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## Regional institutions in Europe and Southeast Asia: Lessons for economic integration in South Asia

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## **ADB Working Paper Series**

### **REGIONAL INSTITUTIONS IN EUROPE AND SOUTHEAST ASIA: LESSONS FOR ECONOMIC INTEGRATION IN SOUTH ASIA**

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**Abstract**

Except for the history of colonialism, the European Union (EU) and the Association of Southeast Asian Nations (ASEAN) have similar roots and they share initial targets to foster economic growth and competitiveness. However, the EU and ASEAN have diverging economic integration paths. The ASEAN Way implies non-interference in the internal affairs of the member nations. ASEAN has deliberately avoided creating a strong supranational regional institution and it has also avoided a strong EU-type agency. ASEAN is a major economic bloc, but compared to ASEAN, the EU is a stronger and more successful regional organization. Following profound integration initiatives in Southeast Asian countries, this region has now become the most dynamic and fastest growing regions of the world, especially when compared to other Asian subregions such as South Asia. In Southeast Asia, intra-regional trade has increased to 25% in the 2010s from 18% of total trade in the early-1990s. Southeast Asia has also become an attractive destination for foreign direct investment, which stood at 20% of total investment today compared to 12% in the early-1990s. Compared to Southeast Asia, South Asia has an abysmal performance in intra-regional trade and bilateral trade is throttled between India and Pakistan. Therefore, there is a need to harness the potential of regional cooperation through promoting regional institutions by learning from the experiences of EU and ASEAN to address the challenges faced by South Asia.

**Keywords:** economic integration, regional institutions, Southeast Asia, Europe, South Asia

**JEL Classification:** E02, F15, F36, N73, N75, O43

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# 1. INTRODUCTION

Regional power is defined as the state's capability to shape foreign policy relative to other states (Gardini 2016) for development of the regions (Fawn 2009). Here, regions are defined as the state's form of economic institutions, which are developed by multiple actors at multiple levels of aggregation (Wunderlich 2007), whereas regionalism is defined as the "structures, processes and arrangements that are working towards greater coherence within a specific international region in terms of economic, political, security, socio-cultural and other kinds of linkages" (Dent 2016, p. 8). Regionalism places emphasis on opening regional markets to realize economies of scale and inter-regional trade negotiations. In the 1970s and 1980s, the 'old regionalism' was based on an import substitution strategy (Baer 1972), whereas the 'new regionalism' of the 1990s was based on export-oriented strategy, which made developing countries more attractive locations for production and stronger actors in trade negotiations. Comparative regionalism focuses on common trends and differences between regionalisms around the globe. Meanwhile, regional architecture is defined as "a reasonably coherent network of regional organizations, institutions, bilateral and multilateral arrangements, dialogue forums, and other relevant mechanisms that work collectively for regional prosperity, peace and stability" (Hu 2009, p. 4). Regional organizations embody regional communities, which share certain core norms and values.

Regional integration is defined as a process that gradually abolishes discrimination between economies (Balassa 1961), which increases welfare and reduces development gaps by increasing competition. This enables economies of scale and develops regional production networks (Ginsberg 2007) to reduce poverty through trade, investment, and cooperation (Kweka and Mboya 2004). It reduces the barriers to trade, improves economies of scale and attracts investment and led to more economic benefits from trade and welfare gains (Sapir 2011) via higher trade liberalization and multilateralism and non-economic benefits from increased national income and poverty reduction (Calvo-Pardo et al. 2011). The ability of states to cooperate or integrate requires the regional powers to pursue benevolent, leading, and integrating strategies. Furthermore, economic cooperation among developing countries builds solidarity and helps them to address common developmental challenges. Regional integration improves trade-investment links and provides a basis for regional trade cooperation in Asia, which is one of the biggest markets. In addition, more than half of Asia's trade is intra-regional, which makes a strong case for regional economic integration. The existing economic synergies in Asian economies could be effectively used through regional economic integration.

Over the past few decades, the European Union (EU) has emerged as a prime mover of regionalization in the global economy. EU member states have subscribed to liberal human rights, peaceful dispute settlement, and multilateralism (Schimmelfennig 2005). In contrast, the Association of Southeast Asian Nations (ASEAN) is based on the principle of market liberalism as a provider of growth and social stability (Nesadurai 2006). The ASEAN Regional Forum was seen to be a way to socialize ASEAN's neighbors into the norms of the ASEAN Way of regional cooperation (Acharya 2001), while Europeanization is based on use of conditionality in EU's enlargement and association processes (O'Brennan 2016). Since the 1990s, there has been a steady surge in regional integration initiatives globally. The process of economic integration in ASEAN has been market-led, while the EU's integration has been accompanied by a commensurate institution building. However, the EU and ASEAN have followed different integration paths. While the EU is formed of sovereign like-minded nation-states with a

robust institutional framework and growing supranationalism, ASEAN seeks to unite culturally very heterogeneous nations.

The regional integration initiatives in South Asia are even weaker than those in Southeast Asia. South Asia has an abysmal performance in intra-regional trade and bilateral trade is throttled between India and Pakistan. The South Asian Free Trade Area (SAFTA) members have roughly similar trade structures and relatively high tariffs, which limits the welfare benefits of the trade liberalization. Therefore, strengthening regional cooperation and integration in South Asia offers great potential to eliminate poverty, and achieve inclusive and sustainable development. However, we need to harness the potential of regional cooperation through learning from the experiences of Southeast Asia to address the challenges in South Asia. Given this context, the main objective of this paper is to assess the challenges and obstacles of economic integration in Southeast Asia, and to compare it with the EU, which is a well-connected and integrated region, to provide some practical policy recommendations for South Asia. This paper also intends to review the institutional evolution of the EU and ASEAN, to evaluate the economic achievements of regional economic integration within ASEAN, to analyze the process and status of regional economic integration within ASEAN in comparison with EU, to find political and economic impediments and potential benefits of economic integration in South Asia, and to draw lessons for increasing economic integration in South Asia from the EU's and ASEAN's integration processes. Secondary data and information have been collected from various national and international publications, including multiple data sources, using data triangulation and a deductive content analysis to evaluate the data more comprehensively and scientifically.

