

# Chapter 1

## Growth and Gaps in East Asia: Trade Investment, and Economic Integration

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March 2008

**This chapter should be cited as**

Lim, H. (2008), 'Growth and Gaps in East Asia: Trade, Investment, and Economic Integration', in Sotharith, C. (ed.), *Development Strategy for CLMV in the Age of Economic Integration*, ERIA Research Project Report 2007-4, Chiba: IDE-JETRO, pp.17-46.

## Chapter 1

# GROWTH AND GAPS IN EAST ASIA: TRADE, INVESTMENT, AND ECONOMIC INTEGRATION

*Hank Lim*

### ABSTRACT

Economic integration in East Asia is picking up speed, due to foreign direct investments (FDI). This integration is increasingly based on production networking of agglomeration and fragmentation by optimizing the process of globalization.

However, there are visible evidences of constraints such as income gap, development gap, and institution gap. Globalization has relatively widened further the gap between the more-developed and the less-developed countries in the region. This has resulted in an uneven economic integration in East Asia.

There are a number of bilateral and subregional economic and technical assistance schemes for Cambodia, Lao People's Democratic Republic or Lao PDR, Myanmar, and Viet Nam (CLMV), but the scope and substance of such schemes are inadequate. It is considered as necessary, therefore, to develop policy packages and incentives in order to utilize globalizing and regional production network. There is, in fact, a clear sign that economic agglomeration is starting to influence industrial location, whereby CLMV could benefit from such process. The geographical proximity of China, India, Thailand, and Viet Nam as growth centres are definitely an advantage, as long as CLMV can reduce setup cost and service link cost. In turn, reducing such costs will require a gradual but vast improvement in infrastructure, institutions, human resource development, and governance of CLMV.

Toward this objective, it is suggested that multilateral stakeholder fund is put in place through policy recommendations and further commitment to increase and coordinate intra-ASEAN Official Development Assistance (ODA) is established. These will have to support infrastructure development, human resource development, and domestic policy reform. In the end, reducing development gaps will go a long way in improving ASEAN economic competitiveness and in moving towards a common production base and single market as embodied in the ASEAN Economic Community.

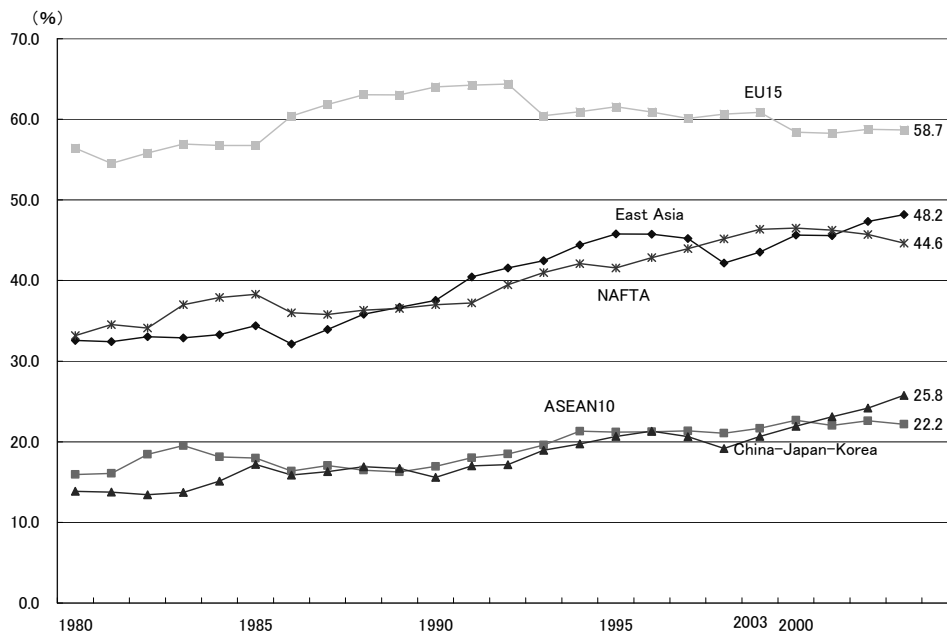
## 1. INTRODUCTION

Prior to the Asian financial crisis in 1997, rapid and dynamic economic growth in East Asia was facilitated through market-driven forces. Various regional economic cooperation initiatives and schemes were introduced, including an agreement on ASEAN Free Trade Area (AFTA) in 1992, which came into full operation by end of 2003.

The impact of ASEAN-initiated regional cooperation was negligible, because ASEAN economies were basically competing on the same product range and their main export markets were non-ASEAN countries. However, a clear evidence has been recently identified, which indicates that the impact of AFTA has encouraged production networking on some intermediate and consumer goods in Thailand, Viet Nam, and other ASEAN economies.

Some economists claimed that de facto economic integration has proceeded in East Asia, even as there was no effective implementation of AFTA and other regional bilateral trade and investment agreements. The nature and characteristics of de facto economic integration are crucially important in policy discussion to understand how far integration has been realized and what sort of integration has been achieved so far. Understanding such fundamental issues would be helpful for policymakers in designing regional and bilateral Free Trade Areas (FTAs) that will facilitate and accelerate further regional production networks. The development of vertical production networks have certainly been supported by trade liberalization efforts. On the other hand, the trade regime in East Asia is still far from a single production base and a single market. Substantial barriers in service trade still remain in East Asia. The development of vertical production networks and the remaining

**Figure 1. Intra-regional Trade (Exports and Imports) Ratio ( percent)**



Source: IMF, Direction of Trade, 2004 CD-ROM.

trade barriers affect the nature of ongoing process of de jure economic integration in East Asia.

Since the early 1990s, international production networks have been developed in the ASEAN and surrounding East Asian countries. Production networking and regional division of labour have been pursued, resulting in massive vertical intra-industry trade in parts and components within the region.

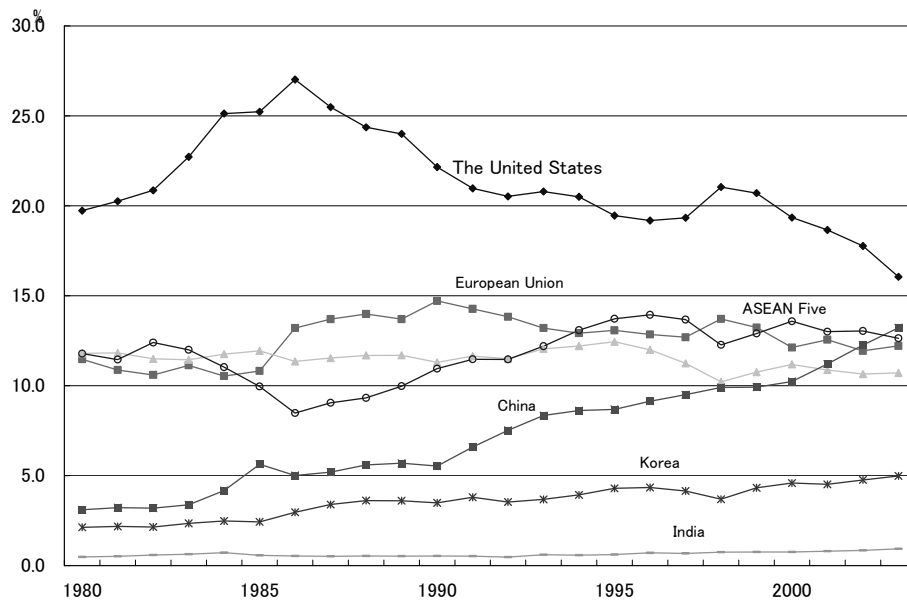
International trade statistics clearly presents the recent advancement of de facto economic integration in East Asia. In Figure 1, which shows the share of intra-regional trade (exports and imports) within several economic areas, the share of intra-East Asia trade remarkably rose from 34.9 percent in 1980 to 52.4 percent in 2003 (East Asia comprises the ASEAN 10, China, Japan, Hong Kong, and the Republic of Korea). Surprisingly, this

increase is higher than that of NAFTA (44.6 percent) though a bit lower than that of the EU (58.7 percent). 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 in the late 1990s when the Asian currency crisis happened.

However, economic integration in East Asia does not seem to develop in an even manner. The share of intraregional trade of the ASEAN 10 and China–Japan–Korea in 2003 remained at only 22.2 percent and 25.8 percent, respectively, as compared to that of East Asia (52.4 percent). This suggests then that economic activity requires a large space for expansion, that is, the whole East Asia, as the spatial economists would argue. Moreover, China and the ASEAN 5 (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) increased their shares in East Asian trade, as shown in Figure 2. This suggests that even countries with relatively low-income levels have played a significant role in the expansion of the intraregional trade in East Asia.

It should be noted that the trade pattern inside East Asia has changed, from the traditional pattern (in which final products, such as consumer goods, intermediate goods, and capital goods, were being traded) to a pattern where parts and components were traded. To put it differently, intermediate goods in the same industry have been actively traded among the Asian countries, expanding intra-industry and intraregional trades. For instance, import shares of parts and components within East Asia increased from 7.2 percent in 1980 to 32.2 percent in 2003, while those of processed goods decreased from 37.3 percent in 1980 to 28.0 percent in 2003. The shares of parts and components became the largest among commodity groups (see Figure 3).

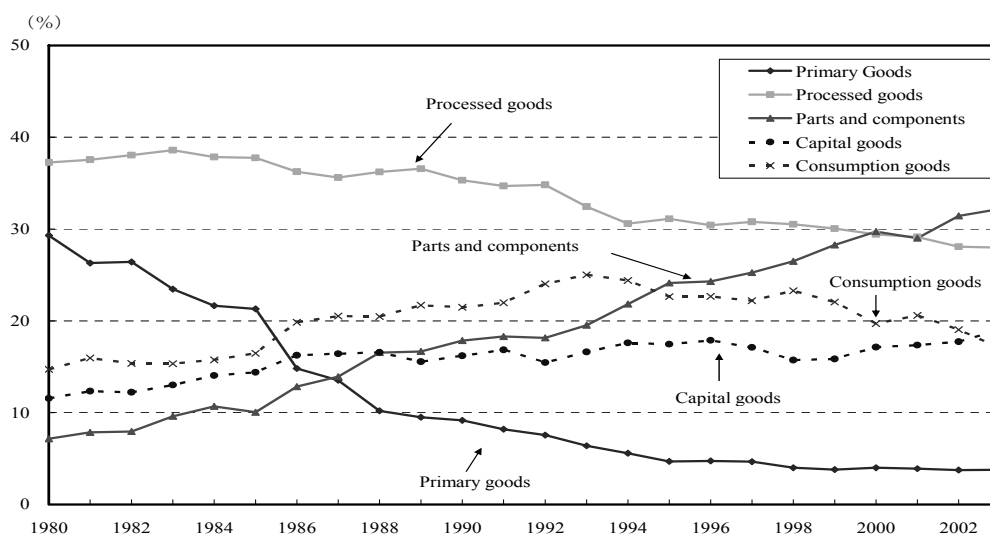
**Figure 2. Trade Share of East Asia with Partner Country ( percent)**



Note: East Asia consists of ASEAN 10, China, Japan, Hong Kong, South Korea, and Taiwan.

Source: IMF, Direction of Trade, 2004

**Figure 3 Trade Pattern Inside East Asia ( percent)**



Source: ComTrade

From this development we can generate an observation about an explosive increase in East Asian trade in intermediate goods, particularly in machinery industries, based on production process-wise international division of labour among countries with different income levels and development stages. Trade patterns in today's global competitive climate where economies of scale strongly work are quite different from the traditional ones that are based on static comparative advantage. The whole production processes involve sequential production blocks located across countries. Different stages of production are shared by different suppliers located in different countries. Instead of final products, companies in different countries traded components and intermediate input.

This phenomenon is known as cross-border production sharing or fragmentation of production. Production processes, located in different countries in East Asia, are finely divided into many stages. 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 being processed in country B. In this case, the good crosses a national border four times. This is what actually happens in East Asia—when trade costs decline, such decline comes with substantial increase in the competitiveness of the whole East Asia.

In the ASEAN and surrounding East Asian countries, international trade in parts and components has been expanded, and the international division of labour in terms of production processes has grown 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. The fragmentation of production processes and the formation of economic agglomeration, however, are rather new phenomena that started in

the late 1980s or the early 1990s. To understand the mechanism of agglomeration and fragmentation, understanding the new economic geography and the fragmentation theory would be useful.

The new economic geography explains the formation of economic agglomeration 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, which 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, an automobile assembler would attract a number of upstream suppliers, and the resulting productivity enhancement and market expansion may in turn attract another assembler. Such circular causality would generate a sort of economies of scale in a geographical sense.

On the other hand, 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 tough price competition among firms, and cause traffic congestion, and air pollution. Due to such negative effects, dispersion forces would be intensified.

One of the important factors that delicately affect the balance between agglomeration forces and dispersion forces is the broadly defined transportation costs, which includes freight cost, tariffs, nontariff barriers, and risk for exchange-rate variation. As transport costs decrease, agglomeration may grow. With a further decrease in transport costs, production activity may rather disperse. The new economic geography analyzes factors, some of them are policy variables, that determine industry location among countries or cities in different sizes.



The fragmentation theory focuses on the location of production processes. Production processes are fragmented into multiple slices and located in different areas, say, in different countries in East Asia. Suppose that an electronics company originally has a huge factory in a developed country, and this factory takes care of the whole production processes, from upstream to downstream. If the company can separate production processes and establish them in appropriate places, the total production cost may be maximized.

There are three elements that make fragmentation possible. First, there must be production cost savings in fragmented production blocks; the company must take advantage of the differences in location between the original position and the new position. Second, the cost of service links that connect remotely located production blocks (that is, costs of transportation, telecommunications, and various types of coordination) must not be too high. Third, the cost of network setups is small. When additional cost for setting a new plant is relatively small, the production process can be easily fragmented.

The feasibility of fragmentation, therefore, heavily depends on the nature of technologies in the industry and the economic environment. New economic geography and the fragmentation theory provide insights into important factors that determine the location of economic activities in the globalization era.

## **2. POLICY ENVIRONMENTS THAT ENABLE UTILIZATION OF GLOBALIZING FORCES**

International production or distribution networks in the ASEAN and surrounding East Asian countries are relatively the most advanced and sophisticated in the world. East Asia has no doubt developed a favorable policy environment suitable for globalizing corporate activities. However, such policy environment has been realized through accumulated

profit-motivation actions by the private sector, rather than being developed with well-designed strategic moves. Analytical evaluation of policy environments that enable countries to take advantage of globalizing forces for economic development is necessary and important.

The new economic geography and the fragmentation theory provide rich implication for policy environments in the globalizing era. The new economic geography suggests policies affecting the agglomeration forces and the dispersion forces. The fragmentation theory lists up policies affecting production cost savings, service link cost, and network setup cost.

Combining the new economic geography, with careful consideration on policy needs that are possibly have different development stages, it is possible to develop desirable policy packages in order to utilize globalizing forces.

## **2.1 The Economic Development of Latecomers**

The economic development of latecomers, in particular CLMV, is a very important agenda not only for CLMV but also for the ASEAN and the whole East Asian countries. The relationship between two objectives—to deepen integration and narrow development gaps—takes the most extreme form in this context.

### *2.2.1 Macroeconomic Indicators*

In Table 1, which shows wide gaps in terms of GDP per capita between the ASEAN member-countries, Brunei and Singapore topped the list in 2006. On the other hand, CLMV, with GDP per capita of less than US\$1,000, took the bottom of the list. Note that

even among the older ASEAN-6 member-countries, there are wide gaps, with Indonesia and the Philippines trailing behind.

Cambodia, Lao PDR, and Myanmar are primarily agro-based, while Viet Nam has relatively large manufacturing and services sectors. Viet Nam's share of services in GDP was already on par with that of Indonesia's and Brunei's, while Singapore took the lead on the list. This explains that for economic integration to proceed smoothly, the issue of incompatible economic structures needs to be tackled.

**Table 1: ASEAN Macroeconomic Indicators**

	GDP at current prices (US\$ '000 mil)		GDP per capita at current prices (US\$ '000 mil)		Share of Agriculture in GDP		Share of Industry in GDP		Share of Services in GDP	
	2001	2006	2001	2006	2000	2004	2000	2004	2000	2004
Brunei	4.2	11.6	12.1	30.2	1.6	2.1	59.5	58.4	38.9	39.5
Indonesia	164.8	364.3	0.8	1.6	15.6	15.0	45.9	44.5	38.5	40.5
Malaysia	88.0	156.9	3.7	5.9	8.4	7.9	44.2	42.4	47.4	49.7
Philippines	72.0	117.5	0.9	1.4	19.9	19.7	34.7	33.0	45.4	47.3
Singapore	85.9	132.3	21.0	29.5	0.1	0.1	33.8	32.6	66.1	67.3
Thailand	115.6	206.6	1.8	3.2	10.3	9.3	44.4	46.7	45.3	44.0
Cambodia	3.8	7.3	0.3	0.5	39.6	32.8	23.3	30.7	37.1	36.5
Laos	1.7	3.5	0.3	0.6	52.1	50.2	22.7	24.6	25.2	25.1
Myanmar	8.3	12.0	0.2	0.2	42.9	42.9	17.3	17.3	39.7	39.7
Vietnam	32.6	61.0	0.4	0.7	23.3	20.2	35.4	39.4	41.3	40.4

Source: ASEAN Statistical Yearbook (various issues)

ASEAN Statistical Pocketbook 2006.

### 2.2.2 Human Development Index (HDI)

Average achievements in basic human development can be measured and compared using the human development index (HDI). Based on three component sub-indices (life expectancy, education, and GDP), the HDI value of a country, which ranges from 0 to 1, shows the distance the country has to travel to reach the maximum possible value of 1.

Table 2 compares the development states of the ASEAN member countries. The latest HDI rankings (“UNDP: Human Development Report 2006”) put Singapore, Brunei, and Malaysia in the “high human development category,” while the rest fall under the “medium human development” category.

**Table 2: ASEAN Human Development Indicators**

	Human Development Index (Rank)		Human Development Index (Value)		Life Expectancy Index		Education Index		GDP Index	
	1999	2004	1999	2004	1999	2004	1999	2004	1999	2004
Singapore	26	25	0.876	0.916	0.87	0.90	0.87	0.91	0.89	0.94
Brunei	32	34	0.857	0.871	0.85	0.86	0.86	0.88	0.87	0.88
Malaysia	56	61	0.774	0.805	0.79	0.81	0.80	0.84	0.74	0.77
Thailand	66	74	0.757	0.748	0.75	0.75	0.84	0.86	0.69	0.73
Philippines	70	84	0.749	0.763	0.73	0.76	0.91	0.89	0.61	0.64
Indonesia	102	108	0.677	0.711	0.68	0.70	0.79	0.83	0.56	0.60
Vietnam	101	109	0.682	0.709	0.71	0.76	0.84	0.81	0.49	0.55
Cambodia	121	129	0.541	0.583	0.52	0.52	0.66	0.69	0.44	0.53
Myanmar	118	130	0.551	0.581	0.52	0.59	0.75	0.76	0.39	0.39
Laos	131	133	0.476	0.553	0.47	0.50	0.51	0.66	0.45	0.50

Source: UNDP. Human Development Report - 2001 & 2006.

As if this is not bad enough, those falling within the “medium human development” category can be further subdivided into “upper,” “medium,” and “lower.” Note that Lao PDR was in the “low human development” category in 1999 but is now within the “medium human development” category in the latest rankings.

Table 3 shows the HDI trends of the ASEAN countries from 1985 to 2004. Though there have been improvements in HDI readings for all ASEAN countries, it is not likely that improvements expected to be achieved over the next 10 years or so by the less-developed ASEAN countries will be enough to enable them to catch up with the more-developed countries, because these countries will also be moving forward.

**Table 3: Human Development Index Trends**

HDI RANK (2004)	Country	HDI Values				
		1985	1990	1995	2000	2004
25	Singapore	0.786	0.823	0.862	...	0.916
34	Brunei	...	...	...	...	0.871
61	Malaysia	0.696	0.723	0.761	0.791	0.805
74	Thailand	0.680	0.717	0.751	0.775	0.784
84	Philippines	0.695	0.722	0.738	0.759	0.763
108	Indonesia	0.585	0.626	0.665	0.682	0.711
109	Vietnam	...	0.618	0.661	0.696	0.709
129	Cambodia	...	...	0.536	0.545	0.583
130	Myanmar	...	...	...	...	0.581
133	Laos	0.425	0.451	0.488	0.523	0.553

*Source: UNDP. Human Development Report - 2006.*

Since the early 1990s, there have been all sorts of international initiatives to assist the Mekong-Delta countries. With the admission of CLMV into the ASEAN, there are now ASEAN initiatives (e.g., the IAI Work Plan) targeted at these countries. Between 1995 and 2004, Viet Nam improved its HDI reading from 0.661 to 0.709, that is, an increase of 0.048 point, without the help of IAI Work Plan. Assuming that Cambodia, Myanmar, and Lao PDR are able to improve their HDI readings by a very improbable 0.048 point between 2004 and 2015 with the help of the IAI Work Plan, while the HDI readings of the rest of the ASEAN countries remain stagnant at the levels achieved in 2004, these three countries still will not be able to catch up with the rest, not even with Viet Nam.

Various initiatives have been put in place to assist CLMV. It specifically looks at the IAI Work Plan projects, analyzing how effective they have been.

### **3. CLMV-FOCUSED COOPERATION AND ASSISTANCE**

International attention started to focus on CLMV in the early 1990s after the end of the Cold War and the Cambodian civil war, and when the free market reforms were launched in said countries, which started in the late 1980s. The 1990s saw the creation of various international forums and cooperative efforts to promote development in the Mekong region. The efforts include, among many others, the following:

#### **3.1 ADB-sponsored GMS Economic Cooperation Programme**

Since 1992, the countries of the Greater Mekong Sub-region (GMS)—Cambodia, Lao PDR, Myanmar, Viet Nam, Thailand, and the Yunnan Province of the People's Republic of China—have embarked on a programme of economic cooperation, with the support of

international organizations. The programme has so far managed to achieve results that are more tangible and carried more impact on regional cooperation. The high-priority subregional development projects include projects in transportation, energy, telecommunications, environment, human resource development, tourism, trade, private sector investment, and agriculture.

### **3.2. Working Group on Economic Cooperation in Indochina**

The Working Group, which was organized under the umbrella of the ASEAN and Japanese economic Ministers Meeting (AEM-MITI), held its first meeting in 1995. It targeted countries that were not regular ASEAN members—Lao PDR, Cambodia, Myanmar, and initially, Viet Nam. The Working Group aims “to promote the economic development of Cambodia, Lao PDR, and Myanmar and also to promote economic growth of the Southeast Asian region as a whole by strengthening the economic linkages between these countries and other ASEAN countries.”

### **3.3 ASEAN Mekong Basin Development Cooperation (AMBDC)**

Initiated by the ASEAN, ten Southeast Asian countries and China attended the first Ministerial Meeting in 1996. The objectives of this cooperative effort were: (1) to enhance economically sound and sustainable development of the Mekong Basin; (2) to encourage a process of dialogue and common project identification that can result in firm economic partnerships for mutual benefit; and (3) to strengthen interconnectivity and economic linkages between the ASEAN members and the Mekong riparian countries.

The ASEAN’s efforts to help tackle the Mekong region's development issues and challenges were shelved temporarily during the 1997-1998 Asian financial crisis when the

members of the group became too engrossed with their own domestic economic problems. But as Asia started to recover from the financial crisis, the Mekong development moved back onto the ASEAN's agenda.

The ASEAN leaders agreed at the 2004 Vientiane Summit to pursue comprehensive integration of the ASEAN into an ASEAN Community by 2020. At the ASEAN Economic Ministers Meeting in Kuala Lumpur on August 24, 2006, the member-countries agreed to accelerate the objective of the ASEAN Economic Community by 2015. The ASEAN Economic Community is the realization of the end-goal of economic integration, as outlined in the ASEAN Vision 2020: to create a stable, prosperous, and highly competitive ASEAN economic region in which there is a free flow of capital, equitable economic development, and reduced poverty and socio-economic disparities by 2020. Reducing development gaps among the ASEAN members are firmly manifested and embedded in the Hanoi Plan of Actions, the Bali Concord II, and the Vientiane Actions Programme

In the light of these developments, correcting the so-called "ASEAN divide" became a high priority. There was a greater commitment toward assisting CLMV to ensure that no one is left behind.<sup>10</sup> Solidarity would be affected if the divide would not be eliminated. To help hasten the economic development of CLMV and, hence, narrow the development gap between these countries and the more-developed ASEAN-6, ASEAN leaders agreed in November 2000 to launch the Initiative for ASEAN Integration (IAI).

In the meantime, the AMBDC resumed its activities. It held its second ministerial meeting in 2000. At its third ministerial meeting in October 2001, it was agreed that Japan and South Korea would be taken in as additional members. Projects related to infrastructure, trade and investment, agriculture, forestry and minerals, industry, tourism, HRD, and



science and technology have been implemented or are ongoing, but there have been financing problems.

At the Eighth Ministerial Meeting of the AMBDC in August 2006, the member-countries agreed to provide recommendations to place the AMBDC Ministerial Meeting under the ASEAN Economic Ministers Meeting process at the 12th ASEAN Summit in December 2006. The rationale given for the recommendation was that it would be easier to synchronize the economic integration activities, and, hence, would make maximum use of resources available.

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 versus other countries) as well as among domestic regions in each country (e.g., inland versus coastal regions in China). At the same time, the dispersion forces may move manufacturing activities from forerunners to latecomers, and 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 is, in fact, a sign of congestion in economic agglomeration in East Asia, and the dispersion forces start working so as to influence industrial location. We observe substantial increases in production costs in agglomeration due to difficulties in securing labour and land, traffic jam problems, among others. Companies have to find labour from distant places, and some of them eventually set up a new factory in middle-size cities or rural areas. In particular, labour-intensive or land-intensive production processes tend to

shift. In the last several years, many cities have been growing with increasing number of residents, factories, and warehouses. For instance, in Thailand, factories are located in concentration in Lamphun, 50 kilometer south of Chiang Mai. In Malaysia, many parts suppliers are in Johor, and Malacca, where a superhighway is connected from Singapore to Kuala Lumpur.

The fragmentation theory, on the other hand, suggests that the differences in location advantages, such as factor prices, motivate fragmentation of production processes. Differences in wage levels between the ASEAN forerunner countries and CLMV are still substantial, and thus CLMV may have strengths, particularly for labour-intensive or natural resource-intensive production processes. The issue would be the network-setup cost and the service link cost. Their geographical proximity to growth centers would be a strong point, but drastic reduction in the setup cost and the service link cost would be required. Efforts for deeper integration would also be essential to preparing necessary policy environments.

To summarize, latecomers, particularly CLMV, have good opportunities for attracting economic activities in the globalization era. By strategically improving policy environments, they can attain two objectives at the same time: deepening integration and narrowing development gaps.

It is vitally important to understand the extent of the influence of the global value chain (GVC) and de jure regional trade agreements on regional production networking. Global business corporations have extended their production, material and resource sourcing, and markets beyond their domestic economies. Because of the pressure of integration, competition and JIT production system, East Asia is now fully connected into a global value chain system in which it produces the world production output. The

importance of production networking, clustering (agglomeration) and fragmentation must be factored in de jure regional FTAs. There are some studies related to the importance of this issue. What is needed is to focus the linkage and relevance of de jure regional trade and investment arrangements with the accelerating process of production networking. A study should be conducted to examine specific trade and investment areas and sectors that require further government support and facilitations arising from trade and investment agreements.

Economic integration in terms of production networking or value chains has not benefited much from formal regional trade agreements. The basic weaknesses of the ASEAN Free Trade Area (AFTA), the ASEAN Economic Community (AEC), the ASEAN Investment Area (AIA), and the ASEAN Framework Agreement on Services (AFAS) consist of the too many exceptions on key sectors of ASEAN economies, as well as the inadequate standardization and harmonization of rules and regulations (including the existence of nontariff barriers). Transportation, infrastructure, and institutions to implement those trade and investment agreements are either not present or inadequate.

Production network and regional economic integration in Southeast and Northeast Asia, within the framework of global value chain and expanding production network in East Asia, are picking up speed. They are motivated basically by market-driven forces of competition, the rise of China and India, the political stability in the region relative to other regions, and the availability of productive labor force and resources buttressed by individual country's macroeconomic regime and liberal trade and investment regimes that promote economic development.

Despite many distortions and inefficiency in implementing the ASEAN regional cooperation schemes, there are many cumulative positive effects on the rapidly emerging production networking and agglomeration of industry in East Asia. The clustering of

automobile industry and parts in Thailand, the clustering of electronic industry in Malaysia, and the knowledge-based industry cluster in Singapore are cases in point. Indirectly, positive and business-friendly policies and institutional environments in Southeast Asian countries have undoubtedly contributed to the emergence of industrial clustering and agglomeration and production network particularly in parts, components, and intermediate inputs in some sectors and in some selected Southeast Asian countries.

Further and enhanced efforts to accelerate and integrate existing agreements in goods, services, and investment are vitally important for ASEAN economies to meet the challenges and opportunities related to the rise of China and India and the accelerating process of global value chain development trend.

In the case of CLMV, these countries require development assistance in addition to the ASEAN regional economic integration. Without adequate development assistance, trade and investment liberalization alone would not be sufficient for these countries, perhaps with the exception of Viet Nam, to benefit from the emerging production networking and industrial clustering in Southeast Asia. That's because their infrastructures and institutions are yet to be developed.

Economic integration through regional and bilateral FTAs can enhance regional production networking if policy makers can minimize the distortions related to regional and bilateral FTAs in East Asia. Since 2000, bilateral FTAs and subregion FTAs have proliferated in East Asia. What is the nature of the proliferation FTAs in East Asia? Those bilateral FTAs are based on reciprocal preferential tariff schemes. Both parties choose its own sensitive lists. This implies that, for example, the ASEAN-China FTA (ACFTA) is counted as 10 separate bilateral FTAs between China and the 10 ASEAN countries. The

degree of market access faced by an ASEAN exporter varies according to the ASEAN destination markets. This means that there are 45 bilateral preferential trade relationships within 10 ASEAN countries ( $10 \times 9/2=45$ ). In the same way, ASEAN-Japan FTA, ASEAN-Korea FTA, and ASEAN-India FTA are 10 separate bilateral FTAs each. ASEAN-CER (Australia and New Zealand) is 20 bilateral FTAs. A total of 105 ASEAN FTAs are enforced and/or under negotiation. Any ASEAN exporter faces different preferential treatments based on destinations. Baldwin (2006) has called the overlapping FTA problem as East Asian “noodle bowl syndrome.” Potentially, 16 countries would produce 120 bilateral FTAs ( $16 \times 15/2$ ) in the region.

Different FTA strategies by individual country may create severe overlapping FTA problems with various kinds of FTA. Because of the different FTA strategies taken by each country, there are much heterogeneity in exclusion lists, tariff rates, rules of origin, dispute settlement mechanism, mutual recognition, competition policy, and other norms and regulation among existing multilateral FTAs in Asia. The overlapping FTAs would complicate tariff rates and RoO on the same products, according to destinations. It is commonly agreed that the costs arising from the RoO are expected to increase substantially when countries experience overlapping of multiple FTAs/RTAs.

Other than the lack of FTA management arising from different FTA strategy and overlapping issues, there are some crucial impediments in the East Asia’s bilateralism. First, except for a few countries, East Asia has failed in forming high level FTAs in terms of trade liberalization. Reduction in agricultural trade barriers is important for narrowing development gaps. Agricultural products, however, tend to be excluded from preferential tariff treatments.

Moreover, the bilateral FTAs in East Asia have addressed trade liberalization in goods, while liberalization in service trade has not progressed much in East Asia's FTA bilateralism. In short, economic integration in East Asia still remains "shallow." There are limited benefits from such integration, since there are much border-related barriers other than tariffs. A study estimates that trade costs of developed countries total 170 percent, of which 21 percent come from transportation of goods, 44 percent from border-related trade barrier, and 55 percent from retail and wholesale distribution costs. The study suggests that tariff reduction can partly reduce border barriers. Considering that East Asia's border trade barriers other than tariff are greater than those in developed countries, this region can considerably benefit from reduced border barriers.

Present trade patterns are very different from the past patterns as global competition emphasizes economies of scale. Production process involves sequential stages of production located across countries. Different stages of production are divided among different suppliers that are located in different countries. Products traded between companies in different countries are intermediate goods instead of final products, and final products are sold outside the region in which international division of labour in production process happens either intra-firm or inter-firm. This phenomenon is known by many names: production fragmentation, slicing up the value chain, vertical specialization, and production network.

The practice of dividing production process into many stages and locating it in different countries has progressed significantly and is gaining speed in East Asia. Theoretically, it has been confirmed that in such vertical specialization, a slight decline in trade costs induces large trade in intermediate goods, since goods are traded across borders many times.

The policy environment for trade facilitation in East Asia varies considerably by country. For example, customs clearance time in one country is quite different from that of another country. Customs procedures in many countries in East Asia are still complicated and lack transparency. This means that the policy space to facilitate trade or reduce trade costs remains wide. If trade facilitation measures, such as simplification and harmonization of customs procedure, paperless trading, and mutual recognition, are improved, trade costs will be reduced and production network will be expanded to a considerable extent.

The enhancement of logistic infrastructure system, including institutional system, is an issue that should challenge policymakers in East Asia toward realizing deep integration, since this will facilitate trade and location of production. The study on cross-border trade facilitation for ASEAN countries by JETRO (2006) reveals that goods between Bangkok and Hanoi, for example, were transported mainly by sea. This does not fit the “just-in-time” production operation prevailing in other parts of East Asia. JETRO study suggests that if logistic infrastructure system, such as road networks, transportation terminal facilities, and legal institution, is developed and established, then trucking transportation would increase.

#### **4. Conclusion**

Intraregional trade and investment have been developed through production networking in terms of regional division of labour and vertical specialization. Since the Asian Financial crisis in 1997 and the rapid rise of China, production networking has considerably developed in East Asia, Northeast Asia, and Southeast Asia. However, the pattern of industrial development in East Asia is not even and there are many existing structural and policy impediments to regional economic integration, resulting to growth gaps.

In the past, regional economic integration was largely driven by market forces and supplemented by subregional and bilateral FTAs. Since 2000, the impetus of regional integration by way of initiating and establishing subregional and bilateral FTAs has increased considerably. However, due to different FTA strategies adopted by regional countries and the proliferation of low-grade FTAs, subregional and bilateral FTAs have resulted to duplication and overlapping rules of origin, dispute settlement mechanism, and competition policy, as well as other distortions in trade and investment regimes. These constraints tend to increase transaction costs and trade barriers despite continuing reduction in average tariff rates in developing countries in East Asia. Increased transaction costs would tend to reduce industrial dispersion effect in less-developed economies in the region and, thus, the phenomenon of growth gaps in East Asia would tend to persist.

To minimize this trade and investment distortion and increase production networking, economies in the region must aim for high-grade FTA and consolidate the existing plethora of bilateral FTAs. Equally important is policy priority to harmonise customs procedures, mutual recognition of standards, and improvement of infrastructure and other capacity-building efficiency to facilitate cross-border trade. Such policy initiatives and measure would invariably enhance the capacity and competitiveness of the regional economies to leverage the ever-accelerating globalization through global value change (GVC) trend, regional division of labour, and vertical specialization of production process, which is operating more strongly in East Asia than in any other region.

As part of global value chains (GVC) production network, CLMV must be part of the global value chains process for CLMV to prosper. In other words, individual CLMV economy must identify its specific market and production niches and contribute to the overall regional and global production network. Such development strategy applies



particularly to countries that have small domestic market and lack in marketable commodities and resource endowment (Cambodia and Lao PDR may be cited as case in point). Development strategy of Cambodia and particularly Lao PDR necessitates the identification of their specific market and production niches, which can contribute to the production network of the much larger and more-developed economies such as Thailand, Viet Nam, and China.

More than the need for trade and investment liberalization, CLMV economies urgently need to undertake long-term, consistent, effective domestic restructuring, as well institutional and organizational reforms. Likewise, there is a need to institute transparency and enforce legal framework and good governance through effective civil service administration.

Without those internal reforms, FDI, under the impetus of globalization and regional trade and investment agreements, tends to gravitate to more efficient and developed economies and therefore aggravate the widening development gap in East Asia.

Any regional integration requires the provision of regional public goods by more developed and stronger economies. A case in point is the role of Germany and France in providing regional public goods in the early formative years of the European Economic Community (EEC). These public goods can be in the form of technical assistance, grants-in-aid, concessionary loans (ODAs), preferential market access without reciprocity, and other privileges. The provision of these regional public goods is often referred to as “enabling clause,” with the objective to establish human and institutional capacity for the less-developed members. Over a period of time, a level playing field may emerge, which would contribute to the realization of more prosperous, competitive, and equitable ASEAN economies as envisioned in the ASEAN Vision 2020.

It should therefore be the collective responsibility of more-developed ASEAN members to undertake a long-term initiative in providing adequate public goods to CLMV. Such as strategic approach would go a long way in establishing a sense of shared prosperity and in strengthening community value and regional identity as embedded in the ASEAN Social and Cultural Community.

In this context, the ASEAN-6, on a bilateral basis, have contributed about USD\$159.4 million to CLMV to implement various projects and a total of 55.5 percent of the total funding required in the Integrated ASEAN Initiative (IAI). However, much more resources need to be provided in the areas of infrastructure, human resource development, information, communications technology, and customs capacity improvement. In addition, the ASEAN Development Fund (ADF) is up and running with contributions from Australia and India, and to a large extent from Japan through Japan-ASEAN Integration Fund (JAIF) to provide funds for the implementation of Vientiane Actions Programme.

Towards this objective to reduce development gaps, there are existing regional and bilateral mechanisms to implement development assistance to CLMV. Greater Mekong Sub-regional (GMS) Initiative provides a comprehensive framework of development programme. Through the ASEAN-Mekong Basin Development Cooperation, the programme encompasses the ASEAN Highway Network; the ASEAN East-West corridor across Viet Nam, Lao PDR, Cambodia, Thailand, and Myanmar; the Singapore-Kunming Rail Link; and the ASEAN energy network. In this respect, Japan has committed to providing more than \$3-billion assistance to ASEAN for human resource development and exchange programme for the development of the Mekong sub-region.

What is also urgently needed is a sense of priority and political commitment to implement those agreed initiatives and programmes based on existing mechanism. With

greater and consistent assistance in providing regional public goods, the GMS assistance, accompanied with timely and correct domestic reforms, CLMV would gradually integrate with the rest of ASEAN as envisioned in the ASEAN Vision 2020.

Reducing development gap is an important and strategic measure that will establish ASEAN as a credible and dynamic regional organization ready for economic integration and the ASEAN Community by 2020. Economic integration goes parallel with economic competitiveness. To meet the economic challenges that go with the rise of China and India, ASEAN has to establish a single market and production base of 550 million people.

Without adequate and consistent development assistance to less-developed economies of CLMV, trade and investment liberalization and domestic reform measures would not be sufficient to engender a sustained overall development for CLMV. To enable these countries to participate and contribute fully to regional integration, development agenda are more important than liberalization in trade and investment at this stage of their development.

The framework for reducing development gap is already in place. ASEAN needs policy focus as well as coordination and political commitment among more developed members and their external partners, particularly within the ASEAN-Plus-Three (APT) framework, to provide regional public goods (external economies) for their less-developed ASEAN members.

## **5. Policy Recommendations**

1. Initiate and set up multilateral stakeholder fund and a commitment to increase and coordinate intra-ASEAN Official Development Assistance (ODA);

2. Accelerate economic integration measures as embodied in the Bali Concord II to increase ASEAN economic competitiveness as an important mechanism to reduce development gap;
3. Undertake a study to identify policy measures to attract FDI into infrastructure development in CLMV through a series of workshops organized to review the recommendations of the study and formulate an implementation strategy;
4. Emphasize intra-ASEAN assistance for education and technical trainings for the youth;
5. Initiate infrastructure joint development in CLMV to support economic integration;
6. Strengthen coordinating mechanism within the existing subregional arrangements in the ASEAN;
7. Develop subregional and bilateral trade and investment agreements consistent with wider regional agreement and will eventually converge to minimize trade and investment distortions and duplications of rules; and,
8. Establish a scheme to reduce development gaps, which is consistent and in line with the increasing competitiveness in ASEAN and moving towards a single market and production base.

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