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# The ASEAN Economic Community and the European Experience

by Michael G. Plummer

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# The ASEAN Economic Community and the European Experience

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## *Abstract:*

In November 2002, the Association of Southeast Asian Nations (ASEAN) committed itself to the creation of an ASEAN Economic Community (AEC), in which goods, services, capital, and skilled labor would flow freely by the year 2020, or possibly even 2015. Hence, the AEC will guide the ASEAN integration agenda for at least the medium-term. The object of this paper is to analyze the lessons (both positive and negative) for the AEC that might be gleaned from the European Union (EU) economic integration experience. The paper notes that while there is much that the EU experience can teach ASEAN, the region should not underestimate the substantive differences between the two regions or their differing historical contexts. Based on this analysis, the paper also suggests various approaches to the creation of the AEC that ASEAN might consider as it concretizes the AEC program.

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# ASEAN Economic Community and the European Experience

## I. Introduction

At the Association of Southeast Asian Nations (ASEAN)<sup>1</sup> Heads of Government meeting in Phnom Penh in November 2002, participants proposed that members consider the creation of an “ASEAN Economic Community” (AEC) by 2020. Naturally, the name is evocative, for “Economic Community” immediately summons up the European experience. In fact, when APEC was “reinventing” itself, someone proposed that the acronym “Asia-Pacific Economic Cooperation” should be replaced with “Asia-Pacific Economic Community.” This was rejected explicitly because APEC did not want to give the impression that it intended to move toward the EC model—too controversial.

For ASEAN Heads of Government to consider an economic community, even with the baggage the term carries, is really nothing new. ASEAN has always carefully studied the progress of European economic integration and viewed it as something of a “role model,” though within the context of Southeast Asia’s development. In this paper, we will consider what lessons the European experience might hold for ASEAN, as well as offering some suggestions—based in part on the EU experience—as to how ASEAN might evolve into an AEC. We begin with a brief look at the context of how ASEAN interacts economically, particularly in terms of trade, using some comparison with the early years of the EU. Section III follows with a review of the evolution of ASEAN economic integration, culminating in the AEC concept. Section IV delineates salient lessons of the EU experience for ASEAN. And finally, in Section V we offer suggestions as to how the AEC might proceed.

## II. Intraregional ASEAN Context

In 2004, ASEAN intraregional trade was 22% of total trade (Table 1). Intraregional trade as a percentage of total trade was highest for Myanmar (45%) and Laos (33%). In terms of value, Singapore was first, followed by Malaysia, though it should be noted that Singapore’s share was particularly high as it handles considerable intraregional entrepot trade. Within ASEAN, the trade share was lowest for Cambodia (8%) and the Viet Nam (13%). Outside of the region, approximately 14% of ASEAN exports were destined for European Union (EU) markets, less than the 16% to the United States (US) and over 12% going to Japan. The EU was the most important single market for four ASEAN countries (Laos, Myanmar, Singapore, and Viet Nam); the US was the largest market for Cambodia, Malaysia, and Thailand, with Japan largest for Brunei Darussalam, Indonesia, and Philippines. The “Triad” (the EU, Japan, and US) also dominate foreign direct investment (FDI) flows to the region.

Hence, ASEAN has its most important economic partners outside the region, and any view of its regional economic integration must be appreciated in this context. As discussed below, this important fact is key to why ASEAN economic integration has been mainly geared toward “open regionalism.” The cost of an inward-looking approach to regionalism, or “Fortress ASEAN,” would be far too high. Regionalism in developing countries that have focused on an insular approach have generally failed (e.g., the Latin American Free Trade Area). It would be a disaster in ASEAN’s case.

European economic integration, therefore, stands in contrast to the ASEAN process. As we argue below, the EU<sup>2</sup>

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<sup>1</sup>The Association of Southeast Asian Nations (ASEAN) include Brunei Darussalam, Cambodia, Indonesia, Lao People’s Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.

<sup>2</sup>There is a difficult acronym issue in this paper: the European Union (EU) was the successor to the European Community (EC), which integrated the various economic communities in Western Europe, including the European Economic Community (EEC) and the European Coal and Steel Community (ECSC). We use EU throughout the paper for simplicity, even if we are actually referring here to the EEC.

**Table 1: ASEAN Exports to Selected Partners: 2004**

	World	ASEAN 6	ASEAN	PRC	JPN	ASEAN + 3	Asia ex JPN	CER	US	NAFTA	EU- 15
	(\$ millions)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Brunei Darrusalam	4,511	17.2	17.2	4.5	38.1	73.9	35.8	14.1	8.6	8.7	2.6
Indonesia	71,550	17.1	18.2	6.4	22.3	55.6	37.8	2.9	12.3	13.3	12.2
Malaysia	126,510	24.0	25.1	6.7	10.1	51.3	44.8	3.6	18.8	19.9	11.8
Philippines	39,680	15.5	17.2	6.7	20.1	54.8	35.0	1.3	18.2	19.2	16.4
Singapore	179,674	22.0	24.3	8.6	6.4	53.2	50.7	4.2	13.0	13.7	13.7
Thailand	96,245	18.1	22.0	7.4	14.0	50.4	38.5	2.9	16.1	17.7	14.3
ASEAN 6	518,170	20.5	22.6	7.4	12.2	52.9	43.9	3.5	15.2	16.3	13.3
Cambodia	2,589	3.0	7.5	1.1	3.5	12.5	9.1	0.1	55.9	60.0	25.5
Lao PDR	540	19.4	32.8	2.1	1.3	36.5	35.3	0.1	0.6	1.9	27.0
Myanmar	3,161	44.6	45.3	5.9	5.2	58.5	66.2	0.4	0.0	0.6	15.5
Viet Nam	25,850	11.4	13.0	9.0	13.6	39.5	26.4	7.2	20.1	21.5	22.5
ASEAN-10	545,799	20.2	22.2	7.4	12.2	52.1	43.0	3.6	15.5	16.6	13.8

ASEAN 6 = Brunei Darrusalam, Indonesia, Malaysia, Philippines, Singapore, and Thailand

ASEAN = ASEAN-6 plus Cambodia, Lao PDR, Myanmar, and Viet Nam

PRC = People's Republic of China

JPN = Japan

ASEAN + 3 = ASEAN plus PRC, JPN, and Republic of Korea

CER =

NAFTA = North American Free Trade Agreement

EU-15 = Austria, Belgium, Denmark, Finland, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, Netherlands, Portugal, Sweden, and United Kingdom

Source: International Monetary Fund, Direction of Trade Statistics, CD-Rom, April 2006.

in earlier stages of economic integration maintained fairly high levels of trade protection. This was reinforced in the 1950s by the European Payments Union, which discriminated in favor of intra-EU imports. These policies implied considerable costs in terms of lost welfare, and certain institutional arrangements that emerged from the EU integration process continue to be expensive to the EU—the Common Agricultural Policy, for example. Still, in its early stages the share of intraregional EU trade and investment was far higher than in ASEAN today. In 1958, the first year of the implementation of the European customs union, intra-EU trade was about 37% of total trade<sup>3</sup>. By the time the customs union was completed, it was over 50%.<sup>4</sup> Today, it is about 60%.