## **2. REVIEW OF THE INSTITUTIONAL EVOLUTION OF THE EU AND ASEAN**

In 1957, six European countries decided to establish economic and trade links and formed the European Economic Community (EEC), referred to as the European Community, which developed from the functional integration and institutional integration in the EU. In 1992, the Common Market project was initiated, which combined the EU with a monetary union. Several attempts were made to build regional clubs, including the Comecon group of Central and Eastern European communist countries, the European Free Trade Association (EFTA) of independent, smaller European countries, and the European Economic Area (EEA) of smaller EFTA countries with the EU. Southeast Asia is an important regional actor and ASEAN was an early mover in Asian regional innovation. When ASEAN was established in 1967, it faced a highly uncertain regional and global environment including conflict in Viet Nam, the Lao People's Democratic Republic (Lao PDR), and Cambodia, the dispute over Sabah in Malaysia and the Philippines, and leftist insurgencies in all but Singapore. Therefore, ASEAN focused primarily on establishing regional harmony, and explicitly emphasized socioeconomic cooperation and development. Trade liberalization and various cooperation activities have included commerce and industry, agriculture, tourism, transport, and telecommunications.

The second phase of ASEAN's evolution started in early-1976 with the beginning of a formal set of regional cooperation measures, including ASEAN Preferential Trading Agreement (APTA), ASEAN Industrial Projects (AIPs), ASEAN Industrial Complementation (AIC), and ASEAN Industrial Joint Ventures (AIJVs). APTA was aimed at intra-ASEAN trade through institutional integration and regional trade preferences, while AIPs aimed to establish large-scale inter-governmental projects in ASEAN member

nations, and AIC and AIJVs were designed to promote specialized complementary products and resource pooling. However, these economic cooperation programs have had only a minimal impact on regional economic relations. For instance, APTA had little impact on intra-regional trade due to low tariff cuts, and the failure to consult and involve the business community. AIP, AIC, and AIJVs have also had limited success.

The next phase of ASEAN's evolution started in 1992 with the announcement of ASEAN Free Trade Area (AFTA), which emphasized stronger economic cooperation and reduction in the common effective preferential tariff (CEPT) rates, due to increased self-confidence in the region, sweeping policy reforms, attracting large FDI inflows, and increased competitiveness and other changes in the regional and global commercial architecture. ASEAN countries have reinforced their outward orientation and built confidence in reform initiatives to learn from their more advanced neighbors. Over this period, the majority of products have been included in the respective Inclusion Lists, with tariffs of 0% to 5%. In the mid-1990s, ASEAN started to develop the trade in services and it promoted investment. For instance, the Framework Agreement on ASEAN Investment Area (AIA) was signed in late-1998 and expanded into ASEAN Comprehensive Investment Agreement (ACIA) in early-2009. In 2008 to 2009, the global financial crisis (GFC) lowered the growth trajectories in ASEAN member states and Southeast Asia region lost some of its commercial attractiveness, due to which ASEAN was termed as an ineffective and feeble institution.

The creation of distinctly Asian institutional forms can be traced to the creation of ASEAN, the East Asian Economic Community (EAEC), the idea of Asian Monetary Fund (AMF), development of the Chiang Mai initiative, formalization of ASEAN Economic Community (AEC), routine East Asia Summit (EAS) processes, and the initiatives around Regional Comprehensive Economic Partnership (RCEP). In 2007, the AEC Blueprint was established, and was eventually realized by 2015. It is due to be replaced by the Blueprint 2025 (ASEAN 2015a). The new phase of AEC 2025 focuses on the creation of a deeply integrated and cohesive ASEAN to achieve inclusive growth. Besides trade and investment, the new blueprint emphasizes science and technology, human resource development, good governance, and connectivity.

Southeast Asia took long time to develop market-led integration under ASEAN, which attempted an institutional integration, functional integration, and AFTA, the Pacific Basin Economic Council (PBEC) and the Asia-Pacific Economic Cooperation (APEC). In contrast, the EU's integration is based on binding and built-in legal enforcement mechanisms, which differs from ASEAN's norms and values, and mutual respect for national sovereignty (Katsumata 2003). ASEAN is based on the principle of non-interference and recognition of sovereignty, in contrast to EU's promotion of supranational institutions in a system of binding decisions. ASEAN's non-interference creates the space to evade unfavorable arrangements and, in such situations, member states tend to pursue self-interest and not collective interest. For example, the ASEAN member states are relatively reluctant to abolish the non-tariff barriers (NTBs), which act as major trade barriers (Pelkmans 2016), increase the transaction costs, and hamper trade flow and free factor mobility. ASEAN's consensus building approach in inking agreement and decision-making is slow but it has led to its success.

The current phase of ASEAN's evolution is dominated by the return to growth and meeting the challenges of a rapidly-changing regional and global environment, which includes the spread of preferential trade agreements (PTAs), post-crisis macroeconomic coordination, intra-regional trade liberalization, and rise of fragmentation trade. ASEAN's focus is the theme of building resilient and innovative regional economies through deepening regional connectivity for seamless economic activity and growing opportunities, especially in e-Commerce and the digital economy. The new initiatives



include ASEAN Single Window (ASW), which will connect and integrate the national single windows, wherein preferential tariff duty can be granted on the basis of electronic data through ASW gateway; the ASEAN Framework Agreement on Services (AFAS), which will promote services integration to the next level; the ASEAN Agreement on Electronic Commerce, which will promote cross-border e-commerce; the ASEAN Joint Declaration on Cruise Tourism, which will transform the region into a vibrant cruise destination; multilateral electricity trade to promote energy cooperation and multilateral electricity trade in ASEAN Power Grid; ASEAN–Hong Kong, China (HKC) Free Trade Agreement (FTA); and ASEAN–HKC Investment Agreement for external economic relations, highest priority on the negotiations for RCEP, future ASEAN-EU FTA and potential ASEAN-Canada FTA, and ASEAN and the Eurasian Economic Commission for closer economic cooperation among members (ASEAN 2018). The ASEAN region is highly diverse in levels of economic development but strongly united in vision. Meanwhile, Southeast Asia is acquiring new economic prowess, which has tremendous potential to shape the future global economy.

Southeast Asian countries are culturally more heterogeneous than Europe. In contrast to the internal focus of the EU, ASEAN has an external orientation. The EU's economic integration has been policy oriented, in contrast to the market-oriented integration of ASEAN. The EU's focus has been on exclusiveness, in contrast to ASEAN's focus on inclusiveness. ASEAN has successfully integrated diversity compared to the EU. In Southeast Asia, economic cooperation has occurred without preferential regional agreements, in contrast to the EU. The financial crisis of 1997 had a considerable impact on the ASEAN economies (Chia 2013), which led to intensification of regional integration efforts and plans to create a single market by ensuring free factor mobility (MacGillivray and Carpenter 2013). The Belt and Road Initiative (BRI) is likely to improve the trade links between the ASEAN countries and Europe. RCEP presents a huge opportunity for Southeast Asia, with potential to integrate the entire Asia and Pacific region. ASEAN has been able to integrate diversity, while the EU has not. However, ASEAN has to learn from the EU's loss of the UK along, with the strength of its diversity. In summary, ASEAN has become a high-performing trading region and is now a highly attractive investment destination, which succeeded by transforming the region through cooperation and economic integration brilliantly, and can be termed as a second EU in the making.

### **3. ECONOMIC ACHIEVEMENTS OF REGIONAL ECONOMIC INTEGRATION WITHIN ASEAN**

Until the early-1990s, ASEAN economies had not shown impressive economic achievements thanks to the neglect of economic cooperation between ASEAN members until 1976. Even after 1976, doubts remained about the benefits of economic cooperation. Consequently, ASEAN countries followed widely differing development strategies, including free trade in Singapore, export promotion strategies in Thailand and Malaysia, and import substitution in Indonesia and the Philippines. In the mid-1980s, the economic policy priorities between ASEAN countries were sufficiently converged, which paved the way for economic cooperation. The Southeast Asian economy grew at 5.3% in 2017, and was projected to surge at slightly lower rate of 5.2% in 2019 and 2020 due to a structural slowdown in the People's Republic of China (PRC), rising geopolitical tensions, tightening of global financing conditions, and increased global protectionism (IMF 2018), whereas the combined gross domestic product (GDP) of Southeast Asia is expected to surge five-times to reach \$10 trillion by 2030 (ADB 2018). In 2017, Europe's growth rate stood at 1.7%, which is expected to decline to 1.5% in 2022 (IMF 2017). ASEAN's share of global GDP rose markedly from 0.8% in 1970 to

1.5% in 1990 and 2.6% by 2015. ASEAN region has been transformed from a relatively poor region in the 1960s into a robustly growing region of middle-income to high-income countries. The per capita income in Southeast Asia has increased 33 times from \$122 in 1967 to \$4,021 in 2016. ASEAN's global GDP share rose to almost the same as the South Asian Association for Regional Cooperation (SAARC) region by 1980 till 2000, and thereafter SAARC's share in global GDP increased during 2000 to 2018 (ADB 2018).

ASEAN's share in world total trade has increased rapidly since the 1980s, from 4% in 1980 to 7% in 2016, compared to growth of intra-regional trade. This reflects de facto achievements in integrating regional markets and liberalizing intra-regional trade. During the same period, RCEP's share in world trade increased from 16% to 31%. In 2016, the EU share stood at 33% of global trade, compared to over 40% of global trade in 1993 (World Bank 2018). ASEAN's extra-regional trade in goods increased from 55% in the 1980s to more than 90% in the 2000s, followed by a sharp decline to below 80% in the late-2000s and afterwards. This reflects the fast integration of the ASEAN region into a global economy and its deep interdependency with the world economy, which is a double-edged sword to the region. Intra-ASEAN trade has increased significantly from 18.6% in 1980s and 20% in the early-1990s, to 25% of total trade of ASEAN countries in 2018. Intra-ASEAN merchandise trade is significantly more than intra-SAARC trade but is significantly lower than the EU. However, the lower intra-regional trade share in ASEAN compared to the EU does not indicate failure of regional integration in ASEAN. The region also has a robust trade with non-ASEAN countries, including the PRC, Japan, the Republic of Korea, and India, which reflects open regionalism and growth of regional production networks in East Asia. Multilateral trade liberalization, implementation of AFTA, and the AEC blueprint have dramatically reduced the average tariff rate within ASEAN and the average preferential tariff rate on intra-ASEAN trade declined from more than 20% in 1990 to 0.64% in 2015 (IMF 2018).

ASEAN's dynamism is also attributed to its success in attracting FDI inflows, which increased by more than six times in 2000 to 2014, and stood at \$136.2 billion in 2014 but declined to \$120.8 billion in 2015. In 2015, ASEAN's FDI was at 6% of the world's total FDI flows. Nearly 25% of FDI inflows into RCEP during 2010 to 2015 and over 17% of inward FDI to ASEAN were intra-regional compared to nearly 20% of intra-regional FDI to NAFTA, 30% to RCEP and over 50% to the EU. Outward FDI from ASEAN countries significantly increased and stood at about 4% of world FDI. There has been marked rise in intra-ASEAN FDI in the 2000s. The share of intra-ASEAN FDI in ASEAN's total FDI inflows increased from 8.9% in 2004 to 18.4% in 2015, which reflects the growing regionalization of ASEAN-based firms. The share of intra-regional investment in total FDI inflow to ASEAN increased from 15% in 2010 to 19.4% in 2017. About 20% of ASEAN FDI was intra-regional during 2010 to 2017. The share of RCEP countries to ASEAN's total inward FDI stood at 44% and EU and the United States contributes about 15%–20% regional FDI during the same period. The East and North-East Asian (ENEA) subregion is one of the most dynamic parts of the world. ENEA countries account for 26% of world GDP, 23.6% of global population, and 20.3% of world trade and more than \$5 trillion foreign reserves. However, intra-subregional trade in ENEA stood at 21.3%. Intra-regional FDI among ENEA economies is low and 7% of inflows and outflows were within the subregion in 2008 to 2014 (ASEAN 2018). Over the period, ASEAN's global share in FDI inflow increased significantly, which reflects a surge of FDI inflow into ASEAN since crisis years in the late-1990s and ASEAN significantly outperformed SAARC in global shares of FDI inflows in recent years.

Total FDI inflows to ASEAN have remained lower and trade was higher in 2017 compared to 2016, which reveals a faster global trade recovery compared to investment. At the same time, intra-regional trade-and-FDI linkages have surged robustly in

Southeast Asia in 2017 and are likely to double the intra-ASEAN trade by 2025 (ADB 2018). Intra-regional trade in EU stood at 63.8% in 2017, which was lowered by 0.1% from 2016. In Southeast Asia, intra-subregional trade stood at 22.4% in 2017 (World Bank 2018) and inter-subregional trade has increased in 2017 due to robust trade with regional trading partners. However, the region faces the tough challenges of sustaining economic growth and strengthening regional economic integration in view of strong undercurrents in the world trading system. Southeast Asia's market-driven integration has been derived by trade and investment resulting in welfare gains to ASEAN countries. The increase in share of intra-regional trade to total regional trade is an indicator of market integration. Since the 1980s, the intra-regional trade has increased in Southeast Asia and the fastest increase in intra-regional trade occurred in early-1990s till 1998 financial crisis (IMF 2018).

In the early-1990s, the increase in Southeast Asia's intra-regional trade was due to strong growth of their economies, whereas in the early-2000s, surge in intra-regional export trade has been less than increase in intra-regional import trade. Market integration in Southeast Asia has been attributed to liberalization of trade and investment regimes and outward investments from Japan on account of the Yen revaluation in the mid-1980s. This led to a surge in trade and export-oriented investments due to the emergence of regional production networks and supply chains by multinational corporations (MNCs) (Kawai 2005), contributing to the strong increase in machinery and electronics products in intra-regional trade and emergence of international production networks in Southeast Asia.

There is only 25% of trade within ASEAN countries, which might not sufficiently increase GDP per capita of the members and has created possibility of trade diversion. In 2016, ASEAN GDP stood at \$2,549 billion, which is equivalent to 2% of global GDP compared to 22% share of EU in global GDP. The average applied tariff rates of ASEAN countries have declined from 8.92% in 2000 to 4.52% in 2015, while the number of non-tariff measures (NTMs) have increased from 1634 to 5975 during the same period (IMF 2018). ASEAN's share of total intra-ASEAN exports and imports in ASEAN total trade stood, respectively, at 24.5% and 23.5% in 2015 (ASEAN 2016). In contrast, the EU's share of intra-regional trade stood at 67% of intra-regional trade share of total trade (European Commission 2017). Over this period, Southeast Asia has emerged as an important source of FDI and cumulative investments have been substantial (Kawai 2005). This has played an unintentional role of integrating Southeast Asia. The intra-ASEAN FDI has the largest share of FDI flows in ASEAN, which increased from 17% in 2014 to 18.5% in 2015 (UNCTAD 2018).

Economic and structural reforms are the driving force in the promotion of free trade and regional integration. ASEAN integration has become a platform for competitive liberalization because regional economic integration is very difficult to resist. In recent years, ASEAN has made vital commercial policy commitments, such as ASEAN+3 and ASEAN+6. ASEAN's regional economic integration efforts aim to establish an AEC, for which ASEAN Economic Blueprint was adopted. ASEAN also participates in numerous regional and multilateral initiatives, including APEC and WTO-based negotiations. ASEAN is moving cautiously toward formulating an economic group and it has significant achievements to its credit, which includes an effective functioning entity, freedom from major conflict, rapid economic development, and rising living standards, and effectively playing a balance of power politics. However, despite these achievements, ASEAN has not succeeded in deeper economic integration, affecting factor markets and a common macroeconomic policy regime, and it has been unable to develop a set of emergency support mechanisms.

The recent phase of ASEAN integration has faced numerous problems including the commitment for necessary domestic reforms, financial miscalculation, distinct regional characteristics, and congregation of national interests. However, institutional change, governance, and corruption have remained big challenges, which need to be addressed through democratic and decentralized governance. Therefore, learning lessons from overcoming the limitations of European integration can be highly valuable to ASEAN countries facing similar situations (Capannelli and Filippini 2010). There has also been reluctance on the part of ASEAN member countries to delegate enforcement mechanisms to sub-institutions. The transit to full Community in 2025 is just a few years away (Chia 2013), which calls for the hindrances to accelerate development to be addressed (MacGillivray and Carpenter 2013).

The scope for intra-regional specialization and commerce is significant because of the greater diversity in economic structure in ASEAN countries. Institutional and commercial policy environments are also diverse in ASEAN economies. For example, Singapore is one of the most open economies in the world compared to Malaysia, Viet Nam, Thailand, and Cambodia. Like tariffs, NTBs are declining in ASEAN economies but have remained significant in some cases (World Bank 2019). The current levels of intra-regional trade and investment indicate further deepening of economic integration process in ASEAN countries.

The removal of trade barriers and adoption of non-discriminatory treatment seems to be insufficient to induce deeper economic integration and the creation of a single market. The regulatory heterogeneity in Southeast Asia might also hinder deeper integration because of the higher costs for cross-border activities, specifically with the increase in a regional production network. The high interdependence of ASEAN countries generates regional and international externalities, which calls for greater regional regulatory harmonization and coordination to pursue deeper integration (Obashi and Kimura 2016). Since its establishment, ASEAN has emerged as one of the most successful regional collaborative initiatives based on the principles of openness and gradualism (Jusoh, Ramli, and Damuri 2019). In ASEAN countries, the complementarities bring greater benefits from regional integration, whereas heterogeneity could generate more gains from its comparative advantage compared to the EU.

The integration among ASEAN economies must be significantly strengthened to achieve a single market through identifying and reducing NTBs, and strengthening the institutions. The current ASEAN agenda is highly ambitious given its limited resources, which calls for a sharper focus to accelerate its liberalization process and tangible outcomes. There is also need to focus more on reducing barriers to trade and facilitating cross-border trade and factor mobility. In particular, ASEAN should focus on significantly reducing its NTBs and switch from its current positive-list approach to a negative list approach in negotiating its service liberalization (Dee 2015). It should also synchronize service liberalization to achieve a single market and single production base (Fukunaga and Ishido 2015). Finally, ASEAN should take the necessary steps toward a customs union for deeper economic integration (Basu et al. 2015).

Robust institutions and organizations are essential for deeper ASEAN integration. However, there is incompatibility between full national sovereignty and economic integration. In the EU, trade integration is based on pooled sovereignty. Therefore, unless ASEAN countries are willing to increasingly pool their sovereignty, economic integration will not be strong. Southeast Asia's deeper regional integration calls for binding commitments, which may be difficult for a number of countries in the region. The European experience reveals that it is better to begin with a small number of countries and on the basis of initial success, reluctant partners will be motivated to sign up to stronger and binding commitments. Both ASEAN and the EU need to work together and learn from each other because the shared global challenges require cooperation and coordination between ASEAN and EU. The economic slowdown, along with recent challenges posed by climate change, disease, demographic changes, and migration needs collective response.

#### **4. STATUS OF REGIONAL ECONOMIC INTEGRATION WITHIN ASEAN IN COMPARISON TO THE EU**

EU and ASEAN launched their single market projects at different times. The European Project, the Treaty of Rome, called for the creation of a common market. Likewise, ASEAN's Bangkok Declaration called for similar ends. The EU fosters supranational authority through its institutions for economic integration, while ASEAN strictly maintains inter-governmental institutions and conscientiously pursues policy of non-interference in the affairs of its members. Therefore, both EU and ASEAN have divergent institutional structures and roles in regional integration. In the EU, there exists an interactive relationship between institutions and actors, which shapes EU policy and governance. EU institutions remained adaptable and play significant role in EU integration (McNamara 2006). The European Commission (EC) enforces regulations to prevent national governments from giving private aid that distorts markets. ASEAN's institutions have led to de facto market-driven integration, which needs stronger regional political institutions to implement a top-down approach.

The EU presents the most outstanding example of a regional economic integration and it serves as a benchmark to analyze regional integration across the world. However, there are significant political, economic, cultural, and historical differences between Europe and Asia. In particular, Asian regionalism is qualitatively different the European regionalism. ASEAN's regional and international project activities include a wide range of initiatives and the region is highly diverse in economic, political, cultural, and linguistic characteristics compared to the EU. ASEAN is different from an EU-type organization and it is highly unlikely to adopt a common external trade regime and to develop formal mechanisms for a common currency or central bank. Therefore, ASEAN is institutionally unable to establish a stronger variant of economic cooperation.

Southeast Asia has a much less ambitious integration agenda when compared to the EU, at least in terms of functionalism and institutionalization. Unlike the European case, the Southeast Asian experience seems to be more in tune with time and the sentiments of ASEAN countries. More economic integration is better because it is far more difficult to reach an appropriate level of integration in both political and economic terms. The EU has recently experienced skepticism as regards its continued path toward regional integration. However, EU policy makers have prioritized their political project and have consequently not found an appropriate level of economic integration that is in line with both the political and economic realities of the member states. Although the EU is a more advanced regional integration compared to ASEAN, it is a closed form of regional

integration and not comparable with the EU. Meanwhile, the EU's institutional and multi-level governance makes it a reference point for regional integration elsewhere in the world. The EU is considered as central to regional integration analysis and also an exception to it, and there remains confusion about how far the EU can be used for comparative regional integration or if it remains an exception.

Since the mid-1980s, several forces have contributed to strengthening economic integration in the Asian region, which includes liberalization of trade and investment regime of many Southeast Asian countries, increasing Japanese FDI into Southeast Asia, strengthening regional economic involvement of Asian newly industrialized economies (NIEs), and the emergence of the PRC as a new industrial location for many firms originating from the region. Consequently, Southeast Asian economic integration, although not institutionalized, has been progressing and has now reached a relatively high level. In regional integration, there is seldom a situation of one-category fits all. ASEAN had initiated efforts to promote deeper regional integration before the late-1980s, but with limited success due to the lack of trust and divergent economic interests of member countries. However, until 1992, ASEAN's goal of common market was not addressed. ASEAN Vision 2020 was aimed at a stable, prosperous, and highly competitive ASEAN Economic Region (AER) for the free flow of goods, services, and investments, including equitable economic development and reduced poverty. AFTA was established in 1992, which was considered as the most significant step toward regional integration. Later, AEC was initiated for further regional trade liberalization and integration.

Numerous regional forums—including APEC, the Trans-Pacific Partnership, the Comprehensive Economic Partnership for East Asia (CEPEA), and the Trans-Pacific Strategic Economic Partnership Agreement—offer alternatives to integration through ASEAN, while the EU is the only viable regional organization for economic integration in Europe. The EU has extensive intra-regional trade, which stood at more than half of all the EU's trade. A similar trend has been noticed in the EU's FDI. This has led to EU market integration.

Intra-ASEAN trade is much lower than those observed in the EU, which leaves ASEAN with less incentive to pursue deeper integration. Furthermore, regional trade dynamics differ in the EU and ASEAN. For instance, trade agreements are structured between EU as a bloc and negotiating party due to which all new free trade agreements affect trade for the whole bloc equally and all members share the benefits. However, individual bilateral trade agreements are common, both inside and outside of ASEAN, and they have not fostered increased regional trade or economic integration in Southeast Asia. Despite alternative paths for addressing trade issues and economic integration, member states have continued to pursue deeper integration exclusively through ASEAN and the regional trade environment faced by ASEAN is significantly different from the environment fostering deeper integration in Europe.

The Asia-Pacific Regional Cooperation and Integration Index (ARCII) has been developed to gauge the degree of regional cooperation and integration (ADB 2017) and to identify different drivers of regional integration (Park and Claveria 2018a), which reveals modest growth of regional integration in Asia over 2006 to 2016. Southeast Asia had the highest degree of integration among Asian subregions followed by East Asia and South Asia and Central Asia have lower degree of integration (Park and Claveria 2018b).

However, ASEAN still suffers from significant institutional weaknesses for effective regional integration because of the lack of binding mechanisms for compliance and dispute resolution. The legal instruments of ASEAN have been incompatible with the aim of creating a single market. ASEAN has significantly influenced the APEC negotiations, which remained a loose institution and a more appropriate model due to the different levels of economic development in ASEAN states. Similar to APEC, ARF has a weak institutional framework based on the norms and principles of ASEAN. The Asian institutions need to move beyond ASEAN Way of informal and strictly consensus-driven cooperation and should adopt greater institutionalization and legalization. There is a need to increase the integration of ASEAN economies by internal liberalization to reduce barriers in intra-regional trade of goods and services, to enhance investment environment, and to better integrate financial sector. Greater regional integration is essential to reap the benefits of global value chains (GVCs), high demand competitiveness, better realization of economies of scale, collective efficiency and organic formation of regional innovation systems (ASEAN 2015b). In brief, the emergent challenge for the EU will be to use effective strategies for engagement with Asia, besides tackling its own economic and social challenges. Asia also faces challenges of human rights and democracy, and environmental degradation and climate change. Both EU and ASEAN need to focus on practical aspects of economic cooperation with the EU's stronger engagement in Southeast Asia.

## **5. POLITICAL AND ECONOMIC IMPEDIMENTS TO ECONOMIC INTEGRATION IN SOUTH ASIA**

Following the success of the North American Free Trade Area (NAFTA) and EU and ASEAN, SAARC was initiated in 1985 followed by the Committee on Economic Cooperation (CEC) in 1991, SAARC Preferential Trading Arrangement (SAPTA) in 1995, the South Asian Growth Quadrangle (SAGQ) in 1997, the South Asian Sub-regional Economic Cooperation (SASEC) in 2001, SAFTA in 2004, and SAARC Agreement on Trade in Services (SATIS) and SAARC Development Fund (SDF) in 2010. Despite these initiatives, regional integration in the SAARC countries has remained very weak and much slower compared to ASEAN countries. Even today, South Asia is facing numerous hurdles in effective cooperation compared to rich experiences in regional cooperation by Southeast Asia. Power asymmetry and diversity are huge in South Asian countries, which are different from Southeast Asia and acts as strong barrier in mutual cooperation and regional integration. There are significant economic gaps among South Asian nations compared to Southeast Asian countries. In addition, the fear psychosis in smaller South Asian countries (including Pakistan) poses a significant constraint in economic cooperation. In addition, political willingness has a minimal role in enhancing economic cooperation between Pakistan and India because the Pakistan–India bilateral relationship dominates the SAARC and the political adversarial relationship is a key hurdle.

Substantial intra-regional trade complementarities exist within the South Asian subregion, which provide immense potential to be realized. However, South Asia has an abysmal record on intra-regional trade. In SAARC countries, more than half of export potential has remained under-utilized, which is proportionally very high in the Maldives and Bangladesh. SAFTA has huge potential for trade creation, which can result in stronger growth and improved welfare for all member countries, more so in relatively poorer countries, including Bangladesh, Nepal, Bhutan, and the Maldives. SAFTA provides strong opportunities for vertical specialization, reaping economies of scale, increased FDI inflows, improved production networks, and high competitiveness.

Besides producers and industry, consumers will also benefit from regional economic integration. In South Asia, the strongest FTA is between India and Sri Lanka, which is also very weak in promoting bilateral trade. SAPTA has limited product coverage and SAFTA is restricted to trade in goods only. The status of NTBs is also worse. The bilateral trade between India and Pakistan is minuscule despite a long, shared border. Most of SAARC member countries have similar trade structures and competing low-value products. Therefore, FTA liberalization has limited welfare effects. SAFTA member countries have relatively high tariffs, and NTBs and FDI restrictions, which results in higher trade diversion. Intra-regional trade liberalization is also not conducive for South Asian countries.

The existing structural barriers—including high transport costs, tariff, and NTBs—are responsible for lower intra-regional trade compared to the potential in South Asia. In addition, unreported informal trade has led to low intra-regional trade, which is more or less similar to formal trade flows. Most of informal trade occurs between India and neighboring countries, which has been estimated multiple times high than formal trade. Stronger regional integration is essential for formalizing informal trade flows in South Asia. The trade costs of intra-SAARC imports are very high compared with far distant markets such as the EU and United States, whereas trade costs for exports have declined to different regions but not for intra-SAARC trade. Thus, intra-SAARC trade has failed to exploit locational benefit and has incurred higher costs compared to distant locations. Therefore, physical connectivity and trade facilitation needs to be improved to lower trade costs. The geopolitical tensions between Pakistan and India are also producing blocks in effective regional integration and have always barred them from active participation in the process of regionalization of South Asia. However, bilateral economic cooperation between Pakistan and India is essential to attain normalcy between them.

SAFTA has lengthy implementation schedule and it has long lists of sensitive or negative products, which hampers trade liberalization and industrial restructuring. Therefore, SAARC countries should compress implementation schedules, implement tariff liberalization, and reduce large sensitive lists of products. Compared to EU and ASEAN, SAARC has failed to emerge as a regional economic power, mainly due to the India-Pakistan adversarial relationship. The recent economic policies of South Asian countries have a strong element of protectionism. In spite of common culture and rich heritage, conflict and rivalry are intense among countries in the region. The liberalized trade and investment policies are not complementary, and their trade and investment rely more on countries outside the region compared to countries within the region. Many SAARC countries have failed to initiate significant liberalization and reforms to facilitate regional services integration (Chanda 2015). In addition, illegal cross-border migration is a serious issue in South Asian countries (Wickramasekara 2011), which needs to be addressed as a priority (Srivastava and Pandey 2017). The tourism and health sector potential of South Asian countries have remained untapped, due to the lack of coherent policies. In addition, telecom and IT-related activities need to be strengthened in SAARC countries to reap its comparative advantage. In this context, the political willingness to proceed in the right direction and wider role of private sectors is not over emphasized. In brief, South Asia's integration with the world economy is low and integration within the region is even more limited because of the poor business environments across borders. Consequently, South Asia has unable to reap the benefit of surge in demand in the United States and the Europe. Stronger regional and global integration is essential to increase productivity and growth, generate more jobs, and reduce poverty in South Asia. Therefore, a long-term strategy is called for more sustainable inter-governmental institutional initiatives to carry forward the agenda of regional cooperation and integration



in South Asia in a well-defined timeline that covers mobility, trade, investment, finance, and infrastructure by robust reforms in all sectors.

## **6. POTENTIAL BENEFITS OF ECONOMIC INTEGRATION IN SOUTH ASIA**

South Asia has experienced a surge in manufactured exports and FDI inflows since the 1970s, but they are very low compared with Southeast Asia. Intra-regional trade as a share of region's total trade has stood at 3–5% since the early-1990s, which is just over 1% of regional GDP and 7% in Southeast Asia, which is attributed to high intra-regional trade-and-FDI barriers. South Asia's trade with extra-regional markets is high compared to countries within the region. For example, South Asia's share in the world trade stood at 1.4% compared to less than 5% of Asia's trade in 2005 (OECD 2018). South Asia has failed to integrate into global manufacturing supply chains compared to Southeast Asia, with the exception of the garments industry in Sri Lanka and Bangladesh. South Asia's share in global processing trade and information and communication technology (ICT) supply chains is negligible. Therefore, South Asia lacks global integration, as well as trade-and-FDI links within the region and with Southeast Asia. In the 2000s, South Asia's intra-regional trade stood at 5% of total trade compared to 50% in Southeast Asia. The gaps between current and potential trade in South Asia are huge. In 2016, South Asia's average tariff stood at 13.6% compared to 6.3% of the world average. Intra-regional investment stood at less than 1% of total investment (WTO 2018).

Since the 1990s, the contribution of service sector to GDP growth has increased considerably compared to the 1970s and 1980s. During the 2000s, all countries in the region except Afghanistan have recorded above 50% contribution of service sector in their GDP (World Bank 2016). India's service sector has increased at compound annual growth rate (CAGR) of 9% compared to 10.9% in the PRC from 2001 to 2012 (GoI 2015). The increase in trade in goods and surge in trade in services has substantial potential for intra-regional trade and regional integration in South Asia (Chanda 2015). The trade in commercial services has been strong in the world economy in 2018 (WTO 2018), which offers considerable opportunities for intra-regional trade in services in South Asia, which are dominated by India, but remained restricted due to policy, regulatory, infrastructural, institutional, and cultural constraints.

In South Asia, regional integration and economic cooperation would help to reduce economic dependence on the developed countries. The potential for intra-regional trade within South Asia is immense, and could be tapped through reducing the transaction costs and enabling faster transportation. Intra-regional trade could improve regional collective self-reliance through horizontal and vertical economic integration, increase trade, and facilitate economic growth in the SAARC region. The complete elimination of tariffs under SAFTA may increase the intra-SAFTA trade by reducing structural rigidities due to adverse political relationship. However, restrictive policies in the South Asian countries result in a low level of intra-regional trade. SAARC countries would benefit not only from regional cooperation in intra-trade but also in other areas. Regional trade could be improved through regional cooperation and regional economic integration is essential to improve trade within South Asian countries. Trade creation and trade diversion will cause overall welfare gains in the regional economies of South Asia. The larger economies of India and Pakistan would particularly gain from preferential arrangements with a bigger block such as NAFTA and EU, while the smaller economies of Bangladesh and Nepal would benefit more from regional integration. South

Asia would gain much from regional integration and trade facilitation measures, such as improving road density, rail lines, and mobile tele-density per capita and better transport and communications, and regulatory regimes. With robust economic growth, high domestic consumption, huge public investments and large population, the South Asian region has immense market potential but has remained one of the least integrated regions of the world due to mistrust, cross-border conflicts, and security concerns.

In South Asia, services capabilities have been more balanced and complementary. India has immense capabilities in computer and information services, while other countries in the region have more capabilities in travel and transport. Therefore, the existing potential of trade in services should be fully utilized for mutual benefits. Industrial restructuring and productive capacities in less-developed SAARC countries have remained under-utilized, which presents substantial potential for these economies in liberalizing investment in joint venture projects to facilitate industrial restructuring. In this context, robust banking and financial linkages are essential for facilitating trade and investments between SAARC countries; however, the existing reciprocal banking links are very poor. Therefore, there is need to expedite the liberalization of banking and financial linkages in South Asian region on a reciprocal basis. In addition, the local capital markets are shallow in South Asia. Only a few, large well-known Indian enterprises have been able to raise capital from international capital markets. The more developed capital markets in India, Pakistan, and Sri Lanka offers immense opportunities for enterprises in less-developed SAARC countries to list and raise capital through subregional stock exchanges. The SAARC Development Fund can also be a potential source for development financing in the subregion. In addition, a SAARC Development Bank could meet the financial needs of bigger projects to strengthen regional connectivity and development needs through a co-financing arrangement with the Asian Development Bank (ADB) and other financing institutions. In South Asia, the trade and transit facilitation have substantial opportunities for developing extended transport corridors to facilitate intra-regional trade and to make the region a hub of East-West trade in the Eurasian region.

South Asia is highly optimistic about the future prospects for regional integration, due to immense potential to facilitate investment and industrial restructuring and to exploit the subregional complementarities in merchandise and service trade for improved trade balances and productive capacity of the less-developed SAARC countries. The political barriers need to be addressed as a priority to sustain regional cooperation. There are huge opportunities for South Asia to take the center stage in global trade and investment, given the prospect of increasing costs in the global factory of Southeast Asia, and to regain its lost place as a link between the East and the West.

In recent years, economic growth has remained strong in South Asia, dominated by India; however, the surge in growth has failed to create enough jobs for millions of young people. Therefore, South Asia needs to generate huge job opportunities to sustain its growth and unlock the untapped economic potential of its young demographic. Manufacturing and related logistics and services have underperformed in South Asia compared to East and South-East Asia, which needs to be revitalized by promoting economic corridors consisting of industrial economic clusters along transport corridors to strengthen the manufacturing sector and generate jobs and facilitate economic integration within SAARC countries, and between South and Southeast Asia.

## 7. LESSONS FOR SOUTH ASIA FROM ASEAN'S INTEGRATION

The EU's institution-led integration and ASEAN's market-led integration are among the most important regional cooperation across the world. In contrast, South Asia's regional integration has been slow following the establishment of SAARC due to the slow reform process in the member countries. The success of the European and Asian integrations, specifically Southeast Asian integration, presents many important lessons to accelerate regional integration in South Asia. In spite of huge diversity and differences between the two regions of Southeast Asia and South Asia, some modifications can be made in the process in regional integration in South Asia based on the broader experiences in certain policy areas of Southeast Asia. In Southeast Asia, the cooperation among the countries is strong, despite the hostility and conflict among South Asian countries. In the recent past, SAARC countries have initiated economic reforms, including trade and investment reforms and liberalization measures, but they have failed to encourage trade liberalization to a level that could accelerate intra-regional trade and investment compared to Southeast Asian economies. This is also evident from the fact that South Asian countries are more introvert and less open compared to higher degree of trade openness and sustained investment in Southeast Asian countries. Protectionism is highly prevalent in South Asian countries, while Southeast Asian economies have preferred accelerated trade and investment reforms even after the Asian crisis.

Southeast Asia's intra-regional trade has been remarkable, whereas South Asia is the least integrated region in the world. This needs to be improved through bilateral FTAs for the fuller benefits of integration with ASEAN and political commitments from the governments. ASEAN needs to be more competitive and it should diversify its export markets to utilize the full potential of regional integration with South Asia. In South Asia, regional cooperation and integration have occurred mostly at the bilateral and subregional levels rather than at the region level. Europe and the United States have been the main markets for South Asian exports and they remained the major sources of the FDI. There should be stronger FDI integration within ASEAN and SAARC countries by increasing intra-SAARC FDI flows and cross-border investments in telecommunications, construction, roadways and financial services. In Southeast Asia, market-led integration has been facilitated by strong regional production networks and the international supply chains. However, South Asian economies, with the exception of India, have failed to participate in the production networks. South Asia and Southeast Asia production network and value chain production activities need to be integrated. In addition, an Asian common market should be established to facilitate the free mobility of goods, services, labor, knowledge and capital within ASEAN and South Asian countries by removing border barriers.

RECI has resulted in robust change in Southeast Asia through economic growth, trade, investment, and competitiveness. It has strengthened the ability of the policy makers to address the domestic challenges with in respective economies. RECI also has a huge potential to eliminate poverty and achieve inclusive and sustainable development in South Asia. Therefore, it is essential to harness the potential of RECI to address immense development challenges facing in the region specifically in the context of meeting the 2030 Agenda and its Sustainable Development Goals (SDGs). The economic integration of South Asia could deliver large benefits to the poor population of the region. The potential areas of subregional links in South Asia should include high market integration, better transport, improved energy, wider information and communication technology and people-to-people connectivity, more investment in infrastructure development, and reducing common vulnerabilities and risks. Stronger

market integration should be given top priority to increase trade in the region. In the post-GFC, the Asian countries, specifically Southeast Asian countries, have emerged as new engines of global growth. Therefore, wider regional and subregional economic integration is a highly desirable policy option to sustain economic dynamism and generating necessary resources for achieving SDGs in South Asia.

## 8. CONCLUSION AND POLICY RECOMMENDATIONS

The ASEAN economies have performed significantly well in the recent past, which has been associated with a long-standing export-oriented development strategy. However, the GFC slowed growth in ASEAN, which was followed by a pronounced rebound with recovery in international trade. Regional trade within ASEAN, