-up costs through trade facilitation, services liberalization, and investment liberalization and facilitation, which are beyond the scope of traditional trade liberalization. East Asia is now at the stage where it should pursue deep economic integration by taking regional collective actions.

### **4.1. Deepening economic integration**

While economic integration in East Asia has substantially advanced for trade in goods — parts and components in particular — and FDI flows, it is far from complete for other elements. That is, there remains ample room to promote international production fragmentation and networking through eliminating such gaps by devising a proper policy environment. This is the process of deepening economic integration.

Recent FTAs envisage deep economic integration, by including not only tariff reduction and elimination but also trade facilitation, services liberalization, investment

liberalization and facilitation, government procurement, standards, intellectual property rights, labor regulations, environmental issues, and economic cooperation<sup>5</sup>. Although the coverage widely varies across agreements, FTAs today share a common feature aimed at deepening economic integration far beyond shallow economic integration with simple border liberalization.

The worldwide development of production networks has revealed the necessity to deepen economic integration, not only by reducing border barriers, but also by working toward convergence in the policy environments, e.g., regulations on services industry, competition policy, technical standards, and intellectual property rights. In other words, the deepening of *de facto* economic integration has begun to require comprehensively-designed institutional arrangements to facilitate deeper economic integration. East Asia, as a region with growing production networks, should follow this global trend, by taking regional collective action.

## **4.2. Implementing the ASEAN Economic Community Blueprint**

In the context of East Asian economic integration, ASEAN has been gaining importance as the hub of regional FTA networks as well as the forerunner to deepen economic integration. Therefore, ASEAN's initiatives toward the ASEAN Economic Community (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.

### *4.2.1. The AEC Blueprint*

The ASEAN Economic Community (AEC) Blueprint, which was officially agreed to in the ASEAN Summit in November 2007, is a very significant development in ASEAN's efforts, based on the substantial realization of ASEAN Free Trade Area (AFTA), towards the AEC. 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

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<sup>5</sup> Evans, *et al* (2006) provides in-depth study on the elements of 'deep' economic integration covered in FTAs involving developing countries.

(Soesastro, 2008b).

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*). From the viewpoint of the New Economic Geography and the fragmentation trade theory, the AEC Blueprint is a policy package, designed to reduce service link and network set-up costs, to pursue deepening economic integration and narrowing development gaps in the wider East Asian region.

The Blueprint 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. Thus, effective implementation is very important for realizing the AEC.

#### *4.2.2. Rules of origin and overlapping FTAs*

First of all, effective implementation of AFTA and several FTAs involving ASEAN is particularly important since, in East Asia, a number of bilateral/plurilateral FTAs are already implemented, concluded, or under negotiation, including those undertaken by individual ASEAN member countries. Figure 4-1 displays the current status of FTAs in East Asia and Asia-Pacific. We observe that the countries in ASEAN have already connected themselves with a number of trading partners within and outside ASEAN by FTAs.

Despite the proliferation of FTAs centering on ASEAN in East Asia, their potential benefits do not seem to have been realized because of the lower-than-expected utilization of FTAs. Our ex post evaluation study on FTAs identified several reasons (Hiratsuka *et al*, 2008).

First, firms, SMEs in particular, are not fully familiar with the FTAs. Second, import tariff exemption systems, e.g. the Board of Investment (BOI) privileges, are intensively used instead of FTAs in ASEAN. Firms are much more familiar with such BOI import tariff exemption systems. Third, the Information Technology Agreement (ITA) of the WTO has allowed exemption of tariffs on information technology related

products. Most electronics parts and components are already being traded with zero tariffs in the WTO member countries. Fourth, FTAs in East Asia have been unimpressive, as phase-out tariff schedules are employed for a large number of products. AFTA preferential tariff rates are zero for substantially all products for the original ASEAN member countries. But, FTAs involving ASEAN are still initial stages of the phase-out tariff schedules. Fifth, the administration cost to satisfy rules of origin (ROO) are very costly for exporters. This is a serious problem for exporters since the current ROOs in East Asia require exporters to prepare documents while the benefits go to the importers. Sixth, due to the so-called spaghetti-bowl effect, “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. As a result, only a few FTAs are being used and not for so many products. Seventh, other provisions in FTAs, such as the one on direct shipment, can discourage the utilization of FTAs.

In order to exploit the potential 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, in particular, the self-certificate system may encourage the utilization of FTAs. There is also a need to streamline ROOs in overlapping FTAs. In reality, however, the ROOs in East Asia tend to employ product-specific rules that differ by products. The problem of overlapping ROOs is likely to be more serious, since ROOs differ by product and by country.

Trade rules should be compliant with the WTO rule. In this regard, import tariff exemption systems, e.g. BOI privileges, contradict the Trade Related and Investment Measures System (TRIMS), which prohibits local content and export conditions, etc. Such import tariff exemption systems should be replaced with WTO compliant rules, such as FTAs. Thus, full implementation of FTAs is a very important issue.

Furthermore, 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. In this regard, a single regional wide FTA is better than multiple bilateral and plurilateral FTAs. Finally, it is crucial to conduct ex post evaluations of existing FTAs to pinpoint key bottlenecks and, on that basis, draw more detailed prescriptions to eliminate them.

Figure 4-1: Status of FTAs in Asia-Pacific region (as of January 2008)

	Russia	Chinese Taipei	Japan	Korea	China	Philippines	Indonesia	Malaysia	Thailand	Singapore	Brunei	Vietnam	Lao PDR	Cambodia	Myanmar	India	Australia	New Zealand	United States	Canada	Mexico	Peru	Chile	
Russia	■			△												△								
Chinese Taipei		■								△									△					
Japan			■	○	△	◎	◎	◎	◎	◎	◎	○	○	○	○	○	○	○	■	△	◎	◎	◎	◎
Korea	△		○	■	△	◎	◎	◎	◎	◎	◎	◎	◎	◎	◎	◎	◎	△	△	◎	○	○	△	◎
China			△	△	■	◎	◎	◎	◎	◎	◎	◎	◎	◎	◎	◎	△	○	○					◎
Philippines			◎	◎	◎	■	◎	◎	◎	◎	◎	◎	◎	◎	◎	○	□	□						
Indonesia			◎	◎	◎	◎	■	◎	◎	◎	◎	◎	◎	◎	◎	◎	○	□	□					
Malaysia			◎	◎	◎	◎	◎	■	◎	◎	◎	◎	◎	◎	◎	◎	○	○	○	○				○
Thailand			◎	○	◎	◎	◎	◎	■	◎	◎	◎	◎	◎	◎	◎	◎	◎	◎	○			◎	
Singapore		△	◎	◎	◎	◎	◎	◎	◎	■	◎	◎	◎	◎	◎	◎	◎	◎	◎	◎	○	○	○	◎
Brunei			◎	◎	◎	◎	◎	◎	◎	◎	■	◎	◎	◎	◎	◎	○	□	◎					◎
Vietnam			○	◎	◎	◎	◎	◎	◎	◎	◎	■	◎	◎	◎	◎	○	□	□					
Lao PDR			○	◎	◎	◎	◎	◎	◎	◎	◎	◎	■	◎	◎	◎	○	□	□					
Cambodia			○	◎	◎	◎	◎	◎	◎	◎	◎	◎	◎	■	◎	◎	○	□	□					
Myanmar			○	◎	◎	◎	◎	◎	◎	◎	◎	◎	◎	◎	■	◎	○	□	□					
India	△		○	○	△	○	○	○	◎	◎	○	○	○	○	○	■	△	△						△
Australia			○	△	○	□	□	○	◎	◎	□	□	□	□	□	△	■	◎	◎	◎				○
New Zealand			○	△	○	□	□	○	◎	◎	◎	□	□	□	□	△	◎	◎	■					◎
United States		△		◎				○	○	◎							◎		■	◎	◎	◎	◎	◎
Canada			△	○						○									◎	■	◎	◎	◎	◎
Mexico			◎	○						○									◎	◎	■	◎	◎	◎
Peru				△					◎	○										◎	○	○	■	◎
Chile			◎	◎	◎			○		◎	◎					△	○	◎	◎	◎	◎	◎	◎	■

Note: ◎: Entered into force / signed,  
 ○: Under negotiation / agreed to negotiate (bilateral),  
 □: Under negotiation / agreed to negotiate (plurilateral), and  
 △: Under consideration (G-G base) / feasible study initiated.

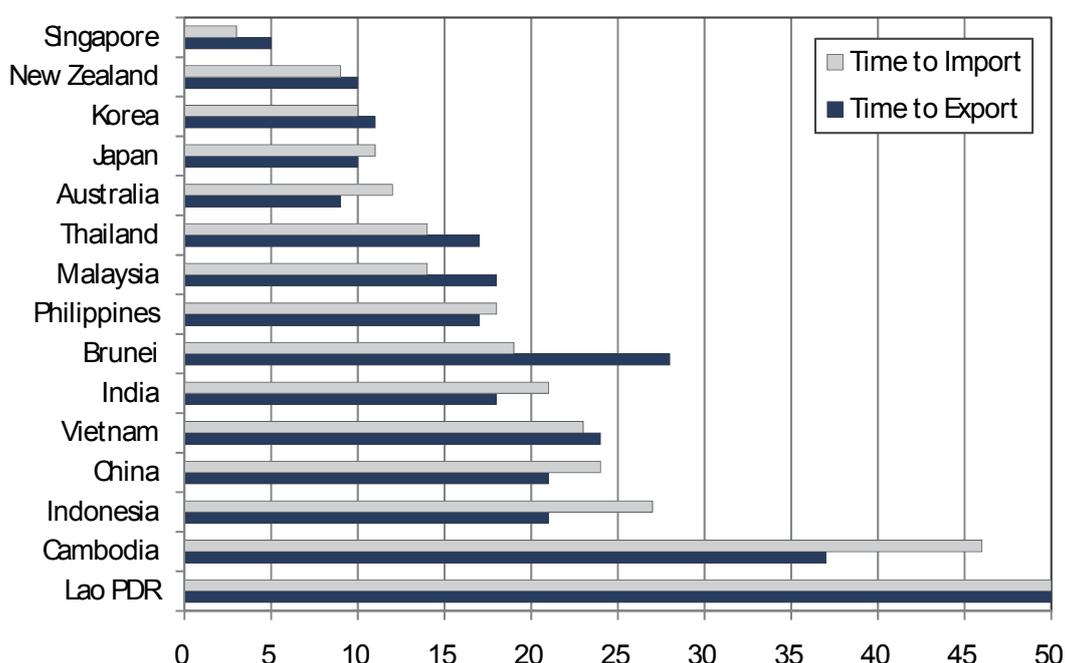
Source: Updated based on Lee, Kimura, Huh and Kuno (2006).

#### 4.2.3. 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. In fact, a study confirmed that trade costs other than tariffs are quite high even for OECD member countries (Anderson and Wincoop, 2004). Also, recent studies on trade costs, employing gravity models, 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.

**Figure 4-2: Time for trading across borders (days)**



Source: World Bank, *Doing Business 2008*, Washington, D.C.

In fact, time and costs of international trade varies significantly by countries; it remains very high in several countries. Among the 16 East Asian countries, the time required for export procedures is 10 times different between the shortest in Singapore (5 days) and the longest in Lao PDR (50 days). Similarly, the time required for import procedures is more than 16 times different between the shortest in Singapore (3 days) and the longest in Lao PDR (50 days). Such long lead times for trade procedures do not match with the current production fragmentation and networks prevailing in ASEAN and East Asia.

In this context, the AEC Blueprint on trade facilitation, in particular, the

establishment of the ASEAN Single Window and customs integration, is necessary because it will significantly reduce service link costs. 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 the progress of implementation (Layton, 2008).

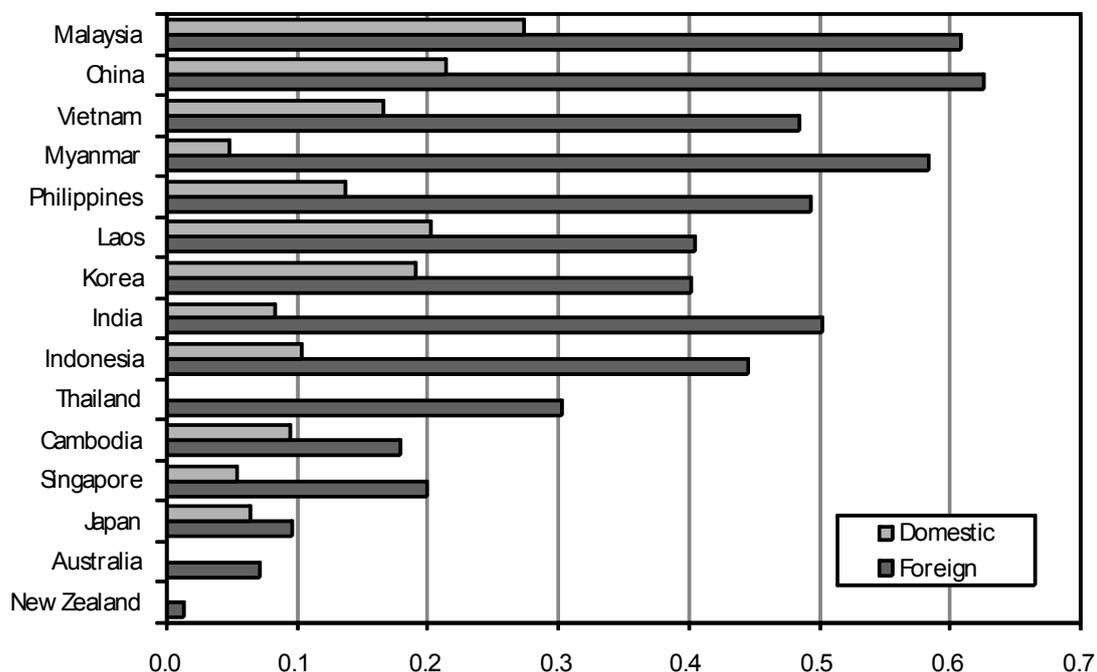
#### *4.2.4. Services liberalization*

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, ERIA has conducted detailed studies on services liberalization in East Asia focusing on the following six sub-sectors: business services, postal/courier services, ports/maritime services, financial services, distribution services, and logistic services (NZIER, 2008a and AJRC-ANU, 2008). These are important sub-sectors and complement the Priority Integration Sectors (PIS) set out in the AEC Blueprint. In an effort to develop sub-sectoral scorecards, taking all the four modes of services liberalization into consideration, the study has compiled sub-sectoral “restrictiveness indices” that can eventually be used to conduct quantitative analyses on the impact of services liberalization (See Figure 4-3 for example).

The most important implication that can be drawn from the study is that gains are much larger from reducing non-discriminatory 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 (Corbett, 2008).

**Figure 4-3: Restrictiveness indexes: Banking sector**



*Note:* Indexes are averaged over three datapoints, 1997, 2001, and 2005 for most countries, except for New Zealand, Korea, India, Philippine and Singapore where the 2005 data were not available at the time of the research. Brunei is not included due to the lack of data. Countries are listed in descending order of the sum of domestic and foreign indexes.

*Source:* AJRC-ANU (2008).

#### 4.2.5. 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.

One of our empirical studies, using gravity models, found that distance, which is a widely used proxy of service link costs, and wage differentials are significant determinants of intra-Asian FDI flows (Rajan, 2008). This further signifies the importance of investment liberalization and facilitation as one of the main policy pillars of the strategic framework to pursue in deepening economic integration and narrowing development gaps.

In addition, another ERIA study on FDI confirmed that the domestic business environments, particularly economic regulations, tax regimes, competition policy, and corporate and labor laws, are determinants of intra-ASEAN FDI (Sudsawasdi, 2008). 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 contribute to the narrowing of development gaps in ASEAN.

#### *4.2.6. Competition policy*

The AEC Blueprint intends to develop a regional guideline on competition policy by 2010, and to introduce 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<sup>6</sup>. 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 policies will contribute to the creation of “level playing fields”, in particular between domestic and foreign firms, in which economic resources will be utilized more efficiently.

#### *4.2.7. 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. The AEC Blueprint entrusts ASEAN to address development gaps by enhancing its existing frameworks 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 of East Asia as a whole. In order to widely diffuse the benefits of the AEC or to narrow

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<sup>6</sup> Ariff (2008a). Further details are reported in NZIER (2008b) and MIER (2008).

development gaps, ASEAN member countries should make self-reliant efforts to improve and enhance their business environment, infrastructure and human resources. In the process, regional collective actions, including economic and technical assistance, are of crucial importance.

#### *4.2.8. 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, however, can be found in the areas of trade policy, including FTA, and investment policy (Atje, 2008). For example, in trade policy, ASEAN members still maintain wide differences in levels of trade protection in several sectors. They also have concluded a number of FTAs without sufficient consultation with each other. 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 domestic laws and regulations that are critical for promoting investment flows into the region. In establishing a system to enhance regional coordination to formulate 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 production and distribution networks because they are multilateral in nature. Moreover, empirical studies continue to reveal that bilateral FTAs are far inferior to unilateral trade liberalization on an MFN (most favored nation) basis.

Therefore, ASEAN members are recommended to focus on the timely completion of comprehensive economic partnership agreements (including FTAs) with their main partners in East Asia (China, Japan, Korea, Australia, 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.

### **4.3. Beyond the ASEAN Economic Community**

The AEC is evidently an ambitious initiative, in the sense that it envisions to establish an economic community with 10 heterogeneous countries within a relatively short timeframe. Though it may sound paradoxical, in order to maximize the benefits from establishing the AEC, ASEAN is recommended not to confine itself to the AEC. There are at least two directions to go beyond the AEC, the geographical coverage and the depth of economic integration.

#### *4.3.1. Beyond “ASEAN” Economic Community*

Although ASEAN is a grouping of 10 nations, it pales in comparison with the European Union (EU) and the North American Free Trade Area (NAFTA) in terms of population size and purchasing power. ASEAN is also dwarfed by China. ASEAN is less than one-half of China in terms of both gross domestic product and population.

Size does matter. While ASEAN countries collectively are stronger and more resilient than they are individually, there are limits to ASEAN’s economic prowess. To be sure, ASEAN cannot afford to be autarkic or exclusive. ASEAN needs to reach out beyond its regional borders. Fortunately, as a group of export-oriented economies, ASEAN has always been an outward-looking entity. Indeed, ASEAN’s external linkages are much stronger than its internal linkages, as manifested by its trade and investment network. Extra-regional FDI inflows into ASEAN are far more important to its member countries than intra-regional FDI inflows. By the same token, extra-ASEAN trade accounts for the bulk of the total trade, with intra-ASEAN trade accounting for only one-fourth.

Equally importantly, geographical distance does matter as it determines service link costs. With advancement of transport and community technology, geographical distance, in terms of time, will be shortened. The combination of size and geographical distance will shape optimal geographical space beyond ASEAN. Wide regional economic space will provide opportunities for ASEAN firms to grow as global companies, and SMEs can form industrial clusters by specialization.

Although the ASEAN economy remains wide open to the rest of the world, ASEAN is not practicing what may be termed “open regionalism”. The latter term implies that the membership is open to all countries or the privileges of membership are

extended to all, without discrimination, which is not the case with ASEAN, or with any other regional grouping for that matter. The only grouping that comes close to this definition is Asia Pacific Economic Cooperation (APEC), which functions in a non-discriminatory fashion, although membership is limited.

What ASEAN practices may be described as “open integration,” as it links up with the rest of the world through trade and investment. The ongoing proliferation of FTAs reinforces the existing linkages, thereby intensifying the integration process beyond regional borders. To remain relevant and effective, ASEAN needs to broaden and deepen the extra-regional integration process. This is akin to drawing bigger and bigger concentric circles, with ASEAN remaining the focal point at the center.

The concept of concentric circles can transform neatly into a long-term vision for ASEAN, with each layer having a specific role to play in the regional architecture. The ASEAN Plus Three (APT), the East Asia Summit (EAS), and APEC may be characterized as the first, second and third layers around the AEC core. The degree or extent of integration would tend to be deeper at the inner layers and somewhat shallower at the outer layers.

ASEAN is envisioned to be the apex of the wider regional architecture with AEC constituting a closely-knit sub-regional economic community, a single market without borders, ensuring efficient allocation of ASEAN resources with intra-ASEAN specialization and division of labor. For meaningful and effective macroeconomic policy coordination and monetary and financial cooperation, ASEAN needs to team up with China, Japan and Korea under the APT umbrella. Even the APT would be too small to effectively handle bigger issues such as energy security, for which EAS would seem better suited. Global issues, which include multilateral trade and environmental concerns, may be better addressed in APEC, not only because more countries are involved in the latter but also because “concessions” are voluntary, albeit with some peer pressure.

Geography need not necessarily be a determinant of such layers, except in the case of ASEAN, which is clearly defined as a Southeast Asian grouping. ASEAN may grow from current 10 into 11 by accepting East Timor into its fold. APT would evolve eventually to include Taiwan and North Korea. For geographers EAS may present a problem as East Asia is stretched horizontally on both sides to include India and Australasia, but EAS does make considerable economic sense. The matrix of FTAs

(Figure 4-1) clearly shows that EAS is interconnected in ways that would constitute a natural configuration. However, it is not unthinkable for Russia, more specifically the Russian Far East, to be a part of the EAS. In the same vein, it is quite conceivable that APEC may also expand to include India, now that India is already a member of EAS.

The roadmap for ASEAN thus goes far beyond the narrow confines of the Southeast Asian boundaries. The concentric circles may grow, regional and sub-regional borders may be re-drawn. What is important is that each layer has a specific and complementary role to play so that ASEAN can orchestrate well with the rest of the world.

#### *4.3.2. Behind-the-border issues*

While the numerous bilateral and regional free trade agreements can help reduce, if not eliminate, tariff and non-tariff barriers to trade, they inadvertently create new barriers through complex sets of ROO. The latter so-called “spaghetti-bowl effect” would raise production and transaction costs for the manufacturers and traders, not to mention the horrendous problems it would pose for customs officers. All this would tend to negate the very purpose of these agreements, namely greater efficiency through improved allocation of resources.

The “spaghetti-bowl” syndrome can be effectively handled in two ways. The first is to craft simpler and standardized ROOs for all such agreements and the second is to mitigate the rising service-link costs by reducing the cost of doing business in all partner countries. To be sure, it is not a case of either or, as the first would reduce the services-link costs while the second would reduce the cost of doing business at home.

In this context, it is important to distinguish the “border” measures from what may be termed as “behind-the-border” measures. The former relates to the protectionist measures that overtly discriminate against foreign goods, services and investments at the border, such as tariffs, subsidies, national content requirements, quotas and restrictions on foreign equity. The latter refers to domestic measures that do not overtly discriminate against exports or imports or foreign ownership, such as crony handouts, affirmative action agendas, monopolistic practices and price controls of sorts.

Although such behind-the-border measures (BBMs) do not directly interfere with trade flows, they do cause market distortions, with serious cost implications. BBMs include, in addition to the examples above, regulations that hinder business at home,

such as licensing procedures; bankruptcy procedures, which depend on the quality of the civil service that administer the system; and the rule of law, which in turn depends on the quality of the legal framework. An important hallmark of such reforms is transparency, which would not only promote better governance and accountability but also facilitate more informed and intelligent public discussion of policy choices.

The argument for reforms targeted at BBMs rests basically on the enormous efficiency gains that would lead to significant reductions in the cost of doing business in a country. Besides, regional economic integration and community building cannot take place effectively if BBM issues are left untouched. Community building implies subscribing to common values and common standards. Although it is impractical for a diverse grouping to adopt a common institutional infrastructure that would govern BBM matters, some convergence would still be desirable and possible, as shown by the European Union experience. A convergence would enable a freer flow of resources within the region and facilitate deeper economic integration.

In the ASEAN context, this issue may be considered highly sensitive, as it entails some loss of national sovereignty. To be sure, BBM matters belong overwhelmingly to the domain of domestic affairs and are mixed delicately with domestic politics. Thus, the BBM issues cannot be placed on the ASEAN agenda to the extent that any such attempt would be construed as interference in the internal affairs of the member countries.

In any case, the BBM issues, by their very nature, do not lend themselves neatly to reciprocal liberalization. Such reforms are best undertaken in a unilateral fashion. ASEAN should encourage its members to do just that. After all, it is in the member country's own national interest to undertake such reforms voluntarily. It is however important for the frontrunners in ASEAN to set the pace for others in the regional grouping to follow, which may be described as leadership by example.

All this boils down to enhancing competitiveness. While ASEAN as a group will have to compete with other regional entities for global markets and investments, individual ASEAN countries will have to compete among themselves within the region to secure a fair share of the gains. Institutional reforms would augment individual country's competitiveness.

As ASEAN becomes borderless, thanks to liberalization "at the border," firms will become increasingly footloose, looking for best possible locations within ASEAN for

their activities. They will opt for places where the cost of doing their business is apparently the lowest, and hence the relevance of “behind-the-border” liberalization.

In the final analysis, it is companies, not countries, which compete in the marketplace. While liberalization at the border would provide easier market access for aspiring firms, their ability to compete in these markets would depend critically on liberalization taking place behind the border in the countries in which they operate. It is in this sense that “behind-the-border measures” tend to weigh more heavily on individual firms than the “border measures”.

## **5. GEOGRAPHICAL SIMULATION MODEL ANALYSES ON ECONOMIC CORRIDORS**

### **5.1. Cross border transportation**

As discussed in the previous chapters, an increasing number of FTAs have been concluded in Asia. Further deepening of economic integration will enhance international trade and investment in this region. In addition to such institutional arrangements, physical construction of transport infrastructure has also made rapid progress, linking major cities within and across Asian countries (e.g., the economic corridors in the Great Mekong Subregion (GMS), the Delhi-Mumbai highway in India).

When service link costs are reduced substantially by the development of logistic networks and the deepening of economic integration, manufacturing firms in the region might be able to supply their products to more remote markets. Similarly, the same reduction of service link costs enables producers to procure their parts and components from the suppliers at more distant sites. Then firms can establish their production networks spread over a vast area, linking highly productive suppliers. As a consequence, industrial production in the region as a whole becomes more efficient, and this brings about larger growth opportunities to the integrated economy.

However, at the same time, such improvement of service links might lead industries to be more localized in limited districts that are eminently suitable for their production. In particular, when there are significant economies of scale in production, firms tend to agglomerate in a limited number of locations, leaving other regions vacant. This likely intensifies the disparities among countries within the integrated economy (e.g., CLMV vs. other countries) as well as among domestic regions in each country (e.g., coastal vs. inland regions in China). To obtain the full benefits of the improvement of service links, therefore, individual countries and regions/cities need to implement industrial development measures with a long-term view to promote agglomeration of core industries.

Taking these issues into account, ERIA attempts to investigate the effects of the improvement of service links (in physical and institutional aspects) accompanying the process of economic integration. In FY2007, particularly, we carried out qualitative

and quantitative analyses of the economic consequences of the economic corridors in GMS — how it improves the potential of surrounding countries and affects economic disparities among them. The following is an overview of the current state of the economic corridors and other trade facilitation programs in GMS, and a brief explanation of our quantitative analyses of their economic influences.

## 5.2. GMS economic corridors

### 5-2-1. GMS Economic Cooperation Program

With respect to the development of transport infrastructure in CLMV countries, the GMS Economic Cooperation Program has played an important role<sup>7</sup>. So far under the program, various development projects have been implemented in nine sectors: 1) transportation, 2) telecommunications, 3) energy, 4) environment, 5) human resource development (HRD), 6) trade, 7) investment, 8) tourism and 9) agriculture.

Of these sectors, the greatest emphasis has been placed on transportation, especially cross-border transport infrastructure (CBTI). In addition, in order to improve service links, cross-border transport agreements (CBTA) that reduce institutional trade barriers have been launched. Furthermore, in order to confer the benefits of transport infrastructure development even on remote villages, building industrial estates and promoting industrial development along the road, are planned. The “economic corridors” of the GMS Economic Cooperation Program have been designed to combining these three pillars (Table 5-1 and Figure 5-1).

**Table 5-1: Progress of three economic corridors**

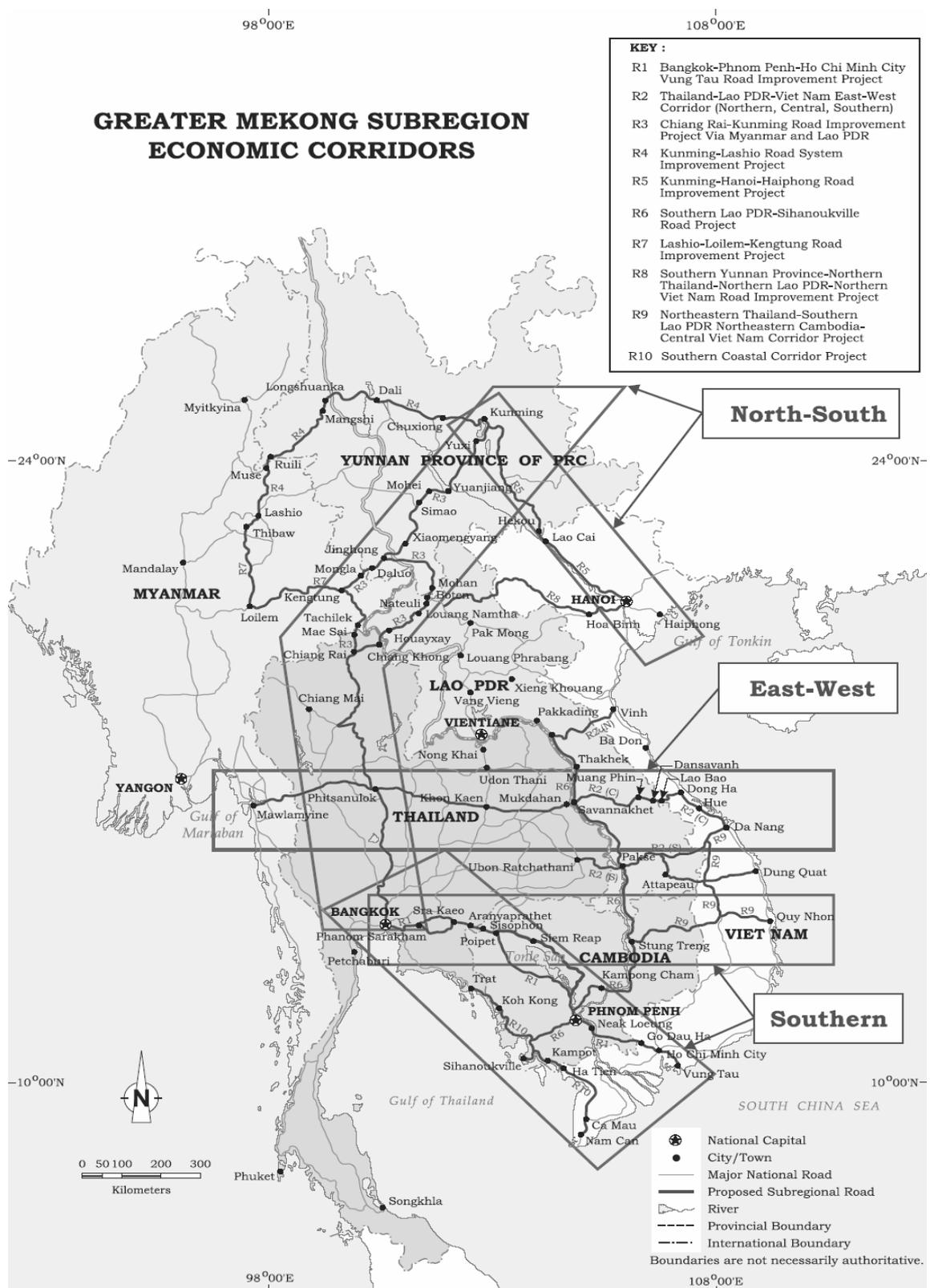
	CBTI	CBTA	Additional Measures
EWEC	Completed	Started to be realized <sup>(1)</sup>	Well-considered
NSEC	Not completed yet	Not yet agree	Considered, but not enough
SEC	Not completed yet	Already agreed	Well-considered

*Note:* (1) Concrete agreements have not yet been achieved between Thailand and Myanmar.

*Source:* Kumagai, *et al* (2008).

<sup>7</sup> This Program was launched on the basis of an agreement at the ministerial meeting of five countries, Cambodia, Laos, Myanmar, Thailand, and Vietnam, and representatives of Yunnan Province of China in 1992, which was held on the initiative of Asian Development Bank (ADB).

Figure 5-1: Three economic corridors in the Greater Mekong Sub-region



Source: ADB (2002).

### *5.2.2. Three economic corridors*

#### (1) East-West Economic Corridor (EWEC)

The EWEC is an economic corridor from Danang (Vietnam) to Mawlamyine (Myanmar) by way of Laos and Thailand. This route has been completed by building the Second Mekong International Bridge between Savannakhet (Laos) and Mukdahan (Thailand) in 2006. On the whole, the EWEC passes relatively poor area such as Laos, Myanmar, central Vietnam and northeastern Thailand. EWEC is expected to reduce development gaps in the region. With the completion of the bridge, logistics services connecting Bangkok and Hanoi by road have attracted quite a bit of attention from the business community. The government of Laos, however, expressed worries about the possibility that the part of Laos on EWEC is utilized just for transit by trucks between Bangkok and Hanoi. In order to benefit from EWEC, one special economic zone (SEZ) has been planned at Savannakhet. Another SEZ has already been developed at the border area of Lao Bao, Vietnam and several factories have already operated. At the border of Lao Bao (Vietnam) and Denhsavanh (Laos), customs clearance procedures have been unified at the importing country as a part of the CBTA that was signed between the two countries.

#### (2) North-South Economic Corridor (NSEC)

The NSEC comprises three routes. The first route connects Bangkok and Kunming (Yunnan); the second one is from Kunming to Haiphon (Vietnam) by way of Hanoi; and the third route goes from Hanoi to Nanning in Guangxi (China). The biggest city in Southern China, Guangzhou exists on the extended route<sup>8</sup>.

The first route is divided into a Myanmar route, a Laos Route and a shipping line on Mekong River from Jinghong (China) to Chiang Saen (Thailand). The three routes are connected to National Road No.1 of Thailand in Chiang Rai Province, and there are some plans to build industrial estates in the province. At present, most of goods traded between Thailand and China are conveyed by ships on Mekong River. On the other hand, the construction for paving the Laos route was completed in 2007, and the Mekong River Bridge between Chiang Khong (Thailand) and Huay Xai (Laos) is

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<sup>8</sup> In 2005, after Guangxi Zhuang Autonomous Region of China becoming a member of GMS Economic Cooperation Program, it was added to the NSEC.

planned to be completed in 2011. With the completion of the bridge, logistics services by road between China and Thailand are expected to increase. However, a CBTA among China, Thailand, Myanmar and Laos, has yet to be signed. On the whole, there are not many additional measures to support economic activities in rural areas and projects are concentrated on the transport infrastructure development.

### (3) Southern Economic Corridor (SEC)

The SEC is composed of three routes. The first route is the Central Sub-corridor which connects Bangkok (Thailand), Phnom Penh (Cambodia), Ho Chi Minh City and Vung Tau (Vietnam). The second route is the Southern Coastal Sub-corridor and it goes along the coastal area from Bangkok to Camau (Vietnam), by way of Thailand's Eastern-Seaboard and Koh Kong and Sihanoukville (Cambodia). The third route is the Northern Sub-corridor, which connects Siemreap (Cambodia) and Quy Nhon (Vietnam). Among the three sub-corridors, the central sub-corridor, which connects two capital cities of Thailand and Cambodia, and the biggest city in Vietnam, is expected to lead to enhanced road transport logistics services between Ho Chi Minh City and Bangkok.

However, the government of Cambodia has concerns that the Cambodian part of the SEC's Central sub-corridor might be utilized only for transit by trucks between Bangkok and Ho Chi Minh City, which is similar to the concerns of Laos about the EWEC. To address these concerns, industrial estates have been planned at the border areas of Poipet, Koh Kong and Bavet. Among these industrial estate projects, several factories have been already operated in Bavet SEZ, while other border areas have not yet born fruit. In addition, CBTAs were already achieved between Vietnam and Cambodia and between Cambodia and Thailand. At present, the construction of Mekong River Bridge at Neak Loeng is expected to be started and the road between Poipet and Sisophon in Cambodia will be paved soon.

### **5.3. Geographical model simulation on economic corridors**

As mentioned in section 5.1, the development of various types of infrastructure, especially transport infrastructure, might change the location of the industrial agglomeration in East Asia drastically in the long run through the reduction of service link costs. However, the exact impacts of the specific infrastructure development on

the location of the agglomeration are quite hard to predict, because the agglomeration of industry is a result of complicated interaction of agglomeration and dispersion forces.

One possible solution is to build a computer simulation model based on the New Economic Geography and actually calculate these complicated interactions of agglomeration and dispersion forces along various scenarios. In an ERIA research project, we are developing the Geographical Simulation Model for IDE/ERIA Infrastructure Project (IDE/ERIA-GSM) predicting the long-run impacts of various transport infrastructure developments on the location of the industrial agglomeration (Kumagai, *et al*, 2008).

### *5.3.1. Geographical simulation model based on New Economic Geography*

Here, we present the outlines of the IDE/ERIA-GSM. The IDE/ERIA-GSM covers the Continental South East Asia (CSEA),” which comprises 10 countries/regions, namely, the CLMV countries, Thailand, Malaysia, Singapore, and Yunnan (China), Bangladesh, and India. The IDE/ERIA-GSM is a gravity model which signifies geographical distances and economic size. The IDE/ERIA-GSM model is unique in several aspects. First, the model converts geographical distances between cities into truck driving time. This makes it possible to analyze the effect of simplification of custom procedures because the procedures can be measured in time. Second, the model is a city/sub-region model. It covers a total of 324 sub-national regions of GDP by sector (primary, secondary and tertiary industries), employees by sector (primary, secondary and tertiary industries), longitude and latitude, and area of arable land. The model includes 486 major cities and 613 links that are mainly based on the Asian Highway networks cities. Third, the regional data and the routes data between cities are compatible. For instance, all the cities on the routes data are appeared on the regional data, with other attributions of the city (region), especially, latitude and longitude. However, most regions of China (excluding Yunnan) and the rest of the world are not included in the current model.

The idea of the IDE/ERIA-GSM comes from the model developed by Fujita, Krugman and Venables (1999)<sup>9</sup>, Fujita, Krugman and Mori (1999), and Midelfart-Knarvik, *et al* (2001 and 2002), which explicitly incorporates transportation

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<sup>9</sup> See Chapter 6, in particular.

costs or service link costs. In the model, a city having good access to the other cities tends to increase in population, because 1) the city can sell the goods to other cities at lower price due to low service link costs, and 2) the city can buy the goods from other cities at lower cost. As a result, firms in the city can generate increased profits, and can employ labor at higher wage rates. The labor force, therefore, would move from the city in which the real wage is lower to the city in which the real wage is higher. The IDE/ERIA-GSM calculates the dynamics of the population, or the movement of labor, based on the differences in the real wages between countries/ regions/ industries. The IDE/ERIA-GSM is able to set the speed of adjustment differently for inter-country/ inter-region/ inter-industry labor movement.

### 5.3.2. *Maintained assumptions*

We set several macroeconomic and demographic parameters constant and change only logistic settings by scenario. We maintain the following macro parameters across the scenarios:

- GDP per capita of each country is assumed to increase by the average rate for the year 2000-2005, other things being equal<sup>10</sup>.
- National population of each country is assumed to increase by the rate forecast by UNFPA until year 2025.
- There is no immigration between CSEA and the rest of the world.

### 5.3.3. *Base-line scenario*

Base-line scenario set the following assumptions:

- The Asian Highway networks all exist and cars can run at 40km/h across the highway.
- The border costs, or the times required for customs clearances are as follows:

Singapore – Malaysia:	2.0 hours
Malaysia – Thailand:	8.0 hours
All other national borders:	24.0 hours

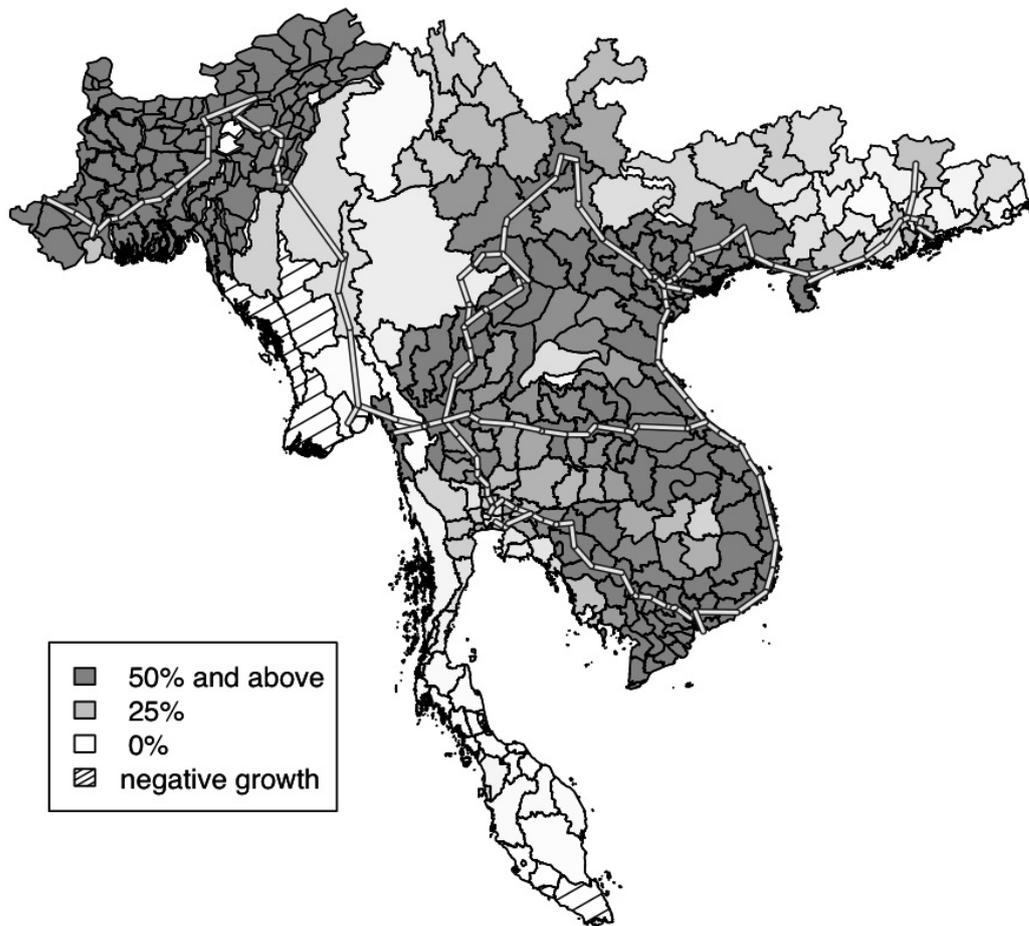
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<sup>10</sup> The growth rate of GDP per capita in each city is likely to differ from the national average for a variety of reasons, and this was actually so in the simulation.

#### 5.3.4. Fully developed economic corridor scenario and results

We set a scenario with the assumptions of the fully developed economic corridors, namely, East-West Economic Corridor (EWEC), North-South Economic Corridor, Southern Economic Corridor, and the Asia Highway No. 1. Trucks can drive on all the above routes at 80 km/h, and other highway at 40km/h. In addition, along these economic corridors, trucks can pass without any border control. Figure 5-2 shows the differences in GDP at 2025 between this and the baseline scenario. Many cities can enjoy large benefits from the fully developed economic corridors. A well-designed development plan would produce bright perspectives on the cities along the economic corridors and highways.

**Figure 5-2: Economic corridor simulation**



Source: Kumagai, *et al* (2008).

### 5.3.5. Effects of customs facilitation

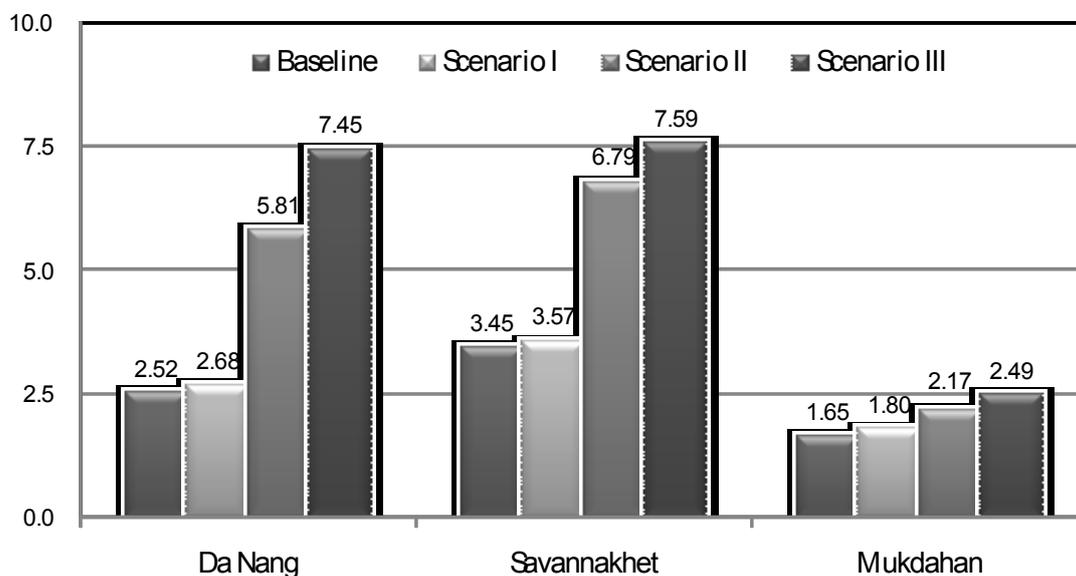
There are a number of border barriers in East Asia. Trade facilitation measures are expected to generate the large effect. In order to see the effect, two scenarios, that are, EWEC (physical infrastructure only) and EWEC (customs facilitation at borders only) are simulated. In the scenario I, trucks can drive at 80km/h on the EWEC but 40km/h on other road. In the scenario II, trucks drive at 40km/h on all the routes, and can pass the EWEC borders without any waiting time. In the scenario III, truck can drive 80km/h on the EWEC and pass the border without any border controls (Table 5-2). The simulation obtained the results that custom facilitation at border has a large effect (Figure 5-3). The simulation results imply that custom facilitation measures are quite important for the development of rural cities.

**Table 5-2: Main assumptions for simulation analyses**

Scenario		Speed on EWEC	Time required at EWEC borders
Baseline		40 km/h	24 hours
I	EWEC	80 km/h	24 hours
II	Facilitation	40 km/h	0 hour
III	EWEC+ Facilitation	80 km/h	0 hour

Source: Kumagai, *et al* (2008).

**Figure 5-3: Gains in GDP by Scenario for Selected Regions (2025) from EWEC**



Source: Kumagai, *et al* (2008).

#### 5.4. Implication of the geographical model simulation results

There is a strong suspicion that only Bangkok and Hanoi benefit from the EWEC but other cities do not. The preliminary simulation results clear up such concerns. The development of EWEC “might” greatly change the geographical distribution of population and agglomeration of industry and significantly benefits the cities along it, as cities along the EWEC are expected to attract population and industry. On the other hand, the cities along the better transport infrastructure are not necessarily going to benefit from it. This means, the development of transport infrastructure will give grade effect on population and industry in the region.

The NSEC benefits northern Vietnam, northern Laos and southern Yunnan province. On the other hand, SEC benefits most of the regions in Cambodia and southern Vietnam. The economic corridors of EWEC, NSEC and SEC seem to be highly complementary projects. Assuming all the economic corridors are developed together, most of the regions in the Greater Mekong Subregion (GMS), except for Myanmar, will benefit.

The North-South Economic Corridor has promoted the traditional type of trade in

which Laos, Myanmar and Thailand export agricultural products to China, and China exports manufactured products to those ASEAN countries. In contrast, the East-West Economic Corridor, which has not performed well until now, is expected to agglomerate manufacturing industry within continental Southeast Asian countries, and promote the new type of trade in which the continental countries export parts and components each other.

To actually realize the estimated results, service link costs must be reduced by the reduction of the border barriers such as the streamlining of customs procedures (the ASEAN Single Window and possibly its extension to an East Asian wide single window system), efficient transportation, financial and insurance services (liberalization of trade in services such as transportation, finance, insurance, professional services related to transportation and logistics services). Also, network set-up costs are to be reduced by the establishment of industrial estates and investor friendly services by central and local government, which will enable investors to calculate costs and time for start-up businesses. In this regard, the special economic zones (SEZs), where those infrastructure and services can be well organized, are to be established.

### **5.5. Infrastructure development in island nations**

The continental Southeast Asian countries can clearly benefit from the economic corridors. Southeast Asia's island countries (Brunei, Indonesia, the Philippines, and some parts of Malaysia), on the other hand, cannot get direct benefits like the continent countries. To grow together with the continental countries, the island countries need to reduce service link costs through comprehensive trade facilitation measures as well as through infrastructure development, such as inland road networks and sea and air port facilities that will better link it to the continental Southeast Asian countries.

The island Southeast Asian countries are themselves undertaking comprehensive liberalization of its transportation sectors through the Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA) initiative. They are currently studying the "corridor concept" as a strategy for accelerating the development of a sub-regional multimodal transport connectivity and for enhancing cross-border trade, tourism, and investment within the sub-region. The success of these corridor concepts will leverage on existing and ongoing initiatives such as

enhancement of transportation connectivity through the expansion of air linkages, interstate mobility of buses and coaches and promotion of sea transport and linkages.

## **5.6. Special economic zones**

The forces of agglomeration and fragmentation have generated production-condition-oriented industrial location and have constructed sophisticated international production and distribution networks in East Asia. As associated with economies of scale in production, fragmented production blocks tend to concentrate in a limited number of locations with low service link costs that also tend to enjoy scale merits.

As a consequence, some countries, regions and cities may attract more and more firms and population; others may be left vacant. To obtain the full benefits of economic integration in East Asia, individual countries, regions and cities need to launch industrial development measures to promote industrial clusters, as mentioned in section 5.1.

Special economic zones (SEZs) have been widely established in East Asia and have proven to be an effective program for industrial development. Export-oriented industries that had led the East Asian developing economies are typically located in export processing zones (EPZs), a major functional type of SEZs. SEZs may also include free trade zones (FTZs), general industrial zones (GIZs) and industry-specific zones such as electronics, garment, financial and even tourism.

SEZs are designed to insulate themselves from the rest of the economies, where business and investment climate are often unfavorable to investors, foreign ones in particular. SEZs, EPZs in particular, are enclaves that are treated as being outside the customs territory of the host state, where export-oriented activities are undertaken, and such activities benefit from a favorable tax regime and the exemption of duties. SEZs are also provided with better infrastructure services, e.g. transportation, telecommunication and energy. It is much easier for the government of a host country to intensively construct infrastructure that is exclusively for use in enclave SEZs rather than develop a nation-wide infrastructure of the same caliber.

Firms located in SEZs, thus, enjoy improved business and investment climate at lower service link costs for the connection with other fragmented production blocks and

markets in East Asia. It could be an effective industrial development strategy to establish SEZs in cities identified by ERIA's simulation (described in 5-3) as offering high potential.

## **6. INFRASTRUCTURE FOR EQUITABLE ECONOMIC DEVELOPMENT**

Infrastructure is a key factor in economic development. Infrastructure development can also help in narrowing development gaps between developed and laggard regions. Infrastructure, especially transport and connectivity, is crucial for regional cooperation and integration. In the absence of efficient physical connectivity, any initiatives taken towards regional trade liberalization will remain ineffective. The ASEAN Secretariat has identified infrastructure development as one of the Priority Integrated Sectors (PIS) of the ASEAN Economic Community. It would also be of crucial importance for programs of regional economic cooperation and integration within the EAS framework. It was in that context that infrastructure development was studied as part of the ERIA work program.

### **6.1. East Asian index of infrastructure development**

Based on estimated scores of infrastructure index for three separate years, we ranked the countries in descending order. As expected, developed countries occupied the top ten positions in infrastructure development, of which one is from North America (USA), two are from Asia (Japan and Singapore) and the remaining seven countries are from Europe. The bottom ten positions are occupied by LDCs from Africa and Asia, such as Myanmar and Cambodia. Developing countries occupy the middle ranks of the ladder. Given the estimated ranks, LDCs and land-locked countries across the world suffer most from infrastructure inadequacy.

Within East Asia (ASEAN+6), we find a heterogeneous group, with Japan, Singapore and New Zealand occupying the top three positions. They, along with Republic of Korea, also rank among the top 15 in the world. Lao PDR, Myanmar and Cambodia occupy the bottom three positions in East Asia. Ten of the 16 East Asian countries successfully increased their global ranking between 1991 and 2005, while the rankings of the other six countries declined.

On the whole the Infrastructure Index reveals a very wide gap in terms of infrastructure availability across the EAS region, a gap that seems to have widened,

rather than narrowed, over time. Hence, infrastructure development in the lagging regions needs to be paid due attention if the regional inequalities are not to widen further. The index could be developed further to analyze the role of other aspects of infrastructure, including social infrastructure, and examine its interactions with other variables of socio-economic development, as well as its role in determining the investment climate.

**Table 6-1: Changing Ranks of East Asian Countries in the world in Infrastructure Development**

	1991	2000	2005
Japan	5	4	2
Singapore	6	2	3
New Zealand	13	12	14
Korea	26	15	15
Australia	7	16	16
Malaysia	37	27	29
Brunei	27	31	36
China	49	43	39
Thailand	43	38	42
India	50	49	51
Vietnam	92	75	61
Indonesia	69	63	62
Philippines	76	65	63
Lao PDR	99	84	92
Myanmar	90	91	95
Cambodia	100	93	98

*Source:* Kumar and De (2008) and RIS (2008).

## **6.2. A regional financing mechanism for infrastructure development**

The East Asian Infrastructure Index reveals very wide gaps in terms of infrastructure availability across the EAS region that seems to have widened, rather than narrowed, over time. Hence, infrastructure development in the lagging regions needs to be paid due attention if the regional inequalities are not to widen further. In order to bridge the infrastructure deficits across the region, a huge magnitude of resources would be needed, an estimated US\$ 200-500 billion per year. On the other hand, the region's

foreign exchange reserves now add up to more than US\$ 3 trillion, far in excess of their bop liquidity needs and that remains invested in western securities, earning negative rates of return in the absence of a regional framework for their fruitful deployment. The Study Group's attention was drawn to an RIS<sup>11</sup> proposal that creation of a regional mechanism to mobilize a very small proportion of these reserves for development of regional cross-border connectivity and other infrastructure would be highly productive. It might also assist in generation of new demand within the region and help reduce global imbalances. The Group felt that this proposal needs to be examined further by EAS policymakers, especially the modalities for operationalizing the regional mechanism through existing regional institutions or creating a new one.

### **6.3. Financing infrastructure development**

The construction of infrastructure and the provision of infrastructure services, including logistics infrastructure, is always costly. The total amount of investment is often enormous, the projects are prone to being exposed to unexpected risks, and the returns on the projects take a very long time to realize, and returns may only be partial due to the existence of externalities. Governments of developing countries well recognize the importance of infrastructure development while facing serious fiscal constraints. Particularly in East Asia, the demand for infrastructure development is huge, despite financial difficulties.

We have to realize that contemporary financial techniques provide various options. In the past, the procurement of infrastructure services was almost automatically taken care of by the government, emphasizing the existence of positive externalities. From the beginning of the 1980s, however, we were under the influence of economic conservatism and tried to minimize the role of government. We thought that whenever possible, infrastructure procurement should be taken care of by the private sector. Such a philosophy certainly enhanced efficiency; however, a number of less developed countries experienced rather substantial delays in infrastructure development. If we only have two polar choices, i.e., 100% public and 100% private, various needs for infrastructure services cannot be met. Since the late 1990s, therefore, the idea of the

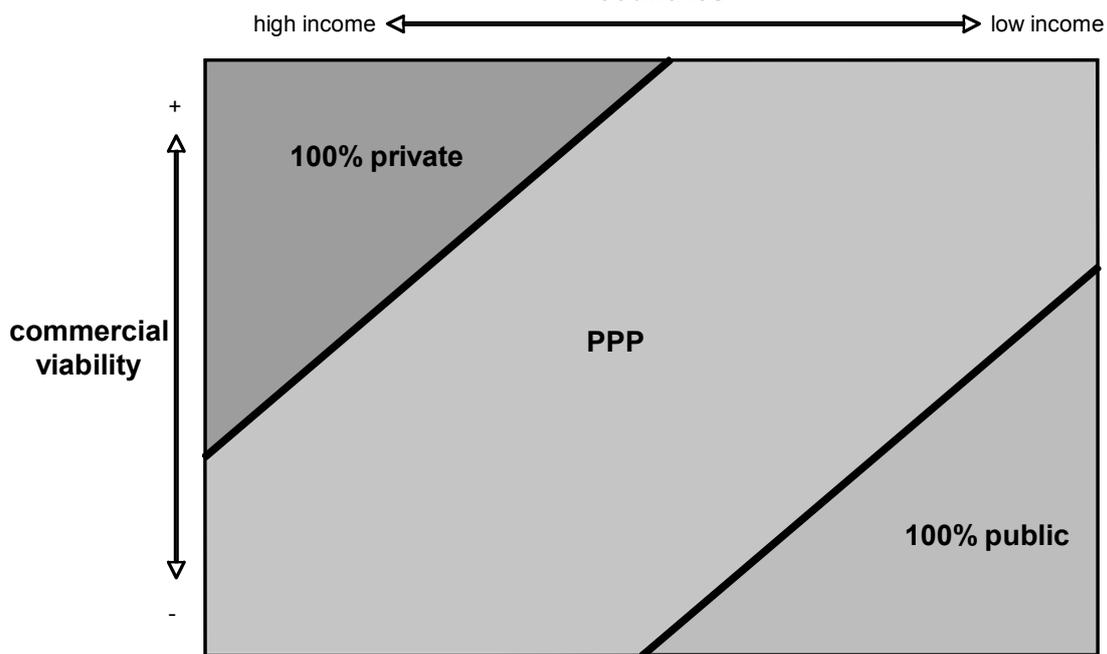
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<sup>11</sup> Research and Information System for Development Countries.

public-private partnership (PPP) has gradually been recognized (Figure 6-1).

In this regard, the outlook for infrastructural improvement in India looks promising. With experience gained in PPPs, formulation of model PPP and concession agreements, infrastructure investments should gain momentum over the coming years. The outlook for infrastructure will depend on how investments in infrastructure are facilitated. Such investments require long-term funding, with long payback periods, which might be appropriate for insurance and pension funds. Thus, success on the infrastructure front will be facilitated by the development of a vibrant bond market, and pension and insurance reforms. A single, unified exchange-traded market for corporate bonds would help create a mature debt market for financing infrastructure.

**Figure 6-1: Infrastructure projects and commercial viability countries**



By Mitsuhiro Maeda.

The PPP, in this context, would design and implement infrastructure development and administrative services with proper cost bearing and risk sharing between the public and the private sectors. Even if a project as a whole is not fully economically viable, the private sector can introduce market dynamism with appropriate involvement of the public sector. Indeed, we recently observed various innovative designs for PPP for infrastructure development in electricity, roads, railways, ports, airports, water supply

and sewerage, various public services, etc..

The key is to properly design the project in terms of the crude design, ownership of assets, operation and maintenance, finance, implementation risks, etc. Once the mechanism of the PPP is effectively employed, we can utilize various financial resources, including both official development assistance and hard commercial loans, which are available for developing countries. The development of a revenue bond mechanism would also be an effective initiative for circulating Asian financial resources for our own development.

#### **6.4. An East Asian Infrastructure Development Committee for sharing best practices and promoting regional cooperation**

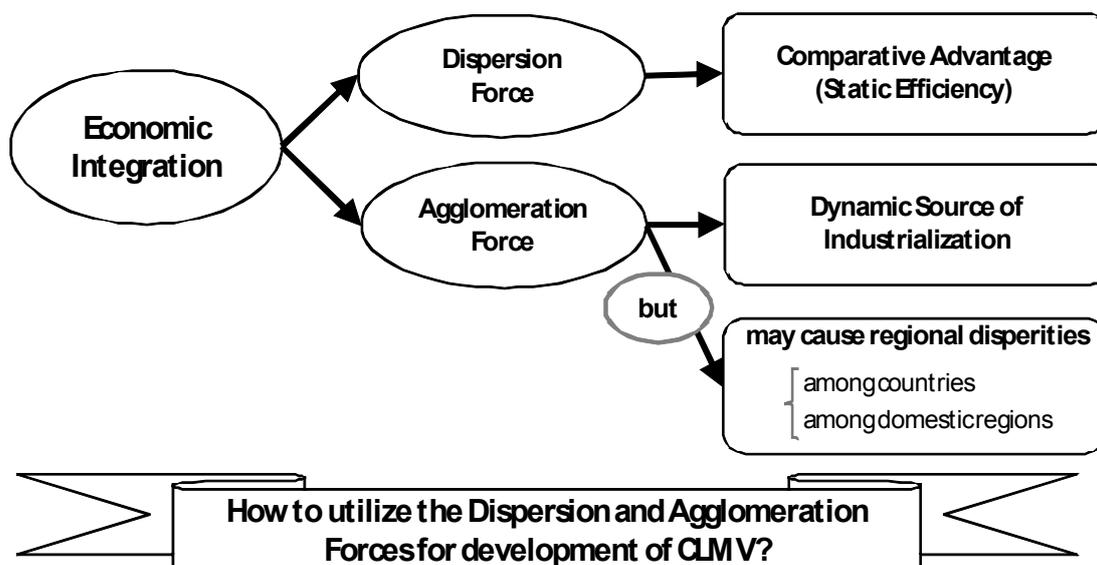
Our country studies on infrastructure (China, India, Indonesia, Lao PDR, Malaysia, Singapore, Thailand and Vietnam) highlight a number of issues, experiments and challenges faced by EAS countries in terms of developing infrastructure. Raising resources, the relative roles of the public and private sectors, models of public-private partnership (PPP), institutional and regulatory capacity, regional inequalities, development of rural infrastructure, and cross-subsidization of infrastructure delivery, policy issues or soft infrastructure that includes regulations and procedure with regard to customs valuation, cabotage rules, conformity assessment procedures, are just some of the relevant issues.

Given the richness of experiments, there is tremendous scope for learning from each other and sharing developmental experiences across EAS countries, e.g. development of ASEAN's single window, Indian experiences in funding of highway development program in India through imposition of cess on petroleum sales, Japanese experiences in modernizing its transportation sector, experiments with respect to viability gap funding for PPP in India, et al. The Study Group, hence, recommends establishment of a structured dialogue between infrastructure, especially transport, authorities of EAS countries to facilitate mutual cooperation and sharing of development experiences and expertise for capacity-building. This mechanism or the East Asian Infrastructure Development Committee could report to Meetings of EAS Infrastructure and Transport Ministers.

## 7. DEVELOPMENT STRATEGY FOR CLMV IN THE AGE OF ECONOMIC INTEGRATION

Huge development gaps still remain in East Asia, as can be observed by the more than hundredfold disparity in GDP per capita (Figure 2-3). We must squarely face up to this challenging reality. At the same time, however, when proper policy environments are provided, this disparity can be turned into a source of economic dynamism for the region through effective utilization of globalizing forces. In other words, the disparity itself can be the driving force to narrow development gaps. This claim is strongly supported by the development experiences of forerunning ASEAN countries.

**Figure 7-1: Development strategy for CLMV in the age of economic integration**



In view of increasingly intensifying global competition, the development strategy of each country should be designed to effectively utilize dispersion and agglomeration forces in production and distribution networking (Figure 7-1). Along the development path, the key issues will start from how to participate in networks, and shift to how to formulate industrial agglomeration, and then how to upgrade industrial structure. Therefore, necessary policy measures differ by country, according to country-specific

conditions such as the phase of economic development, factor endowments, and location.

In order to intensively investigate the development strategies tailored for the latecomers in ASEAN, namely Cambodia, Lao PDR, Myanmar, and Vietnam (CLMV), an ERIA research project entitled “*Development Strategy for CLMV in the Age of Economic Integration*” has been conducted. This chapter summarizes the main findings and policy recommendations.

### **7.1. Narrowing development gaps**

Regional economic integration has been rapidly progressing in East Asia, with increasing numbers of FTAs and EPAs. Liberalization of international trade and investment accompanying the process of integration is expected to accelerate economic growth of the whole region. At the same time, however, there remain persistent concerns that economic integration may also expand the existing development gaps among individual member countries, as well as among domestic regions in each country. If such regional development gaps continue to expand, it could hamper the progress of regional integration in the East Asia.

Though the new members of ASEAN, CLMV, share many similar circumstances, the group also has many differences, e.g. market size, economic priority, etc. For example, while Vietnam has achieved high levels of economic development, per capita income and industrialization, the rest of the group still shares low income and limited human resources.

CLMV share common characteristics, such that they are transition economies, there is prevailing high poverty incidence, their economies are agro-based and there are weak institutions to support market economies. Although CLMV countries have enjoyed a certain degree of macroeconomic stability in recent years and are considered as some of the fastest-growing economies in the region, unemployment and under-employment still persistently exist. The CLMV countries still face huge challenges in fighting poverty and narrowing gaps in wealth among their populations, as well as development gaps among regions, especially rural and urban areas, within their countries.

Though there are some different constraints in the process of development by

individual country, CLMV have vast potential for future development. The development of CLMV has to be depending on individual country effort and support from development partners in and outside the region.

ASEAN is strongly committed to regional integration with a special emphasis on narrowing the development gap among its members. Within this context, the Initiative for ASEAN Integration (IAI) Work Plan for Narrowing the Development Gap within ASEAN was adopted to assist new member Countries with the aim of narrowing the development gaps among ASEAN member countries and expediting greater regional economic integration, promoting equitable economic development and helping to alleviate poverty in CLMV.

Narrowing development gap is consistent with ASEAN's commitment to build an economic community. A fully integrated ASEAN will sustain its relevance, enhance its competitiveness in the face of the increasing challenges of globalization and regionalization, and will serve as a catalyst for strengthening East Asian economic integration. Moreover, an economically strong ASEAN will not only benefit ASEAN alone, but also its partners. Therefore, the integration of ASEAN remains a critical factor which will be of significant benefits to East Asia as a whole.

## **7.2. Challenges ahead of CLMV and the role of regional partners**

This project aims to frame the development strategies for CLMV in the age of globalization and to help narrow development gaps among countries in the region. The focuses are based on the assessment of economic performance, economic reform programs, challenges and policy recommendations for CLMV as a group, for individual countries, and for external partners to achieve substantial development of CLMV economies.

### *7.2.1. Cambodia*

Since Cambodia achieved peace and national reconciliation through the 1991 Paris Accord and 1993 General Election, Cambodia has enjoyed a broad degree of macroeconomic stability and development. Though starting from a very low base, Cambodia is considered one of the fastest-growing economies in the region, with double-digit growth rates and macro-economic stability for the past five years.

However, many development challenges persist, including a high poverty rate, a big income gap, a low production base and poor human resources. The main sectors that contribute to economic growth are the garment industry, tourism, construction and agriculture. The country is implementing the 3rd Five Year Plan, the National Strategic Development Plan (NSDP; 2006-2010), to implement the Government's Triangular Strategy, which focuses on growth, employment, equity and efficiency. Cambodian has very few finished products, and they are usually of such poor quality that they cannot compete with similar products imported from neighboring countries. Human resource development and promotion of trade and investment are very crucial for future development (Chap, 2008a).

#### *7.2.2. Lao PDR*

Within the context of regional economic integration, Lao PDR has been facing numerous challenges as the country being one of the least developed countries (LDCs) in the world. Hence, the Lao government has called for a long-term socioeconomic development strategy with the goal to graduate from the status of LDC by the year 2020. To achieve this goal, the Lao government has made great efforts to build a relatively comprehensive development strategy framework, which includes the Industrialization and Modernization Strategy, the Sixth National Development Plan (2006-2010), the National Growth and Poverty Eradication Strategy (NGPES) and sectoral long-term development strategies. However, to implement the government's development strategy framework based on the country's specific potential and opportunities successfully to narrow the country's development gap within the region, some policy recommendations to be emphasized from a research perspective might be taken into account, namely; (1) infrastructure development with a focus on land-linked countries and economic corridors; (2) strengthening the private sector by promoting SMEs and developing markets, namely, financial, labour, and real estate markets; (3) developing the tourism industry by promoting cultural, eco-based, and historical tourism in the country as a sustainable tourist friendly destination; (4) natural resource based industry both as environmental friendly and economic efficiently industry; (5) promoting processing industries in the country for export and domestic consumption; and (6) human resource development with a focus on vocational schools and training for skilled labour.

### 7.2.3. Myanmar

Myanmar has a vast potential for future economic development due to a big local market, abundant natural resources and a young labor force, all of which have not yet been fully tapped. Though Myanmar is facing many challenges in dealing with domestic and international problems, the country is committed to integrating its economy into the region. The four economic objectives (Basic Economic Guidelines towards Democratic State) are: (1) development of agriculture as the base and all-round development of other sectors of the economy as well; (2) proper evolution of the market-oriented system; (3) development of the economy by inviting participation in terms of technical know-how and investments from sources inside the country and abroad; and (4) the initiative to shape national economy must be kept in the hands of the state and the national peoples. Accelerating economic reforms, especially financial reforms, and re-aligning exchange rates, promoting SMEs, Special Economic Zones and taking advantage of its geographical location between China, India and ASEAN will promote Myanmar's economic development (Kan Zaw, 2008).

### 7.2.4. Vietnam

Vietnam has good conditions to progress in reforming itself. The process of economic reform initiated since 1986, with an important view to pro-actively engaging in international economic integration, has brought about important socio-economic achievements, and laid more concrete foundations for future economic development in the country. Yet, the country still faces many challenges in further reforming itself, which makes realizing its development goals a challenging task. Vietnam has set some ambitious basic development objectives for the years to come: (1) to sustain high economic growth; (2) to escape the status of a poor country by 2010 (there is a high possibility that the objective will be realized in 2008); (3) to accelerate industrialization and modernization process so that by 2020, the country will basically become "a modern-oriented industrialized country"; and (4) to make the slogan "Prosperous people, a forceful country, and an equitable, democratic and civilized society" a reality.

The main policy recommendations are (1) to promote country's comparative advantages moving up along the value chain by: (i) diversifying/differentiating export products and strengthening non-price competitiveness; (ii) attracting efficient FDI; and (iii) improving labor and management skills; (2) to accelerate SOE reform, with the

focus on the large SOEs, by means of securitization and listing on the stock market; (3) to establish better prerequisites for development of the financial market, especially the corporate bond market; build up an effective financial supervision system and appropriate capital account liberalization; and (4) to deepen the tax reforms, especially those associated with the taxation administration and assets tax, to broaden the tax base (Vo, 2008a).

#### *7.2.5. Thailand*

As a close neighbor, Thailand plays a very important role in economic cooperation with CLMV. Thailand's famous policy, "prospering its neighbors," has been started since early 1990s. To determine the importance of trade on economic development, we calculated the trade to GDP ratios for Thailand and CLMV (Chaisrisawatsuk, 2008). The higher the trade to GDP ratio, the more important trade is to the economy. The volume of international trade has been increasing not only for Thailand but also its neighboring countries. With Thailand leading the pack, the role of international trade in improving per capita income has been significant, especially in Cambodia and Vietnam. Trade between Thailand and its neighbors has also increased over the last decade. Thailand should help CLMV with capacity building, especially to improve human capital and productivity and encourage participation from private sector; to synchronize domestic rural development plan with international cooperative development programs; to build economic networking in the region to achieve the goal of narrowing development gap. Logistics networking can be a starting point of further networking so that the region will be developed into a single hub.

#### *7.2.6. ASEAN*

There is no doubt that the integration gap, also a development gap, is an important concern because the level of ASEAN integration achieved at the end of the day will decide whether the regional grouping will be able to face increasingly stiff globalizing economic headwinds. However, given the possibility that the development gap within the three-tiered grouping may widen further because benefits arising out of globalization may become even more unevenly distributed among the disparate members of the grouping, the integration gap could be considered not as critical as the previously mentioned three development gaps, viz. infrastructure gap, income gap, and

institutional gap. After all, the quantum of trade between ASEAN-6 and the CLMV countries remains trivial, and integration does not seem to be actually that important a concern for ASEAN, as suggested by its actions when it devised new rules to accommodate members' requests for delays in the inclusion of certain products in the coverage of AFTA. And since the integration gap could be considered not as critical as the infrastructure gap, income gap, and institutional gap, the IAI Work Plan could thus divert some resources away from projects that presently come under the area of "Regional Economic Integration."

#### *7.2.7. China, Japan and Korea*

China, Japan and Korea are the most important partners to help develop CLMV to the next level of development. Increasing amounts of trade and investment from these countries will help promote CLMV economies through the promotion of technology transfer, skills enhancement, job creation, capital mobilization and infrastructure improvement. Official Development Assistance (ODA) from these countries is still vital for CLMV to build the foundations of economic development and help in implementing reform programs. To promote cooperation between CLMV and China, Japan and Korea, CLMV countries should provide competent workers, produce quality products and adopt open door policies to attract FDI from these countries. China, Japan and Korea should continue to support the development of economic and social infrastructure that is in great demand in CLMV countries, and provide assistance to reduce trade imbalances as well. To implement region-wide development efficiently and effectively, it is essential to conduct studies related to the benefits/costs of region-wide development brought by training and capacity building as well as by mechanisms supporting cross-border economic transactions (Hao, 2008; Uchida and Kudo, 2008; and Cheong, 2008).

### **7.3. Policy recommendations**

Policy recommendations derived from this project are expected to provide a basic direction for the development strategies of CLMV countries. However, the specific policy measures are to be determined by each government, according to country-specific conditions. For example, the individual paths of the industry

upgrading should be chosen to reflect the resource endowment and other socioeconomic conditions in each country. Similarly, the most desirable process for development cooperation between CLMV and other East Asian countries also depends on the current status of the international relations. Therefore, country-specific and relation-specific conditions for individual problems should also be taken into consideration.

The following are three policy recommendations that can be regarded as the most urgent and relevant for CLMV as a whole<sup>12</sup>.

### *7.3.1. The development and utilization of special economic zones in CLMV*

The CLMV economies have not been deeply integrated into the East Asian production and distribution networks in spite of their various location advantages, notably abundant, reasonably well-educated and low-waged labor forces. Underdeveloped infrastructure, logistics in particular, and poor investment climates hinder them from participating in such networks in East Asia. Service link costs and other business costs in CLMV have not become low enough to realize total costs reduction.

Special Economic Zones (SEZs) including Export Processing Zones (EPZs) could be a good policy tool to reduce the business and transaction costs that are embedded in the CLMV economies. SEZs will provide well-developed infrastructure with intensive capital investments in the demarcated production sites. SEZs will also provide efficient administrative procedures, including one-stop services for export and import, business services such as offshore banking and logistics, and governmental support for human resource development and technological transfer. All these efficient services will be made possible in SEZs by insulating them from the rest of the country, where investment climate is generally poor.

SEZs can be located along border areas, since border industry can offer a solution how to overcome high business and service-link costs in the CLMV economies. SEZs located in the border areas can connect to the regional and global economy through their borders with neighboring countries, Thailand in particular, which have logistic hubs such as deep seaports, airports, and trunk roads. Thus, firms, including multi-national companies (MNCs) located in the border areas of CLMV, can enjoy location advantages

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<sup>12</sup> For more policy recommendations, including country-specific ones, refer to Chap (2008a).

such as wage differences, while realizing total cost reduction with lower service link costs. Therefore, CLMV should develop SEZs in the locations with close linkages to transportation hubs. To develop SEZs, each country should provide a favorable legal framework, master plans, infrastructure, land clearance support, after-care services and close links between owners and potential investors, especially leading firms.

### *7.3.2. Transport network (hub) development*

The CLMV countries are endowed with excellent potential of geographic advantage: they face both the Pacific and Indian Oceans and are also adjacent to remarkably growing Asian countries such as China, India and Thailand. In order to fully exploit this geographical advantage, they need to develop a good logistics network that links major cities and ports in the above countries and CLMV. In fact, some parts of the network have been already constructed by the Greater Mekong Subregion (GMS) program, which is an ADB initiative. The main routes of these economic corridors should be extended and connected with each other by several branch links. In this process, the current schemes of public-private-partnership (PPP) should be improved, so as to promote efficient development and operation of the infrastructures. Moreover, to facilitate trade along these highways, “the ASEAN Framework Agreement on the Facilitation of Goods in Transit” should be continuously implemented.

It should be noted, however, that trade facilitation through construction of transport infrastructure is not enough to attract industrial firms to CLMV and help the countries achieve a vigorous economic growth. On the contrary, the good connections could encourage relocation of industries to clusters in the surrounding countries. In order to effectively utilize the constructed infrastructure for development of the CLMV economies, the governments need to launch some specific policy measures for attracting industrial firms to the sites within CLMV.

One of the most feasible measures is to develop transport hubs in the region. It is well known that a process of reciprocal reinforcement generally works between hub formation and agglomeration development.

A transport hub attracts firms, and this encourages the transport services around the hub, which makes the hub more attractive. In order to initiate these circular causations, it is important to encourage firms that heavily use the transport infrastructures. Note that these firms (transport users) do not necessarily exhibit scale economies nor the

tendency to agglomerate. The CLMV countries can start with fostering conventional industries, such as food, garment, resource-based manufacturing and tourism. When they have successfully attained the critical amount of transport demand to create a hub, they may upgrade the industries to those with more scale economies, e.g. chemical, machinery and electronics.

### *7.3.3. Human resource development: Vocational training and public administration*

The immediate and urgent need for human resource development (HRD) is central to the objective of capacity building in CLMV countries. Specifically, HRD must be implemented based on cost-benefit analysis in which the benefit is optimized and the cost is minimized. Investment in vocational training and public administration will supply the much-needed technical and vocational skilled workers. Upgraded and efficient public administrators facilitate the implementation of domestic reforms and institution building.

Often, developing countries spend their scarce resources and accord high priority to academic-oriented education. However, the tangible benefits of higher education in the form of academic-oriented universities are far less than establishing vocational training, especially in the area of practical technical education.

Another critical element of HRD is the training of public administrators, as they are critically in short supply in all developing countries. Public administrators are the key to the success of domestic reforms and institutional building in CLMV. Notwithstanding a plethora of trade and investment liberalization measures, the critical bottleneck is in the implementation, as there is a severe shortage of trained and capable civil servants and public administrators to implement policy and institutional reform.

It is both urgent and imperative to establish a functioning network of civil-service institutes in East Asia, to which CLMV can send their public administrators for training. In this respect, the Civil Service Institute (CSI) in Singapore has been notable in providing civil service training to ASEAN public administrators. In addition, Singapore and Malaysia have established a close collaboration in civil service training.

## **8. STRATEGIES FOR INDUSTRIAL CLUSTERING: INDUSTRIAL AGGLOMERATION, PRODUCTION NETWORKS AND FDI PROMOTION**

Production networks, comprising a number of nodes and links, have been and will continue to be the key device to transform globalizing forces into the forces to deepen economic integration and to narrow development gaps in East Asia. In order to support this process, a key strategy is to reduce service link costs to make the “links” more efficient, as we discussed extensively in Chapters 3 and 4. Another key strategy is to foster the “nodes” through the formation and continuous upgrading of industrial clusters. Although industrial clusters are formed and upgraded as a result of business activities of the private sector, the role of governments is also important. In order to intensively investigate this issue, an ERIA research project entitled “*Analyses of Industrial Agglomeration, Production Networks and FDI Promotion: Developing Practical Strategies for Industrial Clustering*” has been conducted. This chapter summarizes the main findings and policy recommendations thereof.

### **8.1. Industrial clustering as a development strategy**

The formation and strengthening of industrial bases are one of the conditions for developing countries to achieve economic development and poverty reduction. But even after virtuous cycles for industrial agglomeration are provoked in an industrial region, the region can face serious cost competition with other regions that have ample supplies of low-wage labor. To remain competitive, it is necessary for the region to fully seize the prospective benefits from ongoing regional integration and to upgrade its industrial structure to an innovative industrial cluster where companies conduct a range of research and development (R&D) activities, or collaborate to transfer knowledge and technologies. Nevertheless, mechanisms of forming and upgrading industrial clusters and networking them have not necessarily been empirically examined enough.

The objectives of this project are to conduct comprehensive studies on current conditions of industrial agglomerations, the impact of regional economic integration on industrial organizations in Asia, the characteristics of existing production networks of

industrial agglomerations, and industrial policies including FDI promotion and science and technology (S&T) development. This research project, in its initial phase, explored policy measures to facilitate industrial development and establish complementary relations between industrial agglomerations in ASEAN and East Asia. In other words, the main focus of the project was on prioritizing policy measures for industrial clustering to suggest practical strategies for developing industrial clusters, taking into account industrial development stages and types of industry, and ongoing regional trade and investment liberalization initiatives, as well as the accelerating pace of production networking.

## **8.2. Factors for and against industrial clustering: Observation in case studies**

There are well-established and emerging industrial clusters in ASEAN and East Asia. These clusters consist of various types of industries, such as traditional artisanal, labor-intensive manufacturing, and knowledge-intensive service sectors. Their development is based on a mixture of local, national and international factors promoting industrial agglomeration and clustering. In addition, as a result of economic integration that facilitates trade and investments, industrial clusters in the region have become more dependent on one another, and competition among firms and industrial areas have intensified. These phenomena are reinforced by technological as well as managerial changes such as “modulization” and “fragmentation,” which is typically observed in the automobile and electronic sectors.

### *8.2.1. Factors encouraging industrial clustering*

Although various factors are associated with clustering, a conducive business environment is a fundamental prerequisite for triggering industrial agglomeration, because agglomeration and clustering are driven by the private sector and market forces with appropriate support from the public sector, which includes both national and local conditions that influence decisions on investments by local entrepreneurs and foreign investors.

At the country level, stable macroeconomic environment and government institutional infrastructure, including the legal system, are indispensable for industrial agglomeration. These influence entrepreneurship in local companies by reducing costs

of financing, opening new operations, collaboration with other firms, and access to cutting-edge technologies, information and know-how. These also affect choices of country hosting FDI by multinational companies (MNCs).

Local conditions have a larger influence on companies' selection of specific locations in which to locate. Infrastructure, including roads, ports and utilities and size of local markets, are of notable importance. The existence of supporting industries including suppliers of raw materials and parts, banking, legal consulting, and other business services that support business developments, are crucial, since these developments are related to infrastructure and local markets mentioned above. The establishment of MNCs' production bases contributes to the expansion of local markets.

Liberal trade policies and investment incentives have been the key policy instruments used to entice MNCs, which provide the driving force for industrial development. Liberal trade policies are essential to overcoming constraints, e.g. limited size of local markets and weakness of supporting industries. Investment incentives focus not only on MNCs but also on local companies to promote the development of SMEs and supporting industries. These policies need to be introduced, modified, and restructured in a "timely" way, in accordance with stages of industrial development and the degree of market competition.

All countries and local governments do not necessarily develop the capabilities to meet all of the conditions and introduce policies mentioned above. The policy to develop industrial zones and special economic zones (EPZs) by targeting specific geographic areas is cost-effective to economies under severe fiscal and institutional constraints.

### *8.2.2. Obstacles to industrial clustering*

The findings from most of the surveyed countries indicate that the main obstacles to industrial clustering are largely related to upgrading existing industries in the surveyed regions in comparison with the result of successful industrial development. The shortage of low-cost labor is typical. More serious problems are the shortage of skilled labor and professionals that hinder industrial upgrading and innovations. Another constraint is the lack of upgrading physical and institutional infrastructure such as roads, customs procedures, intellectual property rights, legal systems and legislation, in the absence of which it will be difficult to raise the added-value of products and

improve logistics, production methods, and innovative activities.

Coordination failures are one of the most serious key policy issues differentiating the performance of industrial cluster policies. An issue related to this is missing linkages between firms, business associations, public and private research and development institutes, universities, and national as well as local governments. The roles of local governments, business organizations, or key persons in regions are also crucial for success in organizing public-private partnerships to unify all local initiatives into clustering.

For less developed countries, clustering is a new concept, and is not sufficiently reflected in regional and national policies in these countries, which results in insufficient linkages among related parties.

### **8.3. Factors affecting industrial agglomeration and upgrading:**

#### **Evidence from econometric analyses**

Econometric methods were applied to data collected by mail surveys. To summarize the findings from the econometric analyses, the results of the estimations based on the pooled data are presented in what follows.

#### *8.3.1. Factors promoting industrial agglomerations*

At the beginning of industrial agglomeration, companies started with production that was labor-intensive, aiming at local markets in the closed economy. As mentioned in the case studies, factors such as institutional infrastructure and proximity to suppliers/subcontractors are important for the first movers to the surveyed areas. As ASEAN economies became increasingly open, firms tended to be more export-oriented, facing serious cost competition. Consequently, factors such as low-cost labor, and the protection of intellectual property rights (IPR) emerged as important for firms (latecomers) to open offices there, as they became more and more capital intensive, with business activity shifting to the production of components and parts.

Although investment incentives, liberal trade policies, and variables related infrastructures are not statistically significant, the coefficients on these variables do suggest that investment incentives are important for first movers, while liberal trade policy are essential for latecomers. In addition, first movers seem to attach importance

to physical infrastructure, including roads and ports, while latecomers seem to be more concerned with utilities and telecommunications infrastructure. This implies a need to shift policy in accordance with the stage of industrial development.

### *8.3.2. Factors promoting industrial upgrading*

To verify factors promoting industrial upgrading, we developed econometric models with four types of upgrading carried out by respondents in last three years, which are selected as a dependent variable (Y). The independent variables (Xs) include characteristics of firms and levels of “satisfaction” with 20 factors that were the same as the above-mentioned models of industrial agglomeration. We categorized upgrading into the following four types: (a) introduction of a new good; (b) adoption of a new method of production; (c) opening of a new market; and (d) acquisition of new supply of inputs.

In order to strengthen the analysis of industrial upgrading, we developed another model of upgrading that includes “D-score” analysis. D-score is defined as a simple difference between “importance” and “satisfaction” attached to each of the 20 factors. Larger D-score for a specific business condition implies more dissatisfaction with it.

A key finding from the D-score models is that the legal system has a negative impact on most of the types of innovation carried out by MNCs. It is difficult, however, to identify a common factor that is applicable for all four types of upgrading. For example, estimated signs of the coefficients in the econometric model that includes the level of satisfactions with respect to 20 factors as independent variable suggest that promoting factors depend on the type of upgrading. As for the introduction of a new good, a liberal trade policy is an encouraging factor, while utilities and access to export markets are discouraging factors.

### *8.3.3. Sources of new technologies and information*

From the analyses on the sources of new technologies and information based on the D-score model, MNCs tend to transfer technology from other MNCs and have less technical cooperation or assistance from local governments in comparison with local companies. MNCs that are not satisfied with the local financial system tend to receive technical assistance from foreign agencies, including official development assistance (ODA). But those that have problems with physical infrastructure tend to depend on

technical cooperation or assistance from local business organizations that are familiar with local situations.

On the other hand, local firms that face problems with infrastructure and financial system acquire technologies and information through technical assistance from foreign agencies. But well-designed government institutional infrastructure is an important factor for non-MNCs to encourage firms to receive technical assistances from foreign agencies. Technical cooperation or assistance from local universities, or R&D institutes is also important for firms unsatisfied with financial system.

These findings partly reflect the present situation, with MNCs and non-MNCs having different networks to obtain new technologies and information. In other words, MNCs are carefully observing capabilities of local firms in deciding whether or not to establish closer linkages with local firms.

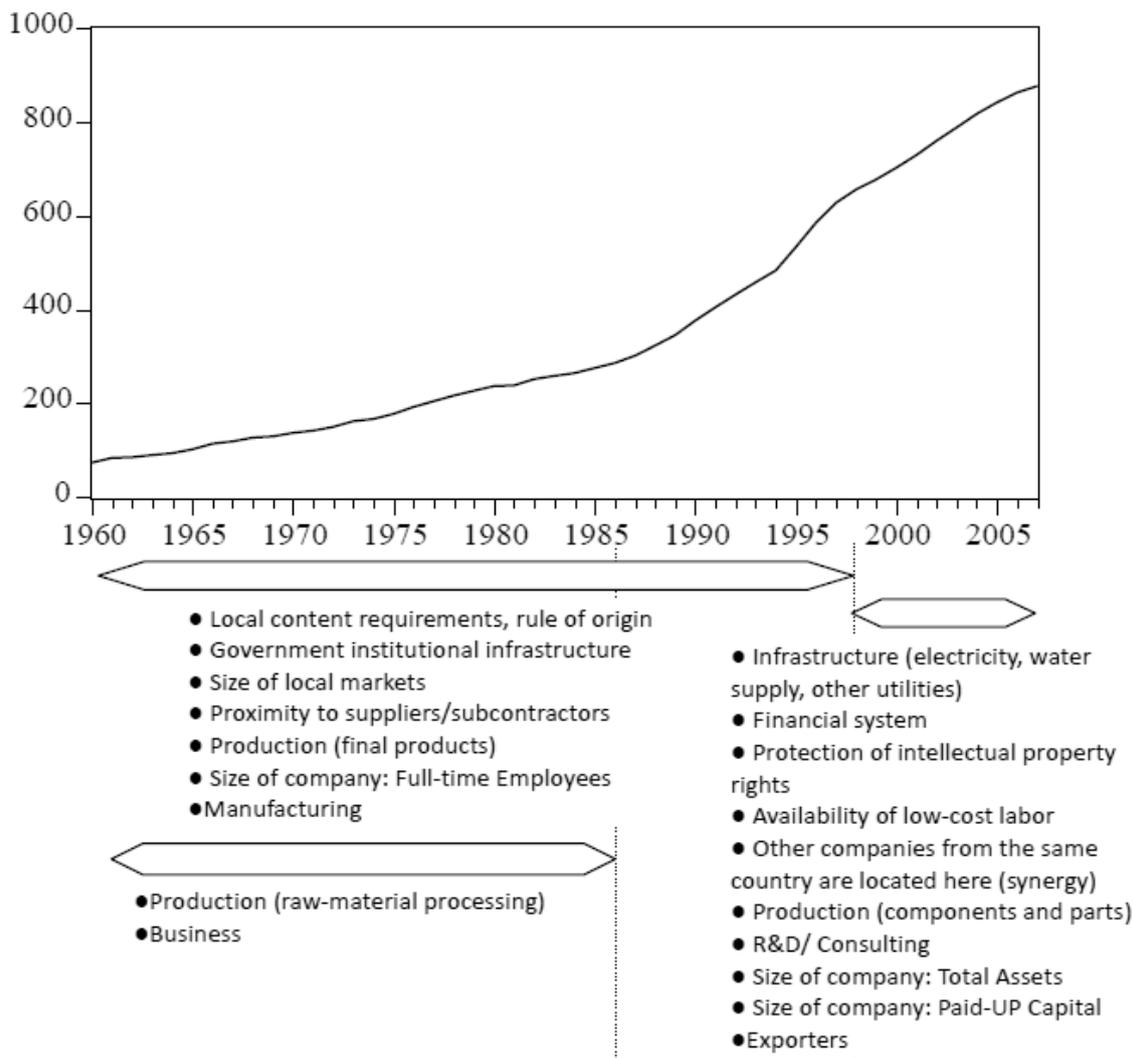
#### *8.3.4. Collaboration among business, universities and governments*

Clustering policies should be determined according to policy priorities and adjusted on a timely basis to meet changes in the business environment. Even though there are no standardized policy packages applicable to all stages of industrial development and all types of innovation, it is imperative to promote interaction among businesses, universities, local governments, other public authorities and other organizations that seek the full benefits of clustering (Figure 8-1).

However, the above-referenced networks, particularly between MNCs and local firms, do not necessarily exist at the beginning, although they represent the key channel for technology diffusion in developing countries. Local firms and business associations are required to consolidate their footholds for absorbing new technologies with the support of local and central governments.

Governments are required to harmonize all local efforts for improving the quality of infrastructure, human resources, and institutional frameworks. Developing these R&D capabilities is considered as “public goods,” which contribute not only to industrial agglomeration but also to knowledge and technology transfers and innovation.

**Figure 8-1: Factors promoting industrial agglomeration**



*Note:*

1. Based on mail surveys conducted in Indonesia, Philippines, Thailand and Vietnam.
2. Indicated factors are statistically significant at 20%.

*Source:* Tsuji and Ueki (2008).

#### **8.4. Policy recommendations**

As countries begin to industrialize, there is a tendency for industries to concentrate initially in areas where physical infrastructure is readily available and subsequently, for related industries, to gravitate closer together, thereby taking advantage of inherent synergies. In the process, industry clusters are formed, with each geographical area specializing in certain activities, leading to spatial diffusion of industries. This is the case not only for early movers like Malaysia and Thailand, but also for the latecomers

like Cambodia and Vietnam. It is important to underscore that this process is essentially a private-sector phenomenon, driven by market forces and aided by government support.

As industrial agglomeration and clustering contribute significantly to economic growth and development through increased competitiveness, there is certainly a case for policies that promote cluster formation. The current focus on physical infrastructure and logistics, liberal trade and investment regimes, economic reforms aimed at privatization and deregulations, practiced in many countries in the region, must continue with increased vigor. Small and medium enterprises, which play an important role as ancillary industries, need much help, as they are beset with various sorts of problems, ranging from lack of market information, bank credit and technical know-how to acute shortages of skilled manpower. Local SMEs are heavily dependent on domestic markets, typically showing no or little interest in exporting. All this calls for policy initiatives at the national level that would provide easier access to factors of production, raw materials, market information and other inputs that would help reduce the cost of doing business for these firms.

Regional initiatives can complement national initiatives in alleviating some of the problems faced by industrial clusters, especially in emerging economies. It is in this spirit that the following three concrete proposals are put forward. These proposals are doable. As the first two proposals would entail large investments, it is suggested that they are financed on a PPP (private-public partnership) basis with both industry and government contributions. The third proposal is envisaged as an entirely private sector affair, albeit recognized and endorsed by the East Asian governments. The latter may help set up such associations, with commercial attaches in embassies playing initially a catalytic and subsequently a facilitating role.

#### *8.4.1. East Asian Centers for Standards and Testing*

The first proposal is to establish East Asian Centers for Standards and Testing for a number of key industries (e.g. electronics, automobiles, machinery, furniture, footwear). This will facilitate harmonization of standards, in addition to certification of standards for all market destinations. A centralized facility for a given industry, catering to the whole region, will reduce cost, thanks to economies of scale and scope. This will also enable products to move more freely within the region once the standards are tested and

certified. This will lead to greater intra-regional specialization and increased intra-industry trade flows, with more and more inputs being sourced externally, which would render the region's industrial products internationally competitive.

#### *8.4.2. East Asian Resource Centers*

The second proposal relates to the establishment of East Asian Resource Centers for selected industries, which will serve not only as repositories of information relating to the focus industry, but also as “intelligence centers” that would gather and disseminate vital information to all the stakeholders and as “alert centers” that would draw the attention of the industry players to new threats, challenges and opportunities. Events, policies, technologies, pronouncements and initiatives in the major markets that would impinge upon the industry will be analyzed by the Resource Center and disseminated quickly for the industry and the relevant ministry to act upon. The timely flow of pertinent information is crucial for strategic planning at the firm level and to facilitate policy adjustments at the ministry level.

#### *8.4.3. East Asia-wide Industry Clubs*

The third proposal calls for the formation of East Asia-wide Industry Clubs for the major industries. These industry associations would enable firms to interact and network with one another and act as lobby groups to influence national, regional and global policies that would impact on the industry interests. The industry clubs can also help the members overcome the problem of acute shortages of skilled workers by promoting skill development. Instead of setting up “regional” technical training facilities to meet the industry needs, it would be cost-effective to make use of existing facilities in the region through mutual accreditation and recognition. The industry clubs can help identify the various training facilities and training programs available in the region. In addition, the industry clubs can mount schemes that would enable its members to send their technicians for hands-on training experience in the workplace of other member firms.

East Asia-wide Industry Clubs are likely to work well, as they provide the “critical mass”, given the extensive regional production network in the EAS region, especially if the EAS can provide an avenue for their concerns and views to be heard by policy makers.

## **9. SME POLICIES IN THE AGE OF GLOBALIZATION**

For the purpose of pursuing deepening economic integration and narrowing development gaps in East Asia, the role of small and medium-sized enterprises (SMEs) are of particular importance. On the one hand, SMEs are expected to play key roles in production networks as suppliers of parts and components. On the other hand, SMEs are expected to function as devices to spread the benefits of economic integration extensively to each country. In order to bring out SMEs' potential, SME policies should be directed to utilizing globalizing forces by facilitating the effective participation into the growing production and distribution networks.

An ERIA research project entitled "*Asian SMEs and Globalization*" has been conducted to examine SME policies in Asian countries within the framework of globalization, taking into account the different stages of industrialization, policy and business environment development in different participating countries. This chapter summarizes the findings and policy recommendations thereof<sup>13</sup>.

### **9.1. The changing role of SMEs in the age of globalization**

Large enterprises (LEs) and SMEs are the two important wheels of development in developing countries. While multinational enterprises (MNEs) and domestic LEs have been playing an important role in accelerating the industrialization process, SMEs provide the crucial industrial linkages to set off a chain reaction of broad-based industrial development. Without SMEs functioning as subcontractors and suppliers of intermediate inputs to MNEs and domestic LEs, industrial development in developing countries will not be able to sustain increases in the domestic value added, employment, productivity and industrial linkages.

In the globalizing era of a borderless world, buttressed by regionalization and liberalization, SMEs provide an important source of domestic employment creation, resilience against external economic fluctuations and a mechanism for local capacity building. It has been widely acknowledged that SMEs are important for economic

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<sup>13</sup> The discussion in this chapter is based on Lim (2008a).

development in all countries.

## **9.2. Current status and challenges of Asian SMEs**

### *9.2.1. Direction of SME policies*

In many cases, SME policies have tried to achieve contradicting objectives, i.e., protecting and promoting SMEs at the same time. Whereas a social safety net is necessary to protect jobs and production in SMEs, it must not mean providing long-term protection against competition. The private sector should take initiatives in the process of SME development, as intervention by government over time would otherwise create economic distortion and misallocation of scarce resources. The role of SME policies is to facilitate the smooth functioning of SME development. SME policies should be flexible enough for SMEs to be able to easily adjust to them.

### *9.2.2. Dynamic change of Asian economies*

#### (1) Subcontracting

Automobile and electrical industries consist of MNEs and foreign or joint venture first-tier subcontractors in many Asian countries. As production volume increased in the Thai automobile industry, MNEs and foreign or joint venture subcontractors in the first tier began to procure components and parts from local companies. Local SMEs in the second and third tiers are formed to supply parts to the subcontractors in the first tier. At this stage technology is transferred from MNEs to local companies efficiently and agglomeration effects become useful.

#### (2) Business Environment

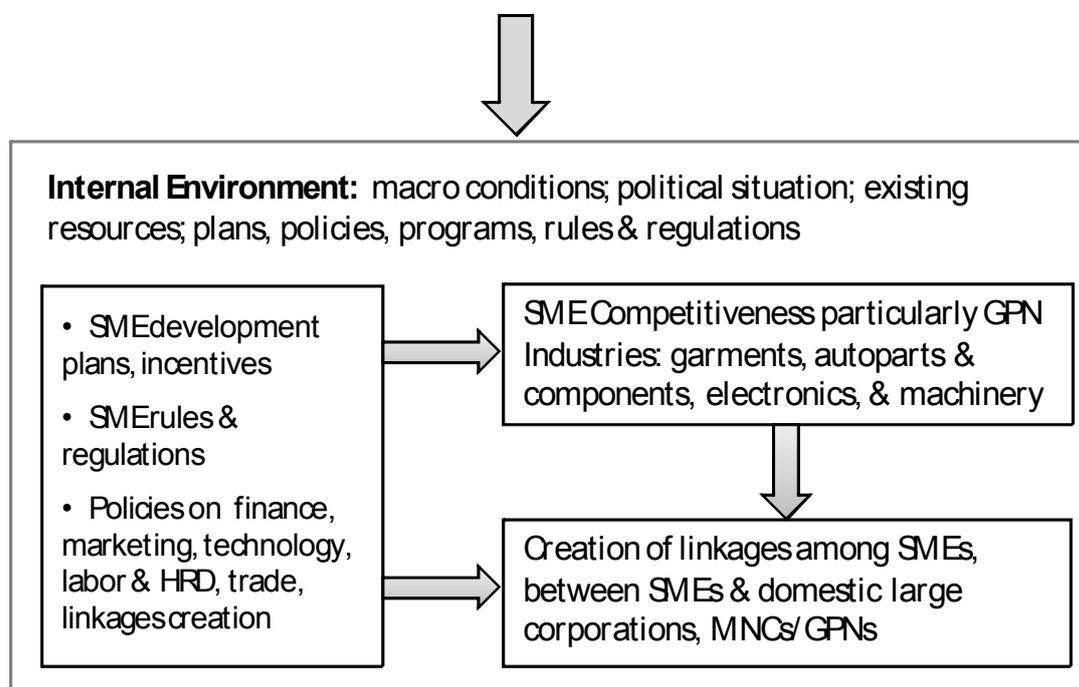
MNEs are strict at selecting subcontractors in ASEAN countries. Only a small number of local SMEs have the chance to be selected as subcontractors in the second tier. Hence, SME promotion policies, simultaneously, should improve competitiveness of existing non-subcontracting enterprises. Moreover, policies should consider private sector initiatives and improve the business environment rather than being directed to meet the specific targets defined by the government.

Labor-intensive industries in Thailand are losing their competitiveness because of rise in wages. Analysis suggests that labor-intensive industries may shift from

Malaysia and Thailand, where wages are rising, to other countries in the future. Low wages are a factor of international competitiveness in labor-intensive industries, e.g. apparel. Improvements in the business environment from, for example, establishing a legal framework, bringing about stability of the macro economy and creating infrastructure, is crucial for the development of SMEs in Cambodia and Laos. The importance of these factors is emphasized by increasing competition in international textiles and garment markets following the abolition of the MFA (Multi-fiber Agreement) in January 2005. Similarly, for some countries like India and Philippines, extending benefits to workers engaged in apparel global production networks (GPNs) requires policy attention (Figure 9-1).

**Figure 9-1: A framework to analyze SMEs in the age of globalization**

**External Environment:** Globalization – trade and investment liberalization, increasing economic integration through bilateral & regional trading arrangements, regional/global production networks (GPNs)



Source: Aldaba (2008).

### (3) Networking

Both China and India have experienced dynamic and rapid economic growth.

Since domestic markets are expanding, subcontracting systems involving local LEs and SMEs have developed. Coordination and exchange of information among SMEs are very important to activate agglomeration effects of industrial clusters. Moreover, SMEs can play an important role to absorb increasing labor force and thereby reduce the problems of unemployment.

#### *9.2.3. Cambodia*

The majority of Cambodian SMEs are still in a very early stage of development. In 2005, over 80 per cent of Cambodian industrial SMEs were engaged in food, beverage and tobacco industries. The SME sector is dominated by family businesses with fewer than 10 employees, processing primary produce for the domestic market. Cambodian SMEs typically use very basic technology and have low total factor and labor productivity. As globalization deepens, they are struggling to compete with imported goods manufactured by SMEs in neighboring countries. There are three key factors impeding the development of Cambodian SMEs: the country's weak regulatory and legal framework, difficulties faced by SMEs in gaining access to financing, and lack of SME support facilities.

#### *9.2.4. China*

SME clusters have been formed in developed coastal areas. Each cluster consists of one or more towns that concentrate on one product. By obtaining economies of scale and scope, SMEs in the clusters can enhance efficiency and reduce costs. Field surveys were undertaken in the Guanlin cable cluster, Shengze textile cluster and Hengshan sewing machine cluster. In these clusters, cooperation among SMEs for procurement and marketing is found to be common. Division of labor among SMEs is also observed in these clusters. Nevertheless, financing is a major constraint facing SMEs. Although the SME promotion policy was enacted in 2003, its impact has been limited.

#### *9.2.5. India*

Small enterprise promotion has continued to remain an important and integral part of Indian development strategy well before the First Five-Year Plan. Some of the most persistent constraints facing the sector, which is dominated by smaller units in the

informal sector, include poor or non-availability of loan finance, low levels of technology, inadequate physical and economic infrastructure, and a policy of product reservation for small scale industries, which excludes entry of LEs. Poor monitoring of the implementation and effect of various small firm policies has been an issue of concern. There has been a definite decline in access to credit by small enterprises among SMEs. Given the large scale attempts to promote industrial clusters in the SME sector, cluster promotion in the Indian context must move beyond the 'sectoral' bind.

#### *9.2.6. Indonesia*

Whereas the local content policy did succeed in creating strong interdependence between SMEs and LEs due to the government's excessive interference, private sector-led subcontracting networks arose in some industries. There are two tiers of subcontracting in metalworking industry in Tegal: first, between large and medium enterprises, and second, between medium and small enterprises. Ample empirical evidence exists to establish that SMEs are able to undertake innovations. It was found in the Tegal metalworking industry that a group of entrepreneurs had successfully designed and produced a hand tractor for the domestic market. However, productivity in SMEs is lower than in LEs.

#### *9.2.7. Japan*

Japanese SMEs have stood on the crossroads since 1991. Many LEs shifted labor intensive processes from Japan to Asian countries and began not only to procure components and parts from local markets but also to import them into Japan from Asian countries. Moreover, long term recession forced the machinery industries to review their procurement strategy. Automobile and electrical equipments manufacturers changed ways of procurement at three points. They began to procure components from companies under different groups, reduced component types and raised the share of components and parts produced in-house. Rationalization of procurement by LEs led to the selection of only efficient subcontractors and ended transactions with inefficient ones. The change of procurement policy by LEs might have caused bipolarization among SMEs.

#### *9.2.8. Lao PDR*

Not only is the average wage for the Lao worker lower than that in the neighboring countries, the labor productivity is lower as well. The Generalized System of Preferences (GSP) granted by the EU has contributed to an increase of exports of handicrafts, silk and textiles. The major obstacles for SMEs are mainly high taxes, high inflation, an unstable exchange rate and a lack of investable funds. In the garment industry, FDI provides opportunity for SMEs to increase their output through subcontracting production linkages. While foreign contractors lend sewing machines to garment units and provide advance payments, collaboration among garment SMEs is not common. Trade liberalization seems to have had a negative impact rather than a positive impact on SMEs.

#### *9.2.9. Philippines*

A decline in subcontracting ratios was observed in wearing apparel, machinery (except electrical, electrical machinery), and transport industries during 1994 to 2003. This indicates that the local content of the country's leading exports has not only remained low, it has declined substantially. The deepening of high technology industries, such as the electronics and auto parts and components industries, in terms of the creation of backward linkages within the Philippine manufacturing industry has remained weak. In the Philippines, the most important factors for subcontractors in maintaining good relationships with contractors are product quality, on-time delivery, and low cost. The high levels of protection in the past explain the lack of competitiveness in many of the country's manufacturing industries.

#### *9.2.10. Singapore*

SPRING Singapore is the lead government organization to spearhead, plan and assist SME development in Singapore. It has identified three key factors fundamental to the development of SMEs: human resources, technology and financing. The financing aspect is particularly critical in the early stage of SME development. The most challenging issues facing Singapore SMEs are increasing operation costs, competition both in domestic and external markets, shortages of qualified human resources and the need to upgrade technology to enhance access to the external market.

#### *9.2.11. Thailand*

In the Thai automobile industry before 2000, the transfer of production capabilities was moderately successful, while the more advanced capabilities such as design was relatively limited. Since the abolition of local content requirement policy in 2000 and more liberalized trade policy, many Japanese and U.S. automobile assemblers and auto parts manufacturers have turned Thailand into a major export base for their global operations. The field survey reveals that inter-firm technology transfer has become more intensive than it had been in the past. The more active role of suppliers and their increased ability to take part in the product engineering process have become increasingly important.

#### *9.2.12. Vietnam*

SMEs have experienced phenomenal growth in the number of registered enterprises and investment, especially since 2000 when the Enterprise Law was promulgated. Vietnam's SMEs remain weak in terms both of internal and external networking, competitiveness, innovativeness, human resource, and low readiness to go global. Apart from the overall development of SMEs from the beginning, these weaknesses have been largely due to the prolonged discrimination against the private sector regarding access to key factors of production, especially, credit and land, lack of a pro-private and competitive business environment, poor quality of human resources and poor availability of business development services.

### **9.3. Policy recommendations**

Assistance to SMEs must be based on long-term comprehensive, coordinated and consistent policy. Often, empirical evidence shows that effective policy measures for SMEs in developing countries are not coordinated among relevant ministries, agencies and organizations and in the long run they are not even consistent. Therefore, we must develop "best practices" on business environment, subcontracting and networking, and a monitoring mechanism to ensure that SME policies are carried out based on proven policies. Successful case studies invariably indicate that an effective collaboration between the government, trade associations, and educational/training institutes is vitally important to reduce costs for human resource development and to disseminate

information through the effective use of available information and communication technology (ICT).

#### *9.3.1. Networking and clustering*

The development of SMEs often requires effective clustering and networking strategies that are developed and made accessible by conscious effective government assistance programs such as industrial incubators, industrial parks for SMEs, and industrial apartment (e.g., *Kojo danchi* in Japanese). Effective cluster environment may create synergy and adequately compensate serious multifarious shortages of resources often faced by SMEs.

In many countries, central governments are taking the initiative of planning and implementing SME policies. Often, the critical role of local authorities and relevant agencies is absent or negligible. Effective implementation of SME policies must be undertaken and monitored by local governments, agencies and organizations with adequate funding and support provided by national governments. Local government can play the critical role to create a database of SMEs and set up a forum of SME owners and local governments.

#### *9.3.2. Improving SMEs database*

There is a need to both streamline and improve the quality of databases on SMEs and clusters. Through the use of ICT, these data sources can be made accessible to a wider group of users and be rendered policy responsive.

#### *9.3.3. Enhancing product and process quality*

In most Asian countries, to enhance SME competitiveness, efforts must be made to introduce easier provisions for ensuring quality certification. Therefore, it is suggested to establish local and regional product testing and quality standards institutes as a public service for SMEs.

#### *9.3.4. Ensuring Competitive Domestic Market Structure*

Anti-monopoly regulations should be enacted and implemented to ensure market access for SMEs. In this context, the establishment of SME “incubators” will be helpful to enhance new entrants and to create a competitive environment.

#### *9.3.5. Subcontracting*

The establishment of joint technology centers by major FDI countries will be a useful mechanism to disseminate information and training to local SMEs as part of capacity building. An example is the establishment of Japan-Singapore Software Technology Center. In addition, governments should encourage trade fairs for procurement to promote subcontracting between MNEs and SMEs. At the trade fairs, MNEs can exhibit components and parts that they are interested in sourcing from SMEs.

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# AUSTRALIA

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## **Australian economy and East Asia**

For 30 years, Australia has attempted to find a balance between its traditional ties with Europe, vital links with the United States, and the emerging possibilities of a fast-growing Asia. Australia sees the advantage of its unique location in Asia and the Pacific. It is committed to supporting Asia-Pacific Economic Cooperation (APEC) along with the East Asia Summit process as mechanisms for promoting regional integration.

East Asia is Australia's main regional trading partner. Australia's export of natural resources and domestic market are vital to the economic growth of East Asia. Australia's economic interest lies in not only maintaining the resource, energy, and manufacturing trade but also in expanding its role in the financial sector and other service sectors.

There are conflicting views on the recent proliferation of Preferential Trade Agreements (PTAs) in East Asia. Some argue that because of increasingly complicated rules of origin, the trend is likely to distort and derail rather than encouraging broader and deeper economic integration. Others believe that the proliferation of PTAs is a natural way to promote region-wide integration, which will be built on the clusters of bilateral FTAs.

## **Importance of financial integration**

From Australia's perspective, financial integration is as important and necessary as trade arrangements. The lessons learned from the Asian financial crisis clearly underpin the importance of financial cooperation in the region.

With underdeveloped financial markets, countries in the region have fewer opportunities to fund investment and lack a mechanism to allocate capital more efficiently. From the Australian perspective, strengthening the domestic financial

markets is the step toward regional financial integration. With a wealth of experience in financial reform and strong capital markets, Australia could play a more active role in the development of East Asia's financial integration.

### **A roadmap and challenges to East Asian economic integration**

Current East Asian economic regionalism is underpinned by two seemingly contrasting trends: the increasing interest in "financial integration" and the growing numbers of bilateral and sub-regional PTAs. The latter can be matched with the former only if preferential trade initiatives are structured to be the building blocks of economic integration.

The underlying goal of regional economic integration is to strengthen regional cooperation in East Asia and to help the economies in the region avoid a financial crisis and other similar catastrophes in the future.

East Asian economies face challenges such as domestic reform, need for realistic and concrete strategies to move toward integration, lack of a regional authority to help control financial volatility, underdeveloped financial markets, and the existence of competing regional architectures. In addition, competition between China and Japan for leadership in the region, the relationship with the United States, and the region's diversity in many respects pose politico-economic challenges.

The likely solution is to opt for something akin to the earlier APEC notion of "open regionalism", designing institutions and agreements that can flexibly be extended to incorporate additional members. Moreover, realistic and plausible views are needed in designing a framework for regional economic integration.

It is important to set attainable targets within realistic timetables so that, gradually, progress can be expected and observed. Due to the different nature and conditions within each nation, East Asian economic integration should be "a hybrid regionalism", a regional arrangement that is beyond Japan's, China's, and other single country's influence.

To accelerate trade liberalization and integration, it is necessary to enhance free trade and factor mobility across the region; to recognize that unilateral trade liberalization is usually in the interests of each country; to minimize security risks of cross-border transactions; and to improve competitiveness through structural reforms in domestic markets.

To foster financial integration, there is a need to build a more concrete framework that may include, but is not limited to, provision of peer country assistance in financial reform; coaching and training to achieve consistent application of policy, legal and

regulatory standards across the region; improvement of accounting standards and skill; clarification of tax rules; upgrade of corporate governance standards; greater transparency and peer surveillance of macro-economic policymaking; better understanding of how closer trade and financial integration imply macroeconomic linkages that will need to be managed.

To harmonize PTAs in the region, ASEAN as a whole and as individual countries, should set and maintain a common standard of practice in trading arrangements. In addition, long-term impacts and benefits should be considered against short-term gain when deciding on the common standard of practice for the PTAs.

To further develop the studies of regional economic integration, the Economic Research Institute for ASEAN and East Asia (ERIA) should be established as a regional think tank that provides broad-based as well as empirical analysis on the trends, challenges, and opportunities of regional integration, and suggests practical recommendations to leaders and relevant officers based on careful studies. The research agenda for ERIA should include both the noneconomic as well as economic aspects of the integration. Greater interaction between policymakers and researchers, and high quality, policy-relevant research, will be of critical importance.

# **BRUNEI DARUSSALAM**

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## **Overview of Brunei's economy**

Brunei Darussalam continues to benefit from high prices for its oil and gas, which account for around 50 percent of real GDP and generate more than 90 percent of total export earnings and government revenues.

Economic diversification is a key to Brunei Darussalam's medium-term growth prospects. To this end, the government has plans to gradually withdraw from economic activities that are best carried out by the private sector, reduce administrative obstacles for business start-ups, better align education and training with the demands of a diversified private sector, and increase value added in the energy sector.

Most of the programs initiated by the leading agencies are focused on large-scale industries, as these are most likely to create spillovers into other sectors. Nonetheless, small and medium enterprises (SMEs) are not left out as they form a very significant part of the private sector.

In general, the trade and investment regime of Brunei Darussalam is relatively liberal. Moreover, in an effort to diversify the economy, the government is working toward enhancing transparency of rules and regulations that will facilitate foreign investments.

## **Potential stumbling blocks to economic integration**

East Asia needs to explore ways to improve rules and regulations to fully tap the advantage in the region. Deepening economic integration also entails freeing up of other quarters in the economy, including services.

Are East Asian countries ready with this shift and will this shift lead to more private sector-driven programs? A lot of valuable lessons can be picked up from the multinational corporations (MNCs) that successfully exploited the advantages of the region's industrial programs.

Statistics have suggested a marginal increase in the intraregional trade activities of ASEAN member-countries, although the total trade volume had increased in a

respectable amount. This raises further questions from experts such as whether ASEAN has managed to successfully link up their programs to the general private sectors. Another question is, what mechanisms are available to ensure that the MNCs or private companies are well informed? Similar problems might repeat in the East Asian economic integration process if the channels suggested above are not properly studied and supported.

### **EU integration framework (or concept of “flexibility”)**

Will East Asian integration follow the European Union’s (EU) integration framework? Or will East Asian economic integration follow ASEAN’s footsteps to persist in its firmly rooted concept of “flexibility?”

The growing debate in the Asia Pacific on macroeconomic and financial issues, including ways to prevent crises and to stabilize exchange rates, are taking place in the “ASEAN+3” (APT) context. So, the first phase of East Asian economic integration might be seen to be adopting a relatively more flexible approach.

### **Current situation of East Asian regionalism**

The most distinct pattern toward East Asian regionalism is the numerous bilateral arrangements, with China and Japan as the hubs.

East Asia economic integration could be hindered by a lack of common vision in a regional economy. Very often, questions such as, “Who should take the lead?” and “What should be the long-term goals?” have been left unanswered.

Also, domestic industries and interest groups have to be closely connected with regional interests provided by the regional economic cooperation. If there is no domestic interests’ foundation for regional economic cooperation, then regional integration may lose its established interests and meet many more obstacles.

### **Comprehensive roadmap toward East Asian economic integration**

The combination of ASEAN Free Trade Area (AFTA) and ASEAN Free Trade Areas with “+3” and “+6”, supplemented by bilateral agreements between individual states in Southeast and Northeast Asia, provides the necessary building blocks for the economic integration of East Asia.

An East Asian FTA should be comprehensive and include investment and trade facilitation, as well as economic cooperation in areas such as environment, food, and energy.

Furthermore, East Asian countries should deepen mutual understanding at all levels,

from top leaders to young people, of the importance of an integrated regional market, and of regional political and social stability.

Finally, East Asia should make every effort to promote multilateral trade negotiations under the World Trade Organization (WTO) and establish FTAs with countries outside East Asia.

### **Some recommendations**

A network could be put in place to bridge the gap between the private sector and the East Asian regionalism, so that all trade and investment programs are synchronized.

It is highly desirable to have an integrated, "one-stop" trade portal for East Asian economic integration to support effective information search and analysis, as well as to enhance communication and collaboration.

Rules of Origin should be precise and transparent in design and substance, and be neutral/least distorting in its trade effects. They should also be consistent, least-cost, and simple; be readily understandable; and conform to WTO requirements.

East Asia should establish four R&D operational groups: Tariff Group, Policy Development Group, Sectoral Development Group, and Business Development Group. At the same time, this mechanism/network ought to also create a comprehensive databank for industry benchmarking.

An Intellectual Exchange Program could be put in place to support the East Asian universities and research institutions that encourage policy-oriented research and dialogue on regional issues of common concern. The ERIA's support is very important in these activities.

# CAMBODIA

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## **Integration of Cambodia into the region and the world**

The Royal Government is committed to push for the integration of Cambodia into the region and the world, specifically focusing on bridging the development gaps among ASEAN member-countries.

Cambodia must strengthen its institutional capacity to implement cooperative strategies with neighboring countries such as the concept of “Four Countries-One Economy”, the creation of the triangles for economic growth, and the establishment of cross-border Special Economic Zones.

Increasing the unfettered access of Cambodian products to the regional and world markets will provide Cambodia with the economy of scales and opportunities that attract investment, create employment, generate increased incomes and accelerated economic growth, all resulting in poverty reduction. Indeed, Cambodia’s participation in the ASEAN Free Trade Area and accession to the WTO constitute strategic and historical steps in the rehabilitation and development of the nation.

## **Issues to be challenged**

Cambodia’s economy is based on agriculture as about 85 percent of the population is living in rural areas. However, agricultural products are in small-sized and family based, which are inappropriate for export because some importers require big volume of products. Cambodia has limited production bases, especially in the processing industry.

Although the decline in poverty has been significant and widespread because average per-capita consumption has risen, Cambodia is still beset with high poverty rate and inequality. The lack of social safety nets and protection, inadequate infrastructure and public utilities, and concentration in urban areas all increase this inequality between Cambodia’s rich and poor as well as disparity between urban and rural areas.

Cambodia’s domestic problems on complicated trading procedures and corruption in the export sector persist. Fisheries, rice, and other agro-products still require

various permits such as transportation permits and exporting permits. Firms frequently encounter delays in clearing imported inputs through customs, thereby jeopardizing their production schedules and ability to meet the delivery dates required by their clients abroad.

## **Policy recommendations**

### *1) Infrastructure development*

The transport infrastructure will continue to focus on the rehabilitation of high-priority trunk and feeder roads and bridges, so as to realize the potential of agriculture, tourism, and trade in the rural areas. There is also the need to develop a comprehensive transport policy framework, addressing issues such as the development of a balanced construction and maintenance program; to increase involvement of the private sector; and to finance road maintenance and cost recovery mechanisms.

Energy, port, and airport should be promoted to meet the increasing demand of production and trade. These developments could greatly reduce transport costs and increase the competitiveness of Cambodian products in export markets. However, the full benefits of such developments will only be realized if people and goods can move across border at minimal cost.

### *2) Trade and investment promotion and facilitation*

The government should play a role in promoting and facilitating trade and investment, especially of local SMEs. Farmers and other local producers should be supplied with quality standard certificates, credit access, and market information. Developing effective mechanisms and training officials for trade promotion and trade support services are clearly warranted. The roles of the Cambodian Chamber of Commerce and other municipal and provincial chambers of commerce in the promotion of private sector participation in economic development should be strengthened.

Assistance is needed in all aspects of an export promotion mechanism, including in detailing the export promotion strategy, developing and managing the necessary national and international databases, and training on how to organize trade fairs and other trade promotion activities. Once again, particular attention needs to be given to promoting the exports of SMEs.

Assistance is also required in putting in place an appropriate legal and regulatory framework for the financial sector. Training on trade finance and trade insurance is required for both the private sector and government officials (in particular, those dealing with export promotion).

### *3) Urbanization and zoning*

There is a huge regional disparity in Cambodia. The most crowded areas are the plain plateaus and along the Mekong River, where soil condition is favorable for agriculture whereas the coastal area is scarcely populated. Most economic activities concentrate only in Phnom Penh and a few other urban areas such as Siem Reap and Sihanoukille. The government should develop an appropriate urbanization plan when assigning growth corridors so as to spread the development benefits to other regions and down to the provinces and districts.

### **Roles of ERIA**

The ERIA's nature as a legal body as well as its research agenda were agreed in a series of expert group meetings and approved by the Asian leaders during the East Asian Summit in 2007. The output of ERIA's research is to be brought to policymakers in regional policy forums; namely, the ASEAN Economic Ministers' Meeting (AEM), AEM + 3, and East Asian Summit (EAS). This institution will be vital since it will have close links to the policymaking process.

In this regard, ERIA will also fulfill a crucial mission in improving policy research capabilities in the less developed countries of ASEAN and CLMV so as to narrow the development gaps and capacity disparities. To enable ERIA to become truly active and to conduct sustainable, fruitful work, it will need the collaboration and support of a wide range of related parties around the region.

# CHINA

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## **China and the East Asian economy**

East Asia is crucial to China's interests. China is, in fact, actively participating and promoting the East Asian cooperation process. Based on a regional production network in East Asia, the Chinese economy becomes an integrated part of the regional economy. A liberalized, secured and stable regional market is for China's interest, encouraging it to adopt an active policy in participating and promoting regional trading agreements (RTAs) and other regional cooperation initiatives.

The role for East Asian FTAs (or CEPs) is to make rules and to develop the legal mechanism among countries in the region. This has profound significance since both "rule of standards" and "rule of law" will help to improve the systems of regional members and to create a reliable foundation for the regional cooperation process. In overcoming the "noodle bowl" effects, it should move to an integrated East Asia FTA (EAFTA).

The ASEAN, because of its pioneering experience in regional cooperation, plays a key role in bringing East Asia together and shaping the direction. The "ASEAN way" may be the major approach in the development of the East Asian Community (EAC). The fundamental role of EAC is to nurture more and more shared principles and rules for regional relations in a new international and regional setting.

## **Challenges of EAC building and China's proposed "easy first" approach**

China well understands that there are great difficulties ahead for EAC building. The first difficulty is the development gap of the regional members. It is crucial that the EAC process helps to reduce this gap and lets every partner benefit from the process. The second difficulty is the relations of the regional members, especially the China-Japan and Korea-Japan political relations, as well as the relations with the United States. The third difficulty is the consensus building on the modality, approach, and steps of EAC. Thus, in realizing EAC, China favors a gradual and "easy first" approach.

## **Recommendations for the roadmap**

The roadmap for East Asian cooperation and integration should take the following steps and measures:

- To support ASEAN's effort on establishing the ASEAN Communities by 2015;
- To support the existing regional cooperation framework, combining different cooperative mechanisms with different functions. It is important to define different roles for different mechanisms. The ASEAN +1, ASEAN+3, ASEAN +6 each has its role. There is no hurry in trying to merge them into one in the near future.
- To create EAFTA, the first step is to complete ASEAN+1, then ASEAN+3, and then to extend to other members of the region. The Comprehensive Economic Partnership in East Asia (CEPEA) may start from an economic cooperation framework with functional cooperation in important areas such as macroeconomic coordination, energy efficiency, environment improvement, capacity building, trade and investment facilitation, opening sky, infrastructure, and logistics.
- To strengthen monetary and financial cooperation through the Chang Mai Initiative mechanism, from bilateral swaps to regional framework, then to regional institutions. The regional monetary and financial cooperation should mainly focus on developing regional monetary coordination, improving monetary and financial stability, developing the regional capital market, but not urging for a regional monetary and financial hard organization or single currency.
- To expand the regional cooperation framework to cover economic, social, cultural, and political areas. The East Asian community building should rest on a comprehensive foundation.

The intellectual inputs are very important for East Asian integration and cooperation. The ERIA's role can be unique since it will act as a permanent institution with its own budget and research network. It will surely serve as both a strong vehicle for capacity building for developing countries and a high-level think tank that provides policy recommendations to leaders.

# INDIA

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## **Indian Economic Prospects and Challenges**

India with a trillion dollar economy growing at an average rate of nearly 9 per cent per annum for the past five years, a 300 million strong middle class, and optimistic long-term outlook for its ability to sustain high growth rates, is emerging as an important growth driver in Asia and the world. With the economic reforms and the Look East Policy adopted since 1991, Indian economy has deepened her economic integration with the outside world especially with East Asia. Peak tariff rates have come down dramatically from around 150 per cent in early 1990s to just 10 per cent by 2007. The share of trade in goods and services in GDP has gone up as a result to nearly 50 per cent. An important and more dynamic aspect of India's outward integration is its emergence as a hub for outsourcing of IT software, business process outsourcing, R&D and design services which complements well with the emergence of East Asian countries as manufacturing hubs. Another aspect of growing global integration is through FDI –inward and outward. FDI inflows to India increased by nearly 100 per cent during 2006/07 to reach US\$ 19 billion. A growing number of Indian companies are also internationalizing their operations and have invested nearly US\$ 10 billion in the last six years in 4000 projects.

Among the challenges that policy makers are currently trying to address include mobilizing massive investments needed for infrastructure development to the tune of US\$ 450 billion over the next five years. Another challenge is to make the growth more pro-poor and inclusive. Although the proportion of population below poverty line declined from about 44 per cent in 1983 to 22 per cent in 2004/05, there are still 220 million people waiting to be lifted out of poverty. Growing regional inequalities between Southern and Western states and the Northern and Eastern states also need to be addressed.

## **India's Economic Integration with East Asia**

India has taken a keen interest in regional economic integration and is an active

member of SAARC and BIMSTEC, among other initiatives for regional integration in South Asia. The Look East Policy has guided her engagement with ASEAN and East Asian countries. India became ASEAN's dialogue partner in 1992, and started participating in ASEAN Regional Forum since 1996 and an annual Summit-level interaction since 2002 with ASEAN. In 2003, India signed a Framework Agreement for Comprehensive Economic Cooperation. A long-term vision document of ASEAN-India partnership and shared prosperity was adopted in 2004. India's engagement with ASEAN is usefully complemented by sub-regional attempts towards economic cooperation such as BIMSTEC and Mekong-Ganga Cooperation (MGC).

India is an active participant in the growing East Asian web of FTAs. It is currently involved in FTAs/ CEPAs negotiations with ASEAN (besides bilateral arrangements with individual ASEAN countries such as Singapore and Thailand), South Korea and Japan and is studying such arrangement with China, Indonesia and New Zealand. As a result of the conscious effort to deepen her economic integration, East Asia comprising ASEAN and Northeast Asian countries has emerged as India's largest trading partner with two way trade crossing US\$ 80 billion in 2006. Furthermore, with imports of US\$ 54 billion from EAS countries being twice as high as her exports to them, India is giving a much bigger market access to the EAS trade partners than it is receiving. India has also emerged as one of the largest sources of tourists for a number of ASEAN countries such as Singapore, Thailand, and Malaysia. East Asia has also become an important source of FDI as well an increasingly attractive destination for Indian companies' operations. India is increasingly getting integrated with East Asian production chains especially in more critical knowledge-based segments such as R&D and product design with major East Asian enterprises increasingly locating their product development activity in India.

### **Roadmap for East Asian Economic Integration: Policy Recommendations**

India sees her growing engagement with East Asian countries as building blocs of a broader Asian grouping and has articulated a vision of an Asian Economic Community as an 'arc of advantage, peace and shared prosperity in Asia' bringing together different sub-regions of Asia in a phased manner.

East Asia Summit (EAS) bringing together 16 of Asia's largest and fastest growing economies, is an appropriate forum for evolving a scheme of broader regional economic integration in Asia. Research has shown that EAS based economic integration has a greater potential to generate welfare gains for all the partners than ASEAN+3. EAS will be able to benefit from the dynamism, complementarities and other strengths of

India, Australia and New Zealand for mutual benefit. Furthermore, it can be argued that an EAS-based grouping will be more balanced than an ASEAN+3 based one and less susceptible to domination by any particular large country.

The first priority for EAS should be to create a broader framework for comprehensive economic partnership arrangement of East Asia (CEPEA) by coalescing various ongoing FTAs between ASEAN and its dialogue partners to provide a seamless market for goods, services and investments. CEPEA could target to liberalize regional trade and investment regimes in a phased manner by 2020 with provisions for safeguards for sensitive products, special and differential treatment for countries at different levels of development, programmes of economic cooperation and capacity-building to narrow the development gaps and dispute resolution. Care must be taken in designing the programmes of regional economic integration in such a manner that they keep equity, employment generation and necessary social transformation and social safety nets for the vulnerable sections of the society at their heart so that it represents regionalism with an 'Asian Face'. By balancing the interests of efficiency and equity, the Asian arrangement could well emerge as a role model for trade liberalization in multilateral as well as regional contexts in the whole world.

Financial and monetary cooperation presents substantial potential of fruitful cooperation considering the fact that the combined foreign exchange reserves of EAS countries exceed US\$ 3 trillion. EAS could take steps towards creating an Asian financial architecture that would facilitate partial mobilization of these reserves for narrowing the development gaps in Asia while spurring the growth. The other initiatives could include creation of an Asian Currency Unit as a unit of account to facilitate intra-regional trade and production networking.

EAS could also provide a framework for cooperation for energy security, development of transport infrastructure and connectivity, and for harnessing the fruits of new core technologies for addressing the digital divide and nutritional and health related issues as well as global governance, peace and security and sustainable development.

### **Role of ERIA**

The process of regional economic integration within the EAS framework needs to be supported and assisted by a think-tank network coordinated by a regional institution. In that context ERIA has a key role to play in assisting the region in its process of regional economic integration with analytical support. ERIA has done well to launch research programmes on deepening integration, infrastructure development, and other important aspects of regional economic development and integration besides capacity

building. Over time ERIA should seek to evolve into a premier regional policy think-tank assisting the East Asian leaders with policy inputs for guiding regional initiatives.

# INDONESIA

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## **Problems and action**

Indonesia is now lagging behind other Asian economies in industrialization and in participating in growing regional production networks; thus, widening the development gap between Indonesia and the rest of the ASEAN 6.

The main factors behind the country's weak industrialization performance are increases and uncertainty of production costs, lack of infrastructure, and the inability of the government to make large-bond policy reform efforts.

The dramatic change in labor policy after the 1997 crisis was one of the important policy decisions that held back foreign direct investment. Two regulations that significantly increased the cost to firms as well as created uncertainty in the level of wages pertained to the determination of the minimum wage, and the severance pay and compensation.

Other key factors that caused Indonesia's weak industrialization are its deteriorating infrastructure due to the reduced financial capacity of the country to maintain and make new infrastructure investment, poor institutions such as those involved in regulatory functions, corruption, and incapable local government.

## **Developing a comprehensive roadmap toward economic integration**

Aside from being a laggard and latecomer in the FTA game, Indonesia is also not pursuing this initiative proactively. There is not much talk in Indonesia about EAFTA. If other members of the ASEAN +3 are eager to develop EAFTA, Indonesia will go along. However, Indonesia will not proactively promote EAFTA.

Its business community is more sympathetic to an EAFTA and other FTAs, largely because of a concern that if Indonesia is not taking part in them, Indonesian exporters will be placed at a disadvantageous position vis-à-vis those in neighboring countries.

Only in the academic circles in Indonesia is there talk about ASEAN's important role in setting the agenda in the wider East Asian region to ensure that the separate agreements have some consistency and coherence, and could eventually be

amalgamated into a single East Asian FTA.

Not much thought has been given so far on whether India, Australia, and New Zealand, who are participants in the East Asia Summit (EAS) and with whom ASEAN also is negotiating FTAs, will also be included in an EAFTA. However, it is desirable that the agreements with these countries follow the same template.

### **Vision for an East Asian Community**

In East Asia, the desire to form a Community (with a capital C) may have its origin in the concept of “regional community building” (community with a small c). East Asia now wants to craft a regional multilateral order that promotes peace and prosperity through mutual trust and respect and in the spirit of cooperation. The new regional order, including the regional economic order, will be built on voluntary decisions and not as imposition by any power.

It needs to be admitted that regional cooperation and community building in East Asia is a broad and open-ended concept. The many overlapping proposals and studies could lead to greater confusion in the region. More importantly, they divert attention away from the real efforts to implement various initiatives toward deeper integration. Greater efforts should be made to undertake serious and systematic deliberations on how to translate the concept of community building in East Asia into concrete actions.

Japan’s proposal to establish an ERIA has been welcomed. The premise for establishing this institute is that ASEAN (being in the driver’s seat) has a critical role to play in community building in East Asia and in strengthening ASEAN’s capacity and supporting its efforts to make the ASEAN Economic Community contribute to East Asian community building. The ERIA will be established as a regional institution. This will help create a strong foundation for the East Asian community building and be a concrete manifestation of East Asia’s efforts to develop its institutional identity.

# JAPAN

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## **The relevance of Japan's development experience**

Based on their own experience, the Japanese believe that deepening integration and narrowing development gaps can be achieved simultaneously with proper policy arrangements.

As a forerunner of economic development in East Asia, Japan can surely provide various lessons with both positive and negative examples to neighboring countries. However, note that Japan experienced rapid economic growth way before the current globalization era. The old-fashioned industrial policy accompanied with trade protection, for example, does not seem to be applicable today anymore. Japan did not utilize inward FDI very much after the Second World War. Today, globalization provides both opportunities and risks in a much more salient way to developing economies, which Japan did not necessarily encounter before.

Japanese firms, together with other multinationals, have played an important role in formulating international production/distribution networks in the region. Japanese official development assistance (ODA) and other development initiatives have progressively promoted economic growth of the region. Japanese beyond-border activities, as such, can also be important sources of novel ideas for development strategies.

## **Globalization and domestic reform**

The Japanese experience highlights the outstanding contrasts between sectors that have properly responded to globalization and those that have not. Globalization has obviously benefited sectors with adequate policy reforms. Sectors behaving against globalization have fallen into trouble.

Japan should establish a coherent system of various policies so as to meet regional and global initiatives for economic integration. Further domestic reform in lagging sectors is urgently needed so as to remove useless politico-economic conflict and to instead establish strategic economic diplomacy.

### **SMEs and equitable growth**

The Japanese have thought much of the development of SMEs for both equity and efficiency. Japan, in fact, strongly supports the initiative of fostering SMEs in neighboring countries. The full range of SME promotion policies applied in Japan can be a good reference point for SME development in the region.

### **Seeking sustainability**

In the past, Japan experienced a series of hardships in energy and environment and bitterly learned the importance of sustainability. Again, these Japanese experiences as well as its hard/soft technologies in these fields may be helpful for its neighboring countries.

### **The importance of the ERIA initiative**

Despite the vigorous effort toward economic integration, intellectual support for integration initiatives has been extremely thin and weak in ASEAN and East Asia. The establishment of the ERIA should provide regional policymakers with useful policy guidance and, at the same time, enhance the region's policy research capacity.

There are waves of new academic literature that explain the mechanism of globalizing economic activities, which are particularly applicable to East Asia. The ERIA can apply a proactive approach in its research works in the effort to both deepen integration as well as narrow development gaps.

Japan strongly supports the establishment of the ERIA from both financial and intellectual perspectives.

# KOREA

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## **Emergence and proliferation of FTAs in East Asia**

Although functional economic integration in term of trade and investment has proceeded quite rapidly among East Asian economies, it was only recently that institutionalization of regional economic integration started among East Asia countries.

In the wake of the Asian financial crisis, the basic institutional framework for regional economic cooperation was established. The first ASEAN+3 (China, Japan and Korea) Summit Meeting was held in Kuala Lumpur in December 1997, and since then, the summit has become an annual event.

Furthermore, some East Asian countries belatedly joined the FTA bandwagon in the early years of this decade, and within a relatively short period of time, many East Asian countries have concluded a number of FTAs. For instance, Korea has concluded FTAs with Chile, Singapore, the EFTA, the United States, and ASEAN. In addition, Korea is in FTA negotiations with Japan, Canada, Mexico, India and the EU.

## **Debate on a region-wide FTA in East Asia**

The debate on an EAFTA has also begun. The East Asian Vision Group (EAVG) recommended the formation of an “East Asia Free Trade Area” in a report submitted to the leaders of ASEAN+3 on October 31, 2001. Then, on November 4, 2002, the East Asia Study Group (EASG) also proposed the formation of an EAFTA.

However, no serious efforts had been made until the 8th ASEAN+3 Summit in Vientiane, November 29, 2004, which welcomed the decision by the ASEAN+3 Economic Ministers to set up an expert group to conduct a feasibility study on an EAFTA.

The Joint Expert Group for Feasibility Study on an EAFTA, which was spearheaded by China, submitted its report “Towards an East Asia FTA: Modality and Road Map” to the ASEAN+3 Economic Ministers, which was held on August 23, 2006.

The Joint Expert Group was followed by the EAFTA Study Phase II, initiated by the Korean government. It was launched in Seoul on May 31, 2007 with a goal of

conducting more detailed analyses on the economic effects of an EAFTA and proposing possible options of an EAFTA.

The Japanese government's recent initiative to create an ERIA and the Track Two Study Group for the CEPEA could also be regarded as proof of rising interest in an EAFTA among East Asian countries.

### **Prospects for an EAFTA**

Despite a worldwide rise of regionalism and the proliferation of FTAs in East Asia, East Asia still lags far behind Europe and the Americas. In fact, among the major economic regions, East Asia remains the only region that does not have a region-wide FTA. In addition, should East Asians want to form an East Asian Community, an EAFTA would be a natural first step.

However, the diversity among East Asian countries, in particular, the disparity in their level of economic development, constitutes one of the most challenging obstacles to overcome for the formation of an EAFTA.

Considering recent developments in bilateral FTAs in East Asia, the most talked about scenario for an EAFTA seems to be through a series of ASEAN+1 FTAs. The ASEAN-China FTA and the ASEAN-Korea FTA were signed. In addition, an ASEAN-Japan Comprehensive Partnership Agreement was concluded in November 2007. Therefore, these ASEAN+1 FTAs, when realized, could serve as the basic framework for an EAFTA.

Along with ASEAN+1 FTAs, should the three Northeast Asian countries form an FTA, it will also facilitate the formation of an EAFTA. Since an EAFTA cannot be formed unless there is a de facto China-Japan-Korea FTA, the three Northeast Asian countries should not neglect the importance of a CJK FTA in their pursuit of an EAFTA.

Lastly, an EAFTA could be achieved by using the existing ASEAN+3 framework. This process may be complex and costly both in terms of the duration and efforts, and consensus building may be difficult among the 13 countries. On the other hand, an ideal EAFTA would be devised from scratch, and a high quality FTA reflecting the sui generis characteristics of the East Asian countries may be possible.

With regard to EAFTA membership, the first key question is whether it will be limited to regional countries or go beyond them, and the next key issue is the question of who will comprise its starting membership.

Since Japan seems to prefer to start from ASEAN+3+3 (Australia, New Zealand and India) instead of ASEAN+3, the membership issue may complicate the debate on an EAFTA and may constitute a major stumbling block, especially at the early stages of the

debate.

Given the outward orientation of the East Asian economies, EAFTA membership should be inclusive, not limited to ASEAN+3 countries. However, as for the starting membership, it would be more realistic for the EAFTA to be first discussed among the ASEAN+3 countries, partly because of the existing ASEAN+3 framework, and partly because it will be already difficult to form an EAFTA among 13 countries. Therefore, in our view, an EAFTA should be discussed among ASEAN+3 countries first, before opening up to other countries, such as Australia, New Zealand and India.

Additionally, ERIA, which is a unique regional institution, is expected to greatly contribute to East Asian economic integration. First, it could enlighten East Asians on the importance of East Asian economic integration by highlighting the benefits of advanced regional economic integration. Second, it could help overcome the existing obstacles to regional integration in many ways. In particular, it could contribute to narrowing the development gaps and enhancing mutual understanding among East Asian countries. Finally it could promote formal and functional economic integration in East Asia by facilitating many ongoing and new initiatives.

# LAO PDR

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## **Economic development of Lao PDR**

In 1986, the Lao government approved a comprehensive reform program called the New Economic Mechanism (NEM) to pave the way for a shift from a centralized economy to a market-oriented economy. Specifically, the development efforts aimed to transition from a command economy to a market economy; from a subsistence-based and isolated rural economy to a production and service economy; and from a relatively closed economy to an open economy. Since the introduction of economic reform under the NEM, considerable progress has been made in macroeconomic stabilization and structural adjustment. After the Asian financial crisis, annual GDP growth averaged about 7%.

Lao PDR is well endowed with natural resources. It has untapped reserves of agricultural arable land, large forest, hydropower potential, and mineral resources that, when efficiently exploited, could contribute substantially to economic development. However, the country also faces serious disadvantages. Its land-locked position, rugged terrain, low population density, and widely dispersed settlements generate high transportation and communication costs and render broad, equitable improvements in social and economic infrastructure expensive.

In the longer term, Lao PDR has many advantages to grow further. It shares borders and many common interests with neighboring countries and has opportunities to participate in the sub-regional, regional and global economic network, forming the real potential forces for economic growth and stability in the future.

The National Growth and Poverty Eradication Strategy (NGPES) emphasizes commercial production and promotion of export-oriented sectors while improving market linkages and facilitating trade. Trade revenues have increased but trade still contributes only a small amount to the Lao GDP. This shows that in many respects, the openness of the country's economy is still inadequate.

In 1992, Lao PDR joined the agreement on sub-regional economic cooperation among Greater Mekong Subregion (GMS) countries. In this respect, the Lao PDR

government requested ADB to help coordinate the efforts of international donors, as well as promote private sector participation in the development of priority sub-regional projects, particularly in the transport and energy sectors. Of particular significance is that Lao PDR is now able to involve itself in the GMS development plan.

In 1997, the Lao PDR became a full member of ASEAN. Becoming a fully responsible member of the region's main organizations (ASEAN and AFTA) is one of the Lao PDR's most important foreign policy objectives. Currently, Lao PDR is preparing to join the WTO soon.

### **Potentials and opportunities for the Lao PDR's economic integration**

Domestic context: There has been political and social stability since the foundation of Lao PDR, and this situation will be sustained. The production capacities and abilities of many industries have increased substantially, and the economic structure has changed significantly. Enterprises and the national economy have adapted better to the international market and the competitiveness of Lao products has improved steadily. The economic structure has changed progressively, and the Party's priority has been implemented methodically in priority projects. The market economy structure has been adjusted and progressively improved. The country has been recognized in the region and globally as having a dynamic economy within a stable political situation and is a safe destination for investment and tourism.

Socio-political stability is an important foundation and an essential precondition for socio-economic development, which is an advantage that the Lao PDR enjoys now. The full membership of the Lao PDR in the regional and global political, economic, and monetary organizations will boost the dynamism of the economy and accelerate the country's development.

Location: Lao PDR is located in the center of the Indochina Peninsula. It is the so-called land-linked country or land-bridge among GMS countries. Hence, the Lao PDR's great potential for the integration is its strategic location, which can be an important overland transit point for trade in the Mekong region and between South-East Asia and the Chinese and East Asian economies.

Natural resources: Lao PDR possesses relatively huge potentials in untapped natural resources. It could become a supplier of commodities to promote economic development in its neighbors, particularly in the fields of hydro and bio-energy production, forestry, agriculture, and mining.

Opportunities: Lao PDR could benefit from the opening up of and integration with the ASEAN market. Some of the preferences it enjoys are the tariff reductions

under the Common Effective Preferential Tariff Scheme (CEPT) and the ASEAN Integrated System of Preferences (AISP) offered by the six original ASEAN members.

### **Major challenges and problems on the integration**

There are at least three challenges to Lao PDR's integration. First, domestic economic regions are not unified, mainly due to the lack of infrastructure in transportation and communication, and to the underdevelopment of the nationwide market economy. Lao PDR is a nation that is topographically segmented, and many regions are still characterized by a subsistence economy that is not adequately incorporated into a market economy. Its domestic commerce-and-market network has not been adequately formed, and institutions are not sufficient for the unification of its domestic market.

Second, Laos is a sparsely populated nation, although the population is growing rapidly. As a result, labor is not abundant. Because the level of wages is not significantly lower than that of neighboring countries, it is a crucial fact that any strategy based on the use of abundant labor is challenging for Lao PDR, at least for the coming decade. In addition, since the literacy rate of the population remains low, human resources are not sufficiently available to uphold the activity of a market economy.

Third, the participation in the AFTA has remarkably shortened the remaining preparation time of its integration into the global market. Lao PDR's is facing an extremely difficult constraint upon its ability to develop several industries at the competitive international and regional levels by the year 2008, because it has been, in principle, required to reduce its tariffs to the 0-5% range for all imported commodities. Beyond AFTA, Lao PDR needs to reform its domestic economic policies and institutions to make such more compatible to the ASEAN-China FTA and ASEAN-Japan Economic Partnership Agreements, mainly by identifying the industries and commodities that have high potential for international competitiveness.

### **The role of ERIA**

From the Lao PDR country team's perspective, some policy recommendations for the country's development strategy are: (1) building and strengthening market institution (particularly the financial, real estate, stock, labor, and technology markets); (2) developing infrastructure, particularly to link the country to other economic corridors; (3) setting up SME development strategies to enhance competitiveness; (4) support nature-based industry with environment-friendly and economically efficient

approaches; (5) backing the agro-forestry and mining processing industry; (6) developing human resource, in particular by supporting vocational school development for skilled labor and strengthening R&D.

To deepen the economic integration in East Asia, the AEC initiative should be supported with the future goal of an EAC. In addition, a practical approach should be established by country group and by region. Issues such as production and trade networks, investment promotion, tourism, labor market and labor migration should be addressed from a regional perspective.

To narrow development gaps in the region, ERIA is expected to contribute to the following issues: (1) Fair trade and competition policy; (2) Development strategies for private sectors in CLMV; (3) Early harvest programs for CLMV in FTAs; (4) Human resource development program for CLMV; (5) education for skilled labor and R&D promotion; and (6) technical assistance for CLMV by training the trainers, and adopting the “learning by doing,” and “doing by learning” approaches.

# MALAYSIA

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## **Malaysia's development experiences**

FTAs are seen as a route that enables Malaysia to achieve higher trade and growth. It should be noted that FTAs go beyond the reduction of tariffs, extending to include cooperation in industry, stimulation of technology transfer and direct or indirect push for economic growth.

Regional FTAs that involve the ASEAN hold the promise of creating a single ASEAN market, and such a market, given the size of ASEAN's population, makes the region extremely attractive. Obviously, if Malaysia can find a niche for itself within a market of such size, it will establish itself as an important center of trade as well as a key location for FDI.

## **The East Asian Summit: Issues raised and their relevance to Malaysia**

Attempts toward an East Asian Community are more important now with the increasing significance of East Asia and India, and Malaysia attempts to identify its place in the new global landscape.

The spread of disease and the financial crisis are two significant events that have negatively affected the Malaysian economy, and could be solved within the context of a regional community.

There are certain areas, e.g., poverty eradication, where Malaysia has achieved remarkable success. In fact, Malaysia is in a position to share its experiences with other less developed countries in ASEAN. The presence of the other +6 countries in the community provides additional opportunities that can be tapped by these less developed ASEAN countries (particularly, the CLMV members) with the support of the more developed members in East Asia.

Malaysia could also benefit from cooperation and dialogue with members of EAC, such as in the area of energy security and environmental management.

## **The roadmap for East Asian Community**

Without going into the details of the political and institutional requirements, it would be useful to summarize the key issues that need to be taken into account when designing a possible roadmap. The following are some of the outstanding issues that demand consideration:

- The ultimate objective of the EAC would be to create a single market, but this is to be accomplished on a consensual basis and without a binding timetable.
- Efforts to bridge the development gap among member-countries should be the focus of attention. Particular attention too should be paid to the CLMV countries.
- Monetary and financial cooperation will be the backbone of attempts to strengthen the economic and financial system of the EAC. This is important in forging intraregional cooperation and integration; it is also essential so as to strengthen the macroeconomic resilience of the region.
- As a step toward facilitating monetary and financial stability, a surveillance process should be instituted, with capital flows, in particular, being regularly monitored.
- Cooperation within the region for the development of infrastructure such as dams and transportation projects that run across a country or across borders, and energy projects, should be improved.
- An assortment of bilateral trade agreements increases transaction costs. Trade and investment will be better served if the region adopts a common trade agreement that encompasses the needs of member-countries and works toward binding EAC members, rather than working on individual bilateral FTAs.
- Important concerns that need to be addressed when working toward an overarching FTA are pressing issues such as rules of origin and a dispute settlement process.
- Other issues that require cooperation include establishing institutions to address cross-border environmental issues, epidemics, and disaster management. It is also necessary that a comprehensive roadmap considers cooperation on education, technology transfer, and scientific advancement.
- It is imperative that the research capabilities of the region be considered. Although national research institutions are already available, a region-wide research institution will have to be considered in developing the requisite research expertise for issues that have a wider, regional focus.

## **ERIA**

What calls for more discussion are the areas on which ERIA has to build its capabilities. In order to clarify this issue, it must be noted that there are many

developing countries within the region that do not have the manpower (or sufficient manpower) to undertake the necessary policy research for pertinent issues.

There are three ways in which ERIA can lend support: (1) It can extend its competence by employing the available expertise from more developed member-countries to build the human capital stock in less developed member countries; (2) ERIA can undertake research and advise member-countries on issues that affect the region as a whole; and (3) ERIA can act as a coordinating agency that draws on the skills and abilities of research institutions in member-countries. The advantage of ERIA in the context of EAC is that it harnesses the expertise of those in the more developed member-countries and can share this expertise with the less developed countries. Another benefit arises from the possibility that ERIA can perform studies on policy issues that have regional implications. Finally, ERIA can play an empowering and coordinating role.

# MYANMAR

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## **Means to avoid marginalizing less developed nations**

In an increasingly globalized economy, the economic integration of EAC not only encourages and strengthens the position of member-states in the region but also brings the group closer to EAFTA. Economic integration would, among others, allow countries to focus on their comparative advantages as well as create an attractive destination for FDI. An East Asian integration poses many challenges for countries in ASEAN such as CLMV; on the other hand, it also offers opportunities for a deeper economic integration even to less developed countries such as CLMV. Appropriate resources should be allocated to ensure the full participation of these countries in the integration process.

One important consideration is the diversification of economies among member-countries. To avoid marginalizing less developed member-countries from economic benefits, the development gap between member-countries need to be narrowed down by facilitating programs in physical infrastructure such as transport, telecommunications, and energy networks; human resource development (e.g., by giving training programs, sending technical experts and providing equipment); Information and Communications Technology (ICT) and regional economic integration. However, one has yet to see effective equalizing programs that can truly level the playing field on behalf of less developed member-countries.

## **Recognizing benefits of integration**

Nonetheless, closer and deeper economic integration among member-countries is expected to result in more economic interdependence and shared interests. Further market liberalization also makes economic transaction faster and more efficient. Moreover, economic integration calls for strengthening governmental cooperation in providing a better economic development environment and preventing or mitigating any market crisis. At the same time, Myanmar endeavors to create closer economic integration with ASEAN and EAC by entering into several arrangements, and supports the move toward an EAFTA.

# NEW ZEALAND

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## **New Zealand's experience**

The main success New Zealand has had is integrating our economy with Australia's. A series of agreements between New Zealand and Australia entered into since the early 1980s have established what is known as a Closer Economic Relationship (CER). CER provides tariff free trade between the two countries, free trade in services (with a few exceptions), mutual recognition of standards and occupations, and free movement of people between the two labour markets.

New Zealand has been a big winner through CER. In absolute terms, Australia may have won more because of its much bigger size but in relative terms New Zealanders are confident they did well. Australians are also happy with the arrangement. While it may seem to outsiders that New Zealand and Australia are natural partners for a comprehensive free trade agreement, the facts are that large parts of the two economies directly compete in both the combined domestic markets of the two countries and in third markets.

Integrating our capital markets continues to represent a stumbling block that inhibits the integration of our two economies. The lack of a fully integrated capital market between New Zealand and Australia imposes unnecessary and burdensome costs on businesses trying to operate in both countries. What is needed is a new common institutional framework for the regulation of our capital markets and full recognition of tax paid in the other country for meeting local tax obligations by each government.

Of course, common institutional frameworks do not always provide benefits. Whether or not they are beneficial depends to a large extent on whether or not institutions and regulation are created on the basis of simple but useful principles such as transparency, predictability, flexibility, open and free competition, and most importantly, simplicity.

Although CER has been under way for around 25 years, the political and public interest in pushing the integration of the two countries further is still high. At the political level, there is strong commitment to a single economic market and political and

officials meetings to progress this occur on a regular basis.

### **The alignment of institutional arrangements**

The alignment of institutional arrangements must be an end goal of economic integration. The often quoted spaghetti-bowl effect of FTAs can tie up economic resources and has been shown to confound traders when it comes to taking advantage of the potential benefits of a free trade agreements and economic integration.

Aligning institutional arrangements does not have to mean harmonization of institutional or regulatory practices. It can simply mean harmonization of objectives such as simplicity, flexibility, transparency, and open competition, and couple this with side deals providing appropriate mutual recognition (such as double tax agreements).

However, to reach such an alignment of objectives, we have to be realistic about the fact that complexity, intransigence, opaqueness, and vested interest are everywhere and everywhere destructive. We must recognize this and be ambitious in our solutions and be ready to find solutions for all people.

We need to start aligning our institutional objectives across a range of areas: standards and conformance; occupational recognition; migration standards; competition; and border procedures. If we leave these issues to one side, we can create all the free trade agreements we want but will not get any closer to integrating the economies in East Asia. Not only would a proliferation of merchandise trade agreements just enforce the spaghetti bowl of compliance issues that traders face in the world today but it also gives rise to destructive preferential arrangements, trade diversion, and a race to the bottom in terms of investment subsidies.

Creating institutional frameworks in collaboration with others can also offer important opportunities for capacity building amongst all participants. It can also offer opportunities to create high quality institutions that may be outside the reach of the less wealthy among us.

### **Vision for an East Asian Community**

The role of ERIA in all this is to create realistic and ambitious intellectual inputs into the process of economic integration. That is a vital role because policymakers need quality information to help them make decisions and to help pull others along with them in the process.

In terms of realism, ERIA needs to be at the forefront of understanding the issues confronting East Asian integration. That means scorecards that summaries the extent of distortions and welfare reducing policies that confront us. Realism also means

learning lessons from attempts to liberalise or integrate economies in the past and to provide ideas for future action or ideas that are to be avoided. However, the key to realism in research outputs is to focus on what can practically be done, not on what cannot be done.

In terms of ambition, ERIA needs to lead from the front, in intellectual terms. That means investigating the costs and benefits of measures or policy settings that may, on the face of it, seem politically infeasible. It also means seeking to find what the right ideas are to make us all better off and leaving the politics to the politicians.

# THE PHILIPPINES

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## **Problems and action**

Over the past 25 years, the Philippines has achieved considerable success in integrating with the global economy. Trade, fiscal, and financial reforms were undertaken to strengthen the economy. Among the specific reforms undertaken were (1) a comprehensive reform program to unilaterally liberalize the trade regime; (2) accession to WTO and various trade agreements; (3) financial reforms that included the rehabilitation of the Central Bank, liberalization of foreign bank entry, liberalization of foreign exchange market, and adoption of an inflation-targeting framework; and (4) fiscal consolidation achieved in the early 1990s and legislative measures to reform the tax policy of the country.

However, there is still much to be done in consolidating the gains from these reforms. Trade and industrial reforms have been inadequate in fueling faster GDP, and allowing employment growth and economic transformation in the Philippines.

The structure of domestic manufacturing value added and manufactured exports is quite revealing. The Philippines has the highest share of medium- or high-technology products in manufactured exports among these countries in 2002. However, it also has the lowest share in terms of domestic manufacturing value added in the medium- or high-technology sectors. The variance indicates a dichotomy between the domestic manufacturing sector and export sector.

Meanwhile, it has been observed that under the tariff-restructuring regime, aggregate exports expanded dramatically, overtaking aggregate imports, but growth occurred in only a few sectors, particularly in electronics. In other sectors such as raw materials and animal and vegetable oils, performance has remained stagnant or has even declined. Per-capita income has hardly changed and there is mixed evidence as to whether these reforms really helped in alleviating poverty and in improving income distribution in the country.

The Philippine experience shows that economic openness and global integration per se will not automatically result to economic development. It is important that efforts

are concurrently placed in strengthening economic structures and good governance. Among the factors and policy shortcomings that prevented the Philippines from maximizing its gains from globalization are (1) the lack of an effective infrastructure program; (2) lack of political will to implement a sustained and credible fiscal reform program; (3) lack of a coherent industrial policy; (4) high transaction costs; and (5) low priority given to basic social services.

There were also gaps in the implementation of reforms and this is related to the failure to address issues in good governance. This focuses on anti-corruption initiatives and institutionalization of acceptable corporate governance practices.

### **Comprehensive roadmap toward economic integration**

East Asian economic integration is very challenging, especially since the countries have a large disparity in levels of economic development, varying political systems and structures, and are culturally heterogeneous. While it is argued that differences can give rise to complementarities and comparative advantage, it is also known that differences can be a major hindrance in integration.

To integrate the economies of East Asia, it is important that development gaps are addressed, financial market and monetary systems are integrated, and that political structures comply with principles of good governance.

Lack of formal leadership in ASEAN and East Asia has proven to be another major obstacle. The EU and NAFTA experiences show the critical role of strong leadership to facilitate integration. The leader should mirror the economic and political strength of the United States or Germany and France in the East Asian region to catalyze integration. This role can be taken by either Japan or China.

The noodle bowl syndrome has hindered economic integration in ASEAN. Too many PTAs being formed by members complicate harmonization of rules and guidelines on economic integration. This also extends to the area of dispute settlement as the externalities of disputes can potentially redound to partner countries not party to the dispute resolution process.

As the need to prove ASEAN origin results in an increase in transaction costs and complexity in administrative procedures, this leads many exporters to use most-favored-nation (MFN) rates instead of the CEPT rates. The rules-of-origin issue creates setbacks in the tariff liberalization progress.

East Asia should aim for a single market without any binding timetable. Countries should identify concrete steps that would improve economic and political relations in the medium term.

Countries could declare that narrowing the development gap is a primary objective that will eventually lead to a proposal to establish the East Asia Regional Development Fund, modeled after its EU counterpart.

To overcome political and noneconomic obstacles, East Asian countries need to deepen mutual understanding at all levels, from top leaders to young people, to increase the awareness on the importance of an integrated regional market, and regional political and social stability. Leaders' meetings should be held regularly and policymakers should establish close communication links. Beijing and Tokyo should develop mechanisms for regular high-level exchanges on issues of bilateral concern.

To secure political gains of closer integration and cooperation, there should be less emphasis on sub-regional FTAs.

The newly established ERIA will definitely provide a boost to efforts for closer economic integration in the region. The six current research projects are quite comprehensive and relevant. The Philippines can benefit from these studies in two ways: One, the recommendations arising from the studies will provide policymakers with additional leverage in the process of domestic economic reform; and two, the studies will provide roadmaps to the domestic reform process in support of economic integration. The experience of other countries will be quite useful in this regard.

# SINGAPORE

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## **Singapore's trade policy**

Singapore's remarkable economic transformation in the last four decades has been, to a large extent, due to its capacity to leverage on external resources and external market to achieve economic growth far beyond its domestic economic resources. Singapore has adopted a trade policy based on the principle of comparative advantage. It also dictates the market mechanism in allocating its scarce resources and oversees its domestic economic management and international trade policy.

The fundamental principle of Singapore's trade policy remains unchanged: Multilateral trade regime is the most optimum in promoting regional and global economic growth and prosperity. However, the changing economic environment necessitates the shift in trade strategy to achieve the same objective. Alternatively, Singapore has actively initiated bilateral trade liberalization with its major trading partners as long as those regional and bilateral trade agreements are the "building blocks" rather than the "stumbling blocks" to nondiscriminatory multilateral trading regime and directed toward freer and more transparent movements of goods, services, and investment across national borders.

These multiple layers and multiple approaches on trade policy are intended ultimately to promote a transparent, fair and rule-based trading regime that covers not only trade in goods and services but also investment flows, intellectual property, free flow of skilled labour, competition policy, market access, technical cooperation, and capacity building.

## **Roadmap to East Asia economic integration**

Singapore is fully committed to regional economic integration through its membership and contributions in the ASEAN Economic Community, ASEAN+1, ASEAN+3 and ASEAN+6. Acting as a model for other ASEAN countries, Singapore is a test case for the diversity of possible approaches that can be utilized in the roadmap to East Asian economic integration.

Singapore supports the Report of the Joint Expert Group on the feasibility study on EAFTA, which aims to meet the challenges of globalization by leveraging on globalization, gaining greater economic benefits from the region-wide arrangement, and understanding the East Asian production networks better.

Diversity and heterogeneity in East Asia can be a source of dynamism with respect to production networking of agglomeration and fragmentation. However, in the short-run, diversity in stages of economic development, domestic policy priorities and constraints can become more of a distortion and impediment to regional economic cooperation.

Trade and investment liberalization must be accompanied with development, specifically with the aim to reduce development gaps through regional capacity building, trade and investment facilitation and other forms of regional public goods. Although ASEAN is accepted as the “hub” of East Asian regional integration, it has provided the opportunity and space for other APT countries to initiate and champion certain positive policy initiatives.

In fact, the process toward an East Asian community must be driven by champions and based on issues raised by APT and EAS members because there is an absence of clearly acceptable regional leaders, unlike those of other regions.

Greater efforts should be made in studying how to translate the concept of community building in East Asia into concrete policy actions. The basic framework and modality of East Asia regional community building has been identified but they are inadequate in terms of a detailed “roadmap,” specifications, schedules and directions on how to proceed.

For this reason, Singapore supports the proposed establishment of ERIA with the following objectives: To facilitate the ASEAN Economic Community and support ASEAN’s role as the driver of the wider economic integration and sustainable growth in the region; to help narrow the development gaps; to foster research activities that add value to public policy; and to nurture a greater sense of community building in East Asia.

To be effective as a regional institution, ERIA must be a credible policy-oriented think tank that can provide the following high-impact policy recommendations:

- To take a rigorous and comprehensive inventory of all bilateral, sub-regional and regional FTAs and identify their positive and negative elements related to regional economic integration;
- To establish a monitoring mechanism and scorecards with respect to the schedule, timeline, compliance and distortions with all trade in goods, services, and

investment agreements;

- To provide policy recommendations that are realistic, pragmatic but at the same time ambitious and visionary.

Singapore's approach to regional integration may serve as a helpful template to ASEAN and other East Asian countries either in bilateral or regional trade agreements. To take initiative and provide proactive recommendations may be a niche role that Singapore can do.

*De jure* integration has not been effective in supplementing and supporting de-facto integration in East Asia, particularly in service and investment integration. Singapore has to cope with the "spaghetti bowl" effect, which arises from the many different sets of rules of origin. What is really needed is a set of regulations that is region-wide and could be applied as a general rule to all products and services.

Policy priority should be given to closer and more effective financial and capital market integration. East Asia is integrated through global financial markets rather than through regional ones and has developed stronger financial ties with the United States and Western Europe than with one another. Stronger economic integration with full international financial integration will enable each country in the region to be insured against country-specific income risks.

Various financial arrangements that promote financial and monetary cooperation in the region such as the network of bilateral swap agreements under the Chiang Mai Initiative seem to be sidelined. The massive foreign exchange reserve accumulated by East Asian countries can be used to finance regional infrastructure and other regional development projects, and to narrow development gaps in East Asia.

The development of SMEs in the region is critical because the success of their collective and individual efforts will go a long way in reducing regional and domestic income gaps, in creating a balance of income and employment and in securing a more sustainable human and social security in the midst of rapid economic growth in income and output.

Intraregional trade and investment is rapidly increasing through regional production networking, agglomeration and fragmentation. To facilitate further regional integration and at the same reduce development gap, it is important to actively promote a comprehensive and integrated infrastructure development plan that will transform the region into an integrated economic geography and entity.

Sustainable development issues such as energy security, water resources, and climate change are as equally important as the need for a regional cooperation on how to promote SMEs and the aim to narrow development gaps. These development issues

have to be given resolutions before they become impediments and bring serious risks to the region.

# THAILAND

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East Asian integration is instrumental in enhancing the accession and realization of the benefits of globalization of Thailand. The proper role of the public sector in influencing East Asian economic integration is to reinforce the market mechanism and make correction for market failures, while at the same time being cautious of government failure.

Thailand's economic growth and development has been, to a large extent, attributable to Thailand's openness to foreign trade and investment. Thailand enjoyed great economic success during 1986-1996 through economic liberalization and restructuring but fell into an economic crisis in 1997 as Thailand's structural and institutional adjustment did not keep pace with globalization's dynamism. What was needed for Thailand to recover from the crisis was to liberalize trade and investment further to achieve more efficient resource allocation and utilization and hence improve Thailand's competitiveness in the global market as well as to seek better and broader market access.

As the Doha Round failed to move forward and as bilateral FTAs proliferated in the Asia-Pacific region as well as elsewhere, Thailand became pro-active in FTA participation so as to accelerate economic recovery from the crisis through export drive, to reduce the disadvantages of being discriminated by various FTAs, to increase competitive advantage through preferred market access, and to improve access to new and diversified markets.

Thailand has participated in many RTAs and bilateral FTAs with developing and developed countries in the East Asian region and outside the region. As a result, Thailand has multiple tariff structures; one tariff structure corresponds with each FTA that Thailand is involved. Each tariff structure tends to protect domestic producers from competitive FTA partners. Altogether, Thailand's RTAs and FTAs give confusing and distorting market signals to various industries, encourage trade diversion and obstruct regional and global integration process of Thailand. Moreover, multiple rules of origin corresponding with these FTAs and RTAs added more complications.

Since most of Thailand's FTA partners are in East Asian region, Thailand would benefit greatly if East Asian economic integration could be instrumental to harmonizing and unifying those multiple tariff structures, rules of origin and other relevant rules, regulations, commitments, and treatments under those FTAs.

Thailand has also been pro-active in narrowing the economic development gap in the region, Thailand contributed to the development of neighboring countries through trade openness and preferences, private direct investment, and official development assistance. Thailand has traded more intensively with CLMV than with other countries. Thailand's trade weighted average tariff on imports from LDCs are lower than most other countries'. Thailand also provided preference with 0 percent tariff rate to exports from CLMV under the AISP and "One Way Free Trade" with Cambodia, Laos and Myanmar with 0-5 percent tariff rate on a number of agricultural products as well as technical assistance to increase productivity.

Thailand played a prominent role in CLMV's capital formation. Thailand's FDI focus on comparative advantage sectors in CLMV not only contributing to improving capacity and competitiveness in CLMV but also to increasing trade between Thailand and CLMV.

Thailand also offered significant amount of ODA in support of human development and poverty reduction in developing countries in the region. Thailand's ODA to developing countries as percentage of GNI was higher than many developed countries' ODA.

Thailand could further contribute to narrowing the development gap in the region by broadening trade and investment liberalization and facilitation and enlarging ODA especially to social sector development and capacity building as well as more untying aid to CLMV.

During the course of development, Thailand has experienced widening income disparity, economic instability, environmental degradation and natural resource depletion. These problems were the fruits of negligence and poor economic management.

To alleviate these problems and meet the challenges of globalization, Thailand in cooperation with member countries in the East Asian region should made an effort:

- to regionalize the member countries' FTAs by extending the FTAs' preference on MFN basis to all member countries in the region;
- to harmonize the rules of origin under various FTAs with allowance for regional content accumulation,
- to harmonize investment regulations and incentives as well as to strengthen

competition policy and competition law enforcement;

- to harmonize logistics and transport rules and regulations;
- to develop institutional framework, mechanism and instruments for regional financial resource pooling and sharing for regional development and financial stability;
- to broaden GSP coverage for CLMV;
- to commit greater amount of development assistance for CLMV with an emphasis on human resource development and health;
- to promote FDI in CLMV;
- to provide easy-term trade finance for CLMV;
- to cooperate in energy and natural resource conservation;
- to cooperate in renewable energy resource development, utilization, and trade in the region;
- to harmonize environmental policy and laws; and
- to strengthen environmental law enforcement.

# Vietnam

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## **Vietnam's economic reform and integration**

The apparent failure of the centrally-planned economic system necessitated Vietnam to launch economic reforms. The economic reform initiated in 1986-1988 has been a process characterized by gradualism. This approach can avoid the crisis/collapse of an economy while gradually gaining confidence in and support for reform. Also, since 1989, the reform has been in conjunction with macroeconomic reforms and the opening of the economy. Vietnam could not have succeeded without trade liberalization and economic integration. The international economic integration should be undertaken within this comprehensive domestic reform framework.

There is now a consensus that the achievements in Vietnam can be attributed to four key factors: (1) the acknowledgment of the right of private business and establishment of institutions for market transactions; (2) the market-oriented reforms (especially in terms of price liberalization and structural reforms); (3) the opening (mostly in terms of trade and FDI) and integration of the economy into the regional and world economy; and (4) the sustained macroeconomic and social stability.

However, there is also a consensus that the process of economic reforms and Doi Moi (Reform) in Vietnam have been complicated and unsmooth. The effective reforms require both political will, changes in the way of thinking and policy decisions reflecting the dynamics of real life.

The development objectives of Vietnam are to sustain high economic growth, to escape the status of a poor country by 2010, and to accelerate the industrialization and modernization process so that by 2020 Vietnam will basically become “a modern-oriented industrialized country.” For Vietnam's further development, the following challenges for reform are identified.

- Aim for a decisive institutional reform. That is, the (still) state-led economic institutions need to change into efficiency-enhancing institutions with more people participation.
- Develop the private sector and attract efficient FDI. With the nontariff barriers to

be removed, the further tariff reduction and substantial uniformity in tariff structure will be an effective way for Vietnam to reduce/eliminate anti-export bias.

- Find out how to effectively coordinate integration with its ongoing structural reforms.
- Identify an appropriate integration roadmap, especially in the context of the “spaghetti-bowl” syndrome of proliferation of regional and bilateral FTAs. This is necessary for Vietnam to effectively reap the benefits from trade creation, rather than trade diversion, and to support its domestic economic reforms.
- Gain benefits from the emergence of China as a regional manufacturing and investment hub as well as from joining the regional production network.
- Last but not least, confront social costs and build a social consensus during the inevitable reform and integration process.

### **Comprehensive roadmap for East Asian economic integration and narrowing development gaps: Some ideas**

To develop a roadmap for East Asian economic integration, the most essential thing is to have a comprehensive analysis/assessment of the key factors such as vision, strategic objectives and contents, socio-economic impacts, implementation method, including risks/difficulties, and supervision.

Cambodia, Laos, Myanmar, and Vietnam, four newer members of ASEAN, see deeper regional economic integration as a necessary and unavoidable process that would bring about benefits as well as challenges to them. A key question for the CLMV is how they can catch up with more advanced economies in the region given their limited resources. Moreover, to a significant extent, the CLMV themselves are also individually different in terms of the pace of reforms and international integration as well as socio-economic performance. Therefore, it is not easy to generalize any proposition or conclusion for the CLMV as a whole.

External assistance for the newer members needs to cover institutional building. Institutions do matter for economic growth and sustainable development. Also, trade liberalization and integration can be viewed as institutional changes and reform. An exchange program on building market institutions can play a role in creating more appropriate institutions for individual economies, especially those in transition. This would make a positive contribution to the process of building political convergence in East Asia.

There are many constraints in developing effective and efficient cooperation among the CLMV countries. This would include limitations in both human and financial

resources as well as a small domestic market size. Moreover, the CLMV have similar comparative advantages and their trade structure is more competitive than complementary. This would provide limited business opportunities and therefore, an effective cooperation among the CLMV should include both other countries and international donors.

There are four “I” gaps that should be considered in the analytical framework when dealing with the development gap issues in the ASEAN community building. The four “I” gaps include the income gap, the infrastructure gap, the integration gap, and the institutional gap. Toward this end, future policy actions should:

- Consider the objective of “bridging the development gaps in ASEAN” as core mission to any community-building strategy in the region.
- Make sure the four “I” gaps are embedded in future action toward an AEC.
- To sustainably bridge the development gaps in ASEAN; the most vulnerable must be prioritized in getting better access to the four “I”s.

Vietnam sets a good example of how a low-income transition economy could succeed in its development as well as in regional cooperation and integration. Vietnam may also serve as a good “bridge” for a better mutual understanding between the newer and older members in ASEAN.

### **The role of ERIA**

The ERIA can also have a significant contribution to the process of building East Asian community if it could realize the following missions:

- To have policy-oriented studies with rigorous analyses and high credibility;
- To be a “good and close bridge” (mechanism) for dialogues between ASEAN Secretariat, East Asian policymakers, business communities, and economic researchers (in and outside of the region);
- To be a “regional hub” for capacity building, especially for the CLMV.

The research agenda for the ERIA should follow closely the pillars in the roadmap toward the AEC (i.e., deepening regional integration; narrowing development gaps; and sustaining development). To be practical, the research projects conducted by the ERIA need not only contain rigorous economic analyses/arguments, but also take into account the social and institutional issues.