It is also relevant that intra-ASEAN trade has been essentially market-driven, rather than being the result of policy-driven discrimination in favor of intraregional economic interaction. Again, this contrasts with the EU case. Nevertheless, while one could argue that the growth in intraregional trade in the EU was in part a result of discrimination, it is important to consider the historical context: in Europe during the 1950s and early 1960s, with the region still emerging from the devastation of World War II. Although it would be difficult to assess the effect of economic reconstruction (complications in devising an “anti-monde” are many), the growth over this period was no doubt the result of a “normalization process” and the pace of Europe’s growth relative to the rest of the world. Certainly, given the size, wealth, and distance of European economies, a gravity model would predict high levels of intraregional trade even in the absence of EU discrimination.

This is not the case for ASEAN. Even if ASEAN—by some definitions a “natural economic bloc”—trades much more than one would expect given the “gravity variables” noted above (see, for example, ADO 2002 and Frankel

<sup>3</sup>Hiemenz, et. al. (1994), Table 2, p. 8.

<sup>4</sup>ibid.

1997), the economic characteristics of its members would suggest that its most important trade and investment partners will continue to lie outside the region, at least in the medium-term, and probably in the long-run as well.

In sum, real economic integration within ASEAN has been quite different from that of the EU. Intraregional trade and investment are less than in the ASEAN case. The highly-divergent levels of economic development within ASEAN, whose members are both among the poorest and the richest developing economies in the world, are far more significant than in the early years of the EU, when each EU member was a developed economy, or at least was by the end of the 1950s. One needs to keep this in mind when trying to draw any lessons from the EU experience for ASEAN's future integration. While no two development experiences are going to be the same, we would still argue that the EU process and experience has many positive and negative lessons for ASEAN policymakers.

### **Box: The Economic Integration of Europe: An Overview**

Arguably, there were three primary motivations for economic integration in Europe in the aftermath of World War II: (i) to avoid wars of such magnitude, destruction, and loss of life; (ii) to draw markets and resources together for economic (and social) reconstruction; and (iii) to build a strong, integrated region as a bulwark against the Soviet Union (the reason why European integration was strongly supported by the US in its early years). Below, we give a brief review of its evolution:

#### **Economic Deepening**

Western Europe started to move toward economic integration in the early 1950s at a sector level with the European Coal and Steel Community (ECSC), created under the Treaty of Paris (1951). The group included Belgium, France, Luxembourg, Italy, Netherlands, and West Germany. The European Payments Union was created to ration then scarce US dollars. Then in 1957, the European Economic Community (EEC) and the European Atomic Energy Community (Euratom) were established by the same six nations under the two so-called "Treaties of Rome." The EEC Treaty of Rome created what was essentially a customs union "plus" (with part of the "plus" the eventual incorporation of the Common Agricultural Policy). Sector schemes—the ECSC and Euratom—were integrated with the EEC and called the "European Communities" (EC) in 1967, after the European customs union was implemented. The Single European Act (1986) modified the EEC Treaty of Rome and sought to create a truly integrated common market in Western Europe—where goods, services, capital, and labor could flow freely. This was done via 284 sweeping directives. While the goal to complete the Single Market was stipulated to be the end of 1992—hence the sobriquet "EC-1992"—the directives were only essentially in place in 1994. There still areas to be liberalized in certain European Member Countries (in the financial services sector). While the Single Market Programme progressed, EC leaders turned their efforts toward monetary integration, culminating in the Maastricht Treaty (1991), which eventually established the European Union (EU) and created the conditions for eventual monetary union. In 1999, 12 of the 15 EU members (Denmark, Sweden, and the United Kingdom opted out) adopted the "euro" as a unified currency, permanently fixing individual monetary units at a predetermined rate to the euro. This was prior to adopting the "hard euro" in 2002, when currencies were completely replaced.

#### **Economic Widening**

In early 1960, the United Kingdom (UK) expressed an interest in joining the EEC, but its application was rejected (vetoed by then French President Charles de Gaulle). However, the UK—along with Ireland and Denmark—joined during the 1973 First Enlargement of the EC. Greece joined in 1981 and Spain and Portugal in 1985. The main purpose of this recruitment was political: all were emerging from authoritarian regimes and the EC wanted to foster democracy by successfully integrating them into European institutions. The Fourth Enlargement brought in Austria, Finland, and Sweden in 1994 (Norway and Switzerland also had accession agreements with the EC, but these were rejected during national referendums). Thus, by the mid-1990s the EU-15 covered almost all countries in Western Europe. Central and Eastern European countries, however, remained outside the EU framework. Still, the EC placed high priority on drawing in Central and Eastern European countries, especially given the delicate state of their fledgling democratic institutions after the 1989–1991 revolutions. Most recently, the May 2004 Fifth Enlargement accepted 10 Central and Eastern European countries—Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia, Slovakia, along with the small Mediterranean states of Malta and Greek-Cyprus. Bulgaria and Romania are slated to be the next to join (though it is not exactly clear when), and Turkey is currently negotiating accession terms (albeit Turkey's membership remains highly controversial within the EU).



### III. Evolution of ASEAN Economic Integration in a Regional Context

There have been many excellent surveys of regional economic integration in Asia (e.g., Kawai 2005, Naya 2002, Asian Development Bank 2002).<sup>5</sup> ASEAN tends to stand at the core of Asian integration, at least from an institutional perspective. Here we provide a brief review of ASEAN's evolution within a regional context.

There are several factors that influence the current trend toward regionalism in East Asia. These stem directly from the 1997–98 Asian Financial Crisis: (i) the obvious contagion of the crisis, which demonstrated the policy externalities across countries in ASEAN and the newly industrialized economies (NIEs); (ii) the widespread disappointment with the US reaction to the crisis, which left the region feeling “being in it alone together;” (iii) APEC's disappointing progress toward closer trade and financial cooperation, as well as development assistance cooperation (“ECOTECH”); (iv) Japan's offer to create an Asian Monetary Fund during the crisis—opposed by the IMF and the US—gave the impression that Japan wanted a more proactive role in the region; (v) arguably, the decision of the People Republic of China (PRC) not to devalue its currency during this period helped create a sense of solidarity; (vi) the “New Miyazawa Plan,” launched in October 1998, which allocated \$30 billion to help spur East Asia's recovery (and was deemed highly successful);<sup>6</sup> and (vii) the IMF policies promulgated to address the crisis that were deemed inappropriate, giving greater credibility and impetus to an “Asian approach.”

Given these factors, the crisis itself set the stage for more serious and durable East Asian regionalism. There are many other internal and external forces at work that have expedited this process, such as the rise of regionalism globally and its potential negative effects on the region the successful example of the Single Market Program in Europe (discussed at length below) and eventual monetary union; general pessimism regarding what can be achieved via the World Trade Organization (WTO) in light of its failure to move forward at the Seattle and Cancun ministerial meetings; and the potential inherent benefits of free trade agreements (FTAs).

There have been many important initiatives in Asia on preferential trading arrangements (PTAs), particularly within ASEAN, and ASEAN + 3<sup>7</sup> (Table 2).

Most of ASEAN's early agreements were political or token in nature.<sup>8</sup> Its first major initiative was the 1992 ASEAN Free Trade Agreement (AFTA). With the exception of the Japan-Singapore FTA (Japan-Singapore Economic Partnership Agreement), which came into force ten years after agreement, AFTA is the only example of cooperation in the region similar in concept to the North American Free Trade Agreement (NAFTA). However, in true ASEAN fashion, rather than overly commit to regional integration in sensitive areas, the specifics of AFTA were purposefully left ambiguous, with the agreement basically committing members to free trade over a 15-year timeframe. Also, “free trade” was somewhat loosely defined, as it left tariffs in the 0–5% range rather than the traditional 0%.<sup>9</sup> After the original agreement, ASEAN broadened the scope of goods covered by AFTA and shortened the implementation period such that AFTA was technically in full effect at the beginning of 2004 for the five original ASEAN countries plus Brunei Darussalam—though there are transitional periods for products on the temporary exclusion lists (e.g., sensitive products such as rice and automobiles in some cases), and some country-specific implementation problems in certain areas. The original target for full implementation was 2006 for Viet Nam, 2008 for Lao PDR and Myanmar, and 2010 for Cambodia. Recently, ASEAN decided to accelerate

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<sup>5</sup>This brief review of ASEAN integration borrows from Plummer (forthcoming) and Naya and Plummer (2005).

<sup>6</sup>Kawai (2005).

<sup>7</sup>ASEAN+3 includes the 10 ASEAN members plus People's Republic of China, Japan, and Republic of Korea.

<sup>8</sup>For example, the Preferential Trading Agreement (PTA) was a positive-list approach to trade liberalization with small margins of preference and limited product coverage. It was expanded somewhat during the 1980s but had no real impact on trade. Industrial cooperation, such as the ASEAN Industrial Project (AIP) system, never really took off.

<sup>9</sup>In fact, this range of tariffs probably contradicts the requirements spelled out in Article XXIV of the GATT/WTO, but as was noted earlier, ASEAN benefits from the Enabling Clause, which has always freed it from these constraints.



**Table 2: Chronology of ASEAN and ASEAN+3 Integration**

AFTA for full completion in 2007. ASEAN has also made important strides in the area of investment

Year	ASEAN Summit	Results	ASEAN + 3-related Summit	Results
1976	1 <sup>st</sup> —Bali, Indonesia	<b>ASEAN Concord</b> <ul style="list-style-type: none"> <li>• ASEAN Secretariat established</li> <li>• Treaty of Amity and Cooperation in Southeast Asia signed (principles of independence, sovereignty, equality, territorial integrity, and national identity of all nations, noninterference in internal affairs and peaceful resolution of disputes</li> <li>• Zone of Peace, Freedom, and Neutrality (1971 Declaration) established</li> </ul>		
1977	2 <sup>nd</sup> —Kuala Lumpur, Malaysia	<ul style="list-style-type: none"> <li>• Basic Agreement on ASEAN Industrial Projects—framework for ASEAN Industrial Joint Ventures (AIJVs)</li> <li>• ASEAN Preferential Trading Arrangements (PTA)</li> </ul>		
1987	3 <sup>rd</sup> —Manila, Philippines	<ul style="list-style-type: none"> <li>• Improve the PTA</li> <li>• Increase flexibility of AIJVs to accelerate implementation</li> </ul>		
1992	4 <sup>th</sup> —Singapore	<ul style="list-style-type: none"> <li>• ASEAN Free Trade Area (AFTA) adopted using a Common Effective Preferential Tariff (CEPT) Scheme as primary mechanism for implementation</li> </ul>		
1995	5 <sup>th</sup> —Bangkok, Thailand			
1996	1 <sup>st</sup> informal—Jakarta, Indonesia	<ul style="list-style-type: none"> <li>• Request for ministers to develop proposal for ASEAN Vision 2020</li> </ul>		
1997	2 <sup>nd</sup> informal—Kuala Lumpur, Malaysia	<ul style="list-style-type: none"> <li>• ASEAN Vision 2020 presented, to advance economic integration and cooperation, with an eventual ASEAN Economic Community in mind</li> </ul>	1 <sup>st</sup> —Kuala Lumpur, Malaysia	Individual ASEAN/PRC, ASEAN/Korea, and ASEAN/ Japan Joint Statements on Cooperation
1998	6 <sup>th</sup> —Hanoi, Viet Nam	<b>Hanoi Plan of Action</b> <ul style="list-style-type: none"> <li>• Advance AFTA to 2002, 90% intra-trade subject to 0–5% tariff</li> <li>• ASEAN Investment Area (AIA)—liberalization by 2010, outside ASEAN by 2020</li> <li>• ASEAN Surveillance Process strengthened</li> <li>• Develop ASEAN Capital Markets</li> <li>• Eminent Persons Group (EPG) proposed to come up with plan for ASEAN Vision 2020</li> </ul>	2 <sup>nd</sup> —Hanoi, Viet Nam	East Asian Vision Group (EAVG) proposed by Kim Dae Jung, President of Korea to discuss long-term East Asian integration

1999	3 <sup>rd</sup> informal—Manila, Philippines	<b>EPG develops plan for Vision 2020:</b> <ul style="list-style-type: none"> <li>Concern that ASEAN not effective in responding to Asian Crisis, so proposed financial cooperation.</li> <li>Speed up AFTA</li> <li>Accelerate AIA</li> <li>To respond to surge of PRC economic development, need to become more competitive, attract investment, faster integration, and promote IT</li> </ul>	3 <sup>rd</sup> —Manila, Philippines	
2000	4 <sup>th</sup> informal—Singapore	<b>Adopted Initiative for ASEAN Integration (IAI):</b> <ul style="list-style-type: none"> <li>Framework for more developed ASEAN members to assist less-developed members when needed</li> <li>Focus on factors to enhance competitiveness for new economy: education, skills development, and work training</li> </ul>	4 <sup>th</sup> —Singapore	East Asian Study Group (EASG) to assess the recommendations of the EAVG and explore the idea and implications of an East Asia summit: <ul style="list-style-type: none"> <li>Develop of institutional link between Southeast Asia and East Asia</li> <li>Study creating an East Asian Free Trade Area (EAFTA) and investment area</li> <li>Begin financial cooperation, such as the May 2000 Chiang Mai Initiative</li> <li>Study an ASEAN-PRC FTA</li> </ul>
2001	7 <sup>th</sup> —Brunei Darussalam	<b>Challenges facing ASEAN:</b> <ul style="list-style-type: none"> <li>Declining FDI, erosion of competitiveness.</li> <li>Road map for ASEAN integration by 2020</li> <li>Move beyond AFTA and AIA by deepening market liberalization for both trade and investment</li> </ul>	5 <sup>th</sup> —Brunei Darussalam	<ul style="list-style-type: none"> <li>ASEAN+3 formally established</li> <li>EAFTA recommendation endorsed, but overshadowed by proposal for establishing a PRC-ASEAN Free Trade Agreement proposal within 10 years, with adoption of the Early Harvest Provision to speed the process</li> <li>A Japan-ASEAN Economic Partnership was proposed in response</li> <li>Japan-Singapore Economic Agreement for a New Age Partnership announced (signed January 2002, coming into force 30 November 2002)</li> </ul>
2002	8 <sup>th</sup> —Phnom Penh, Cambodia	<ul style="list-style-type: none"> <li>AEC end-goal of Vision 2020</li> </ul>	6 <sup>th</sup> —Phnom Penh, Cambodia	Adopt EASG recommendations for deepening and broadening East Asia's integration
2003	9 <sup>th</sup> —Bali, Indonesia		7 <sup>th</sup> —Bali, Indonesia	
2004	10 <sup>th</sup> —Vientiane, Lao PDR	<ul style="list-style-type: none"> <li>-Vientiane Action Plan</li> <li>-Australia attends for 1<sup>st</sup> time</li> </ul>	8 <sup>th</sup> —Vientiane, Lao PDR	PRC accelerates FTA with ASEAN to 2010 from 2015

Note:  
In 1998, 1999, and 2000 the PRC offered to advise ASEAN, a potentially controversial proposal for leaders of other ASEAN+3 member countries, particularly Japan and the Republic of Korea.  
Source: Adapted from Naya and Plummer (2005).

cooperation, e.g., in the form of ASEAN “one-stop investment centers” and the ASEAN Investment Area (AIA).<sup>10</sup> These efforts at industrial cooperation have been designed with essentially the same goal in mind as AFTA—reduce transaction costs associated with intraregional economic interaction.

As already mentioned, ASEAN Heads of Government proposed in November 2002 that the region consider the possibility of creating an ASEAN Economic Community (AEC) by 2020. This explicitly placed the EU experience front and center in terms of design, but clearly with ASEAN characteristics. The ASEAN leaders actually agreed, at the October 2003 ASEAN Summit in Bali, Indonesia, to create a region where goods, services, capital, and skilled labor would flow freely, even if the details remain to be worked out. We offer our own recommendations in the penultimate section, colored by the EU experience.

The reasons behind the decision to create the AEC are many, including (i) the desire to create a comprehensive post-AFTA agenda; (2) the perceived need to deepen economic integration within ASEAN given the new international commercial environment, especially the dominance of free-trade areas (FTAs); (iii) given this environment, the possibility that bilateral FTAs could actually jeopardize ASEAN integration, as all members were free to pursue their own commercial-policy agenda; and (iv) the recognition since the 1997 Asian financial crisis that cooperation in both real and financial sectors must be extended concomitantly, and that free flows of skilled labor would be required to do this.<sup>11</sup>

In addition to an ebb in progress on APEC’s Bogor Vision of open trade and investment, several events have shifted ASEAN’s focus to its East Asian neighbors. First, even with the successful initial APEC summits at Blake Island, US (1993), and Bogor, Indonesia (1994), the East Asian Economic Grouping (EAEG) concept never faded away. On the contrary, it began to grow in substance. Strangely, the initiative derived from ASEAN’s effort to expand economic cooperation with the EU, and accepting the EU’s desire to instead deal with all of East Asia. This led ASEAN to ask PRC, Japan, and the Republic of Korea (Korea) to participate.<sup>12</sup> The first Asia-Europe Meeting (ASEM) was held in Bangkok in March 1996, with officials from ASEAN, PRC, Japan, and Korea meeting with EU representatives—a format that has continued semiannually since. Even though the initial impetus for these meetings was economic cooperation with the EU, the significance for East Asian regionalism is that these meetings brought ASEAN, PRC, South Korea, and Japan together to discuss issues of economic cooperation. In 1997, these meetings culminated in an informal summit of the 13 Heads of Government in Kuala Lumpur.

The original “Miyazawa Plan” was initiated by Japan during the Asian financial crisis to create an Asian Monetary Fund (AMF) to supplement the IMF. This was vehemently opposed by the IMF and the US, but eventually led to the establishment of the Chiang Mai Agreement—a series of currency swap arrangements among East Asian countries (largely bilateral swaps between Japan and the other countries) on the sidelines of ADB’s May 2000 annual general meeting in Thailand.

Generally, financial integration is a complicated process. Usually it occurs well into the process of regional integration, as happened with the EU and the creation of the euro (discussed below), which was only possible after decades of a customs union and a common market. In East Asia’s case, FTAs have become the focus because the benefits of monetary cooperation are less clear—as the direction of trade is heavily weighted outside the region for most countries, the value of exchange rate stability within East Asia are more limited than they were in the EU’s case. Also, the political benefits have thus far been less obvious than in the EU experience.

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<sup>10</sup>A salient component of the AIA is the ASEAN Industrial Cooperation (AICO) scheme, which offers more in terms of tariff (0–5%) and nontariff incentives than traditional industrial cooperation programs. Moreover, ASEAN signed an Agreement for the Promotion and Protection of Investments (September 1996), which includes simplification of investment procedures and approval processes, as well as enhanced transparency and predictability of FDI laws.

<sup>11</sup>The free flow of all labor, including unskilled labor, was deemed too politically difficult to consider in the AEC.

<sup>12</sup>ASEAN plus PRC, Japan, and Korea formally became ASEAN+3 in 2001.

APEC's lack of influence during the Asian financial crisis served to solidify East Asia's move in favor of the ASEAN+3 approach. The current spate of agreements, however, has not been extended throughout ASEAN+3, but rather derives more from ASEAN to individual countries. For example, the completion of the "China-ASEAN joint FTA study" in the summer of 2001 prompted Japan to quickly initiate a study of its own with ASEAN. One month later, at the November 2001 ASEAN+3 meeting, ASEAN and the PRC announced their intention to negotiate a free trade area within 10 years (the agreement was formalized in a Framework Agreement in December 2004).

### III. Lessons from the EU

Before assessing any lessons that can be derived from the EU experience, we begin with several caveats concerning differences in the subjective environment facing the EEC in the 1950s and that facing ASEAN today:

- **The institutional environment facing ASEAN in the first decade of the 21<sup>st</sup> century is far different than that of the EEC in the 1950s.** European integration was clearly pushed both by memories of a devastating war and emerging Cold War tensions. Political and social motivation for economic integration were far different than ASEAN's today—though it should be added that ASEAN has been instrumental in keeping the region peaceful, an important contribution that is often underestimated. The "European Good" is interpreted much differently in Europe than the "ASEAN Good" in ASEAN. This considerably limits institutional development at many levels. Importantly, it reduces the possibility of relinquishing power to supranational organizations. Besides, such institutional development is difficult within the ASEAN context, given that (i) nation-state formation was much later than in the European context, and in some countries must still be given strong priority; (ii) divergence in socio-political institutions are far greater than they were in Europe, especially as some European countries had to recreate these institutions after WWII; (iii) it is not clear that European institution-building has been particularly successful in all areas, though it would receive high marks in economic-related matters (though this hypothesis might also be tested); and (iv) European institutions are quite expensive with ASEAN government budgets much smaller (fortunately, ASEAN would not have to employ an army of translators, as the EU does). That said, it is important to note that the notion of the "ASEAN Good," though viewed differently within the ASEAN context, has evolved over the past decade. For instance, 10 years ago, few in the region (or the rest of the world for that matter) knew what ASEAN was. Today, it is well known.
- **The international economic environment is far different today than it was in the 1950s.** First, the contemporary global marketplace is extremely open relative to the past. Extensive reductions in international trade barriers—due to GATT/WTO rounds along with some unilateral liberalization—and the huge increase in international capital flows (including FDI), which increasingly knit an integrated global marketplace, underpin this wholesale shift. Thus the costs of using regional integration as a form of "Fortress," that is, to maximize trade diversion, are consequently much higher than they were at the time the EEC entered its formative stage. Second, regionalism has rapidly expanded recently; trading groups reporting to the WTO are well over 200, with the majority established after 1995. Some of these groupings include ASEAN's most important trading partners, which could potentially isolate ASEAN as well as force it to pay costs of trade diversion. These trends further underscore the need for an AEC to ensure openness that it be actively engaged in the regionalism movement. The more integrated the ASEAN marketplace is, the easier this will be. These considerations were far less important when the EEC was organized.
- **ASEAN features far greater diversity in terms of economic development.** We mentioned in Section II that ASEAN is far more diverse in levels of economic development than was the case of the EU in its earliest phases, when all members were developed. While the expansion of the EU to include the 10 Central and Eastern European countries in May 2004 significantly increased the EU's diversity, the region remains dominated by developed countries and is far more symmetric than ASEAN, which features developed, "dynamic Asian economies;" middle-income developing countries; and least-developed countries. ADB noted in its *Asian Development Outlook 2002* that the coefficient of variation (standard deviation divided by the mean) on income levels within ASEAN was 1.6 with a mean *per capita* income of \$1,975 in 2000, whereas the corresponding numbers for the EU were 0.6 and \$20,747. Hence, the divergence within ASEAN is far

greater than that of the EU, and the countries are far poorer. This suggests that matters related to the speed of implementation of an AEC, and even the ability of ASEAN to include all its members in the process, will be complex and difficult. Phased “10-X” strategies, which are what AFTA in effect embraces, may not only be desirable but necessary.

- **ASEAN is far more open now than Europe was in the 1950s.** ASEAN countries are small in economic terms and very open relative to the EEC of the 1950s—and even with respect to most EU countries today—with the exception of the transitional CMLV (Cambodia, Myanmar, Laos, Viet Nam) economies. ASEAN members are closely integrated with global markets by trade as well as multinational networks. This is also a policy focus for ASEAN governments. As noted in Section II, intraregional trade and investment in ASEAN is far less important than it was for the EEC in the 1950s. As external trade will likely continue to overshadow intraregional trade for the foreseeable future, one would expect an AEC to be much more outward-looking than the EEC/EC might have. Also, even as an integrated market, ASEAN countries taken together still would not influence international terms of trade (as an AEC would still be relatively small in global terms), suggesting that the optimal common external tariff should be zero. This was not the case with the EEC.

Having noted these caveats, there are at least three major lessons from the real-side integration of the EU. First, on the negative side, ASEAN should avoid some of the pitfalls that inward-looking discrimination brought on the EU (especially in agriculture), and would be potentially catastrophic in the ASEAN context. Intra-ASEAN trade is less than 25% of its global trade compared with about 66% for the EU, indicating that ASEAN members are already globally savvy. Hence, any real-side economic cooperation must be outward-looking, which is why ASEAN leaders ostensibly want to use ASEAN as a means of “going global”—some scholars have noted that AFTA is actually more of an investment agreement than a trade agreement; free trade reduces intraregional transaction costs and presents to multinational corporations a vertically-integrated market.

An AEC should never lose this vision, even when, as in the European case, compromises may have to be made. EU members are more developed, higher-income countries that together form a large economic space. They were able to push economic integration behind relatively protected markets, within an international economy that then remained fairly closed. Today, the GATT/WTO has opened up markets considerably and most of the world—the EU and ASEAN included—have internationalized extensively. One could argue that the EEC’s protectionist approach toward evolving into the EU was not needed to begin with and in fact should have been avoided—the Common Agricultural Policy (CAP) has been by many measures a disaster. Today, the cost of an inward-looking approach to integration has increased exponentially, and it is not a viable option for building an AEC.

Second—and partly related—is that the European experience illustrates that trade-investment links matter. And these relationships are shaping in large part the economic structure of ASEAN economies. While the CMLV ASEAN members remain at the early stages of the economic development process, the original five ASEAN countries have seen tremendous change in their productive structures in general, and in trade in particular. Primary-based exports (roughly estimated as SITC 0-4) have fallen in all the five economies.<sup>13</sup> Only Thailand continues to have a large agricultural-export base—the largest rice exporter in the world, for example. But agricultural exports are also falling in importance relevant to other sectors. Energy (SITC 3) continues to be important to Indonesia and Malaysia, with Indonesia currently a marginal oil importer. The most impressive change in the region—in some cases extraordinary—is the rise in share of SITC 7, or electronics and transport equipment (for ASEAN, this is primarily electronics). During the 1990s, the share of SITC 7 increased in all ASEAN countries—it accounted for 72% of total exports in the Philippines, 68% in Singapore, 58% in Malaysia, and 41% in Thailand during the period.<sup>14</sup>

While economic reform has played an important role in this process of structural adjustment, so has foreign investment. Tamamura (2002) uses input-output analysis to capture the FDI-export link in East Asia, as well as to decompose the effect of external demand (by country) on production, using electrical and electronic products as a

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<sup>13</sup>Data for this structural-change analysis come from Plummer (2003).

<sup>14</sup>The Philippines case is both most dramatic and surprising. The value of SITC 7 exports more than doubled during the decade, with the largest increases in SITC 723 (civil engineering and contractors plant and parts), SITC 728 (machine & specialized equipment), 736 (machine tools), 751 (office machines), and 752 (automatic data processing machines).



case study. He finds that, for 1995 (his latest year), in four of the five original ASEAN members, external demand induced greater production than domestic demand (the exception was Indonesia, where domestic demand fell marginally in relative importance, from 87% to 52%). Most countries used a similar pattern to internationalize electronics production. The most extreme case of reduced domestic demand was in Malaysia, where it accounted for a mere 6% of total production.

Also, most of the directives that led to the creation of a tightly-integrated market for FDI in Europe came with the Single European Act, started in 1986–87 and essentially created a common market by 1994. The European experience shows that establishing a common market goes well beyond mere national treatment or most-favored-nation treatment in the regional marketplace: economic cooperation must reduce myriad transaction costs associated with FDI, including those related to the labor market, mutual recognition of product standards, and the like. An AEC will have to focus *per force* on many of these areas.

A third lesson relates to how the EU gained from intraregional trade liberalization (though, as noted above, this could have been better organized to minimize trade diversion). The customs union was important in building a regional market; the SEA, by creating a Common External Commercial Policy, and was more effective as it kept real-side transaction costs within the EU to a minimum. It produced a truly regional marketplace, resulting in a more efficient division of labor in most member countries.

For an AEC, the stress should be on global economic interaction more generally—of which the ASEAN market is only one part—not merely with expanding the intraregional marketplace. With this, an AEC could become an international springboard. Trade and investment integration policies in ASEAN should be expected to achieve the same general results as they did for the EU. But it could actually manifest itself in a different way, given the fact that ASEAN members are so diverse with most developing countries. To reiterate: an AEC should be a means of increasing economic prosperity and promote the social good rather than focusing on, say, increases in (sometimes misleading) indicators, such as shares of intraregional trade and investment. A successful integration program could theoretically lead to a decrease in regional integration, as measured by trade and investment shares.<sup>15</sup>

A final point involves financial and monetary cooperation and integration, though in part this goes beyond the traditional interpretation of an AEC (discussed below). ASEAN has considered the formation of an ASEAN Bond Market, though problems related to liquidity, potential market depth and the like have led ASEAN to look more toward an Asian Bond Market. This will be a long process.<sup>16</sup> Nevertheless, it is worthwhile looking at what happened in Europe, given that empirical studies (e.g., Frankel and Rose 1998) have shown that monetary integration has strong effects on trade and investment flows. Other studies (e.g., EU commission 2001) have suggested specifically that monetary union would have a far more extensive effect on trade flows and economic integration than the SEA.

In the past, nearly every regional economic integration program almost exclusively focused early on the real economy. Financial integration was always treated as separate, to be addressed at a later date. In many ways, this was less true during European integration, though the point is debatable. While the European Payments Union (EPU) was a financial arrangement, it was merely *ad hoc*, and was quickly phased out as soon as European

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<sup>15</sup> For example, a successful AEC that brings in higher FDI flows from abroad—a key aim of the AIA—will not only reduce intraregional FDI but could also reduce intraregional trade, if multinationals take advantage of the attractive regional division of labor offered within ASEAN. Suppose that, as a result of the AIA, a Japanese automobile multinational set up production stages in Indonesia and Singapore, whereby it exports \$2 billion in car components to Indonesia; adds \$100 million in labor-intensive value added to production in Indonesia before exporting the semi-processed product to Singapore for further \$1 billion in processing and then finally exporting back to Japan. This means that ASEAN intraregional trade would have changed at the margin by: exports to Singapore from Indonesia (\$1.1 billion) divided by exports of Japan to Indonesia (\$1 billion) plus imports of Japan from Singapore (\$2.1 billion), or 35%, whereas extraregional trade would have increased by 65%. The point is that this could be a successful economic activity for all parties involved, but intraregional trade shares might fall anyway.

<sup>16</sup> See, for example, Plummer and Click (2005).

currencies became convertible. This was just as the Treaty of Rome began implementation. The EC did publish the Werner Report, which mapped out a plan for monetary union at a time of great turbulence within the Bretton Woods System (1968), and after the Bretton Woods System collapsed, it tried to create the 1976 European Snake, and eventually the European Monetary System, which expanded the Snake in March 1979. These attempts at exchange-rate cooperation were important because the “customs union plus” needed stable exchange rates in order to run well. Such cooperation was especially necessary for the CAP—created primarily to stabilize farmer incomes—which flexible exchange rates put at risk (the country with a depreciating currency held advantage over a country with an appreciating-currency, which was incompatible with the *acquis communautaire*). Therefore, the EC had to develop a “green” exchange rate system, called “monetary compensation amounts” (MCAs), which prevented this “adverse” structural change. However, the system was very expensive: Pomfret (1997) suggests that the MCAs constituted over 15% of the huge CAP budget.

Nevertheless, European capital markets tended to be substantially segmented until implementation of the SEA was fairly advanced. There had been early attempts to create a single banking market as early as 15 years after the Treaty of Rome, in 1972 (it was stillborn). And in 1977, the European Council established the First Banking Directive, which did very little to integrate markets.<sup>17</sup> But these and other attempts only marginally integrated regional markets until the SEA initiatives. Today, the European banking system is far more integrated, but some aspects of finance remain among the few areas where the Single Market is incomplete. Capital controls were removed as part of the SEA program.

In sum, even with the EU, financial integration lagged behind real sector integration. The tendency as regions integrate seems to be to let financial issues wait, but experience shows that this is an unwise policy. The Asian financial crisis could be seen in this light. Prior to the crisis, APEC, for example, largely ignored financial and monetary cooperation, while ASEAN did little itself. In creating an AEC, therefore, ASEAN leaders would do well to focus on financial issues in tandem with real-sector integration.

The lessons from the EU on monetary cooperation again underscore the difficulty of making comparisons, as relative economic-divergence problems remain critical. Nevertheless, the EU too is a diverse group, especially if one considers regions rather than countries. Also, ASEAN's needs for economic cooperation are obviously quite different from those of the EU. While ASEAN integration may be popular within the region, it is less than it is in Europe, particularly among government leaders. In addition, various EU states had perennial macroeconomic, especially fiscal, problems. The Economic and Monetary Union (EMU) allowed affected members to implement necessary austerity measures in the name of European integration. The result has been a convergence in terms of interest rates, inflation, and other monetary variables, but only after a relatively long process. Yet the credibility of most of the five original ASEAN members is actually quite high in terms of monetary and fiscal policies, (especially for developing countries). Inflation tends to be quite low and most had either budget surpluses or essentially balanced budgets prior to the 1997–98 crisis. Today, most maintain large current-account surpluses. Still, there continues to be widely divergent interest rate spreads in ASEAN markets—convergence could have a major impact on development in certain countries (as discussed below).<sup>18</sup>

Thus, the favorable EU political or political-economic dynamics cannot be considered as important for ASEAN. Nevertheless, in the aftermath of the Asian financial crisis, the situation is changing. ASEAN leaders acknowledge that “policy externalities” exist, that some sort of restrictions on the conduct of monetary and fiscal policy could not only improve the macroeconomic environment within ASEAN but also promote regional economic stability. Also, the possibility of competitive exchange-rate devaluations could damage the establishment of an AEC. Political arguments for wanting to be part of the EU for European countries would be replaced in the ASEAN context by a fear to repeat the economic damage caused by the 1997–98 financial crisis. Cooperation in the conduct of monetary or fiscal policy could be done formally within or outside the AEC framework, without any pretension for or against initiatives leading to monetary union.

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<sup>17</sup>Story and Walter (1997) note (p.14) that of the EU's 9,434 credit institutions at that time, 429 were classified as foreign banks, and only 107 had a parent company based in a member-state. Governments were reluctant to grant licenses.

<sup>18</sup>See, of example, Plummer and Click (2005).



Based on the EU experience, ASEAN financial and monetary cooperation could bring several benefits: (i) creating the necessary Maastricht-type agreements—e.g., restrictions on budget deficits, government debt, inflation, even foreign-currency exposure of the banking system—perhaps interpreted more liberally than in the EU context, but would accompany efforts to create a more stable macroeconomic ASEAN environment, and thus build significant positive policy externalities; (ii) as monetary policy would likely be driven by the country or countries with the best international or regional credit ratings, lower-rated countries would be able to “import credibility”—much as, for example, Italy was able to import German monetary credibility; (iii) interest-rate spreads would converge, making it easier to price risk at the regionally, lowering the cost of capital; and (iv) harmonizing rules, accounting standards, and regulatory frameworks in building an AEC and associated financial initiatives would make ASEAN more attractive to foreign investors, as well as stimulate intraregional capital flows.<sup>19</sup> It would also make cooperation and even institutional integration of ASEAN equity and fixed-income markets easier, something partially occurring in the EU (e.g., smaller stock markets have integrated while larger markets continue to operate separately).

The process of financial and monetary cooperation is complicated, and effective integration demands a steady pace of progress—rather than abrupt changes which could prove counterproductive. The EU process of financial integration and exchange-rate cooperation on the way to monetary union is instructive. The European Currency Unit (ECU) was a basket of EC currencies, weighted by members’ GDP and foreign trade (and therefore subject to periodic change). Introduced in 1979 as part of the European Monetary System (EMS), it was to be a benchmark for evaluating an individual currency’s relative value and to serve as a unit of account among participating central banks. No ECU specie ever circulated, so it was a strictly artificial denomination. However, certain European banks created a banking product for lenders and borrowers to transact in ECUs. Initially, any ECU transaction was simply a portfolio of transactions in underlying currencies—an ECU deposit or loan typically was recorded as separate deposits or loans in individual currencies. However, banks soon established a clearing mechanism for the ECU, enabling ECU transfers without forced to make separate transactions in each of the component currencies. This allowed greater acceptance of the ECU in private commercial transactions—residents could use the ECU as a unit of account for bank deposits, while companies could use it for invoicing sales or maintaining accounts. The first ECU-denominated bond was issued in 1981, just two years after the introduction of the basket. The ECU subsequently became a significant “currency” for Eurobond markets, outranked only by the US dollar and the German mark. A substantial amount of ECU-denominated bonds were placed privately as well.

ECU use for private transactions rapidly developed as the ECU exchange rate tended to be more stable than those of its component currencies. For European investors and borrowers, a depreciation of the home currency against other currencies was offset by an increase in the home-currency value of the ECU, so there was an incentive to hold ECUs to diversify portfolios. Similarly, outside investors and borrowers were drawn to the ECU due to the lower risk compared with individual currencies. In short, the ECU was an attractive alternative because it was less sensitive to single currency volatility.

On 1 January 1999, the euro replaced the ECU with parity—part of the first stage of European Monetary Unification (EMU). The fact that the ECU existed for twenty years prior to the EMU suggests that a simple introduction of a currency basket is valuable, perhaps even necessary, as a precursor to closer monetary cooperation. The success of the ECU was partially due to its official status within the EMS, which helped bind participating central banks. Also, the fact that the private sector found the pan-European currency useful and that the banking system was able to accommodate increasing demand for ECU transactions aided in guaranteeing its success.

## IV. On Building an ASEAN Economic Community

Given ASEAN’s tremendous diversity, how can it create its own “customs union plus,” even by 2020? Tariff dispersion rates across ASEAN are indeed impressive. While ASEAN members tend to have fairly low tariffs and

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<sup>19</sup> For a more complete discussion of the potential benefits and costs of financial market cooperation and integration in ASEAN, with comparisons with Europe, see Plummer and Click (2005) and Click and Plummer (2005).

nontariff barriers (NTBs) relative to other developing countries (except for transitional ASEAN economies), they still vary considerably across the region. The EEC did not have this problem. Moreover, within ASEAN, Singapore is unique with essentially no tariffs. Given the openness of its economy (over 300% of GDP), Singapore cannot raise tariff rates to accept any ASEAN Common External Tariff above zero. Options include a complete free trade zone in ASEAN, perhaps with some external tariff harmonization, or a “10-X” customs union, in which the common external tariff would be determined by negotiations (similar to those of the EEC), but without necessitating all ASEAN members to join.

It is not clear exactly what form an AEC will take. Some scholars have suggested a less-ambitious approach, including an “FTA-plus” arrangement, which would include certain elements of a common market, e.g., free-flow of capital, free-flow of skilled labor, zero tariffs on intraregional trade, but would not include a common external tariff. Given the European example, where markets continue to be segmented and key benefits of integration are stymied without integrated external tariffs, Plummer (2005) recommends a more ambitious approach—that a 0–5% common external tariff in an AEC should at least be explored for the more developed ASEAN countries. ASEAN might accept exceptions in very few industries that might be integrated later on—as the Common Market of the South (or MERCOSUR) did with automobiles, yielding mixed results. While perhaps more difficult to implement, this option would have the effect of substantially reducing transaction costs in the region; mitigating any trade diversion potential of regional integration; increasing ASEAN’s ability to negotiate integration accords with other trading partners, and augmenting clout in international organizations. This could be a critical step in turning ASEAN into a truly open marketplace.

This is not foreign to ideas ASEAN leaders have previously proposed, e.g., the Philippines-tabled proposal to multilateralize AFTA cuts. Also, many ASEAN countries have already committed themselves to “open trade and investment” by 2020 as part of APEC’s 1994 Bogor Vision. True, it is unclear just how the Bogor Vision will be achieved, or even what it means for that matter: details are incomplete and many ambiguities persist. Still, ASEAN tariffs and NTBs have fallen over time in any case and will continue to do so, as part of Uruguay Round commitments, any eventual Doha commitments (if negotiations are ever concluded successfully), and the overall liberal posture of ASEAN leaders.

In this sense, an AEC could be viewed as a purely outward-oriented community—“Fortress ASEAN” was never an option. And why not create an essentially open region? The economic argument for protectionism is extremely weak, as ASEAN leaders recognize. Some might continue to adhere to the infant-industry argument. But this is more of an excuse for protectionism than any effective way of industrializing efficiently. There remains plenty of time before AEC 2020 for any industry to handle the transition. Besides, to make the infant-industry argument convincing, one must identify financial bottlenecks that prevent firms from establishing industries with comparative advantage. This should not be a problem given the state of financial markets in at least the five original ASEAN members. In addition, this open-market solution does not mean that governments would have to abandon incentives for industry-specific development, should they desire to do so. Regardless of the merits of an active industrial policy, this remains possible even in an open customs union, as the European experience clearly shows. Even today, nearly a decade after the completion of the SEA and five years after monetary union, governments tend to maintain active industrial policies, e.g., through direct subsidies, special financial and tax credits, and even *de facto* administrative rules. The EU does have formal restrictions, but they are constantly tested (e.g., the EU market in financial services is far from complete). Tariffs have always been a clumsy way to foster industrialization, and NTBs tend to be even worse.

Naturally, transitional economies face an important challenge here. For example, until recently Cambodia sourced about 70% of government revenue from import-related taxes and duties. However, it is now reducing reliance on foreign trade-based taxes as part of its reform program. This is also true for other CMLV countries. Viet Nam has made tremendous progress and should join AFTA in 2006. Keeping its reform program on track to join an AEC 2020, however, will not be easy. Viet Nam is remarkable in the speed in which it has reinvented itself from a nonmarket, closed, and state-directed economy into an increasingly outward-looking, market-oriented economy. And this has occurred in less time than that remaining before an AEC is targeted to begin. It may even be possible for ASEAN to allow a longer-term transition period for Cambodia, Lao PDR, and Myanmar, especially as there remain political uncertainties in these countries.

Regarding labor flows, it would be politically difficult to adopt the SEA approach of (technically) free labor mobility. Moreover, this isn't necessary for ASEAN, at least from the point of view of multinationals or in terms of integrating the region with the global marketplace. Still, free flow of skilled labor would be important, as would a regional framework for non-ASEAN nationals in obtaining visas.

However, the process will be difficult, as it was in Europe. Mutual recognition of professional qualifications, university, technical education and the like will require a great deal of work. But this process will actually offer a good opportunity for the region—especially for the CLMV—to embrace “best practices.” It may well be that the process will be easier for ASEAN than it was for the EU, as there are fewer entrenched special interests or general resistance to reform on these type of governance issues. Many would, in fact, welcome this approach.

The idea of adopting best practices also extends to other areas that were important in the SEA, e.g., product testing, technical standards, food/health-related standards, among others. Mutual recognition will be necessary and, hence, develop the harmonization of at least minimum acceptable standards. Codes should borrow from internationally-accepted standards wherever possible.

Attracting FDI is an important ASEAN priority. From the beginning leaders recognized the usefulness of a regional approach—with the largely unsuccessful attempts at industrial cooperation in the mid-1970s to the marginally more successful initiatives of the late 1980s and, finally, the ASEAN Investment Area (AIA) in 1998. The AIA is surprisingly comprehensive—and once exclusion lists are incorporated, it will have far to go before creating an integrated ASEAN market. National policies will require increasing harmonization to establish a truly regional market. No doubt FDI will be a high priority in any AEC. But the vision of an integrated market for FDI can not happen without other AEC initiatives in place, working to reduce transaction-costs.

Free-flow of services, increasingly important throughout ASEAN economies, is required as well. The ASEAN Framework Agreement on Services (AFAS) takes a “GATS-plus” approach and is an important step toward creating an integrating market. For an AEC, services will not need a radical change in policies, as the third round of AFAS negotiations—which began in 2001—should cover all sectors and “modes” of service provisions defined by the OECD (at least in theory. These are (i) cross-border supply—companies exporting services, for example, by fax or email; (ii) consumption abroad, —services consumed outside one's home country, such as tourism; (iii) commercial presence—a company supplies the service directly to foreign customers from an established affiliate abroad (this covers over 75% of all trade in services; and (iv) overseas personnel—where the service-exporting country relocates professionals or workers abroad to supply services. Any AEC will ultimately have to ensure a generally open market in services, without policy-induced discriminatory restrictions (including trade taxes), national treatment, and mutual recognition, for example. This was a difficult process for the EU, where service subsectors remain quite sensitive. For example, for financial services, the SEA stipulated three principles: (i) specific minimum requirements; (ii) mutual recognition of each members' laws; and (iii) that the “home country principle” would prevail, whereby regulations of the country in which service occurs takes precedence over those of the host country. (Story and Walter 1997). However, the SEA did not succeed in fully integrating its financial-services sector; retail banking in particular continues to be segmented and protected nationally. Moreover, the “Services Directive,” designed to create a more integrated market in EU services (particularly in light of the EU 2004 expansion), was rejected early in 2005.

So as AFAS expands as part of the AEC process, service subsectors need to be integrated carefully—their very nature is more complicated than the goods sector. Moreover, AFAS progress to date has been weak, and there is a reason for this: certain services are politically sensitive. Although exclusions should be kept to a minimum, specified sectors may require them.

An appropriate institutional framework is needed for the AEC to evolve effectively. In the early 1990s, the author, among a group of regional experts worked on a project—directed by long-time government officials and scholars Amnuay Viravan, Cesar Virata, and Seiji Naya—that proposed ASEAN's secretariat enhance its technical abilities. Many of these proposals were adopted; and the Secretariat has come a long way. However, to reach the level of sophistication for an AEC, it still requires some drastic enhancements. A much larger professional staff recruited from across the region with regional—rather than national—commitment is fundamental, as was

the case with the EU. Many EU directorates could be emulated within an ASEAN context. But the study's view is that the bureaucracy should be kept, to paraphrase Albert Einstein, "to the minimum possible but no less than that." The first reason for this is that the EU bureaucracy is simply too big and expensive. Second, the drain on human capital in ASEAN would be detrimental to other domestic policy priorities, an important consideration, especially for the CLMV. Third, at least in the first stages of the AEC process, ASEAN could maintain its "social bureaucracies"—fairly substantial in the EU, and somewhat of a separate project. While these institutions were important in making the EU what it is today, ASEAN, as mentioned, operates within a very different socio-political context. A fourth and related point relates to the creation of a "mini-state" within ASEAN, as happened within the EU, for example, developing an integrated executive, legislative, and judicial system. Because the EU's willingness to develop supranational institutions is more the exception than the rule, ASEAN should try to minimize the supranational character of an AEC, using "subsidiarity" to its greatest extent. The executive component of ASEAN integration would have to be enhanced considerably, but this could arguably be done by adapting and expanding existing institutions. Or the creation of some sort of AEC judicial authority to "enforce" (hitherto a bad word within ASEAN) its rules will be necessary. No doubt this will be difficult; after all, the EU continues to have its own problems (the Alstom case in France is but one of many good examples). And, as in the case of the EU, it would have to evolve gradually.

## V. Concluding Remarks

In this paper, we have tried to consider what the objectives and substance of an AEC should be, using wherever possible appropriate lessons from the world's most successful example of regional economic integration, i.e., the EU. We note that while there is much that the EU experience can teach ASEAN, ASEAN leaders should not underestimate either the substantive differences between the two regions or their differing historical contexts.

EU integration has been remarkable. It took about 37 years for the region to become a truly integrated market—from the 1957 Treaty of Rome until the implementation of the SEA, essentially completed in 1994. But it wasn't until the process accelerated in the mid-1980s that integration initiatives picked up steam, culminating in monetary union only five years after the completion of the SEA.

At times, some leaders and expert observers gave up on the EU; and the process certainly was familiar with "crisis." In 1976, for example, France (temporarily) slapped import tariffs on Italian wine. In the early 1980s, market segmentation increased with the use of NTBs outside the purview of the EC, leading some to suggest that the EC was doomed. After the September 1992 crisis in the EMS, it was easy to be pessimistic about the future of a monetary union. And there continued to be skeptics to the end.

But the EU persevered due to its leaders' commitment and evolution of critical social elements. This is a very basic lesson for ASEAN, particularly given the fact that an AEC will have to be far more comprehensive and "intrusive" in national markets than ever. It will take strong commitment indeed to move the process forward and maintain steady, positive momentum.

No doubt this is why there is much skepticism regarding the AEC. It was no different in the case of AFTA: in the late 1980s, when many pundits speculated that as the region's political exigencies had changed, ASEAN had no future as a regional organization. Instead, ASEAN leaders responded by moving forward impressively on the economic front, with AFTA the first major initiative in this process. Since then, AFTA has expanded and deepened; cooperation has advanced significantly in investment (AIA); liberalization of services is actively pursued within the AFAS; other "deepening" measures are being spearheaded; and horizontal integration has expanded about as far as it can go, with ASEAN now comprised of all 10 Southeast Asian nations. While an AEC will require much more extensive commitment, it can become reality and to the benefit of all if the ASEAN leaders have the political will to see it through.



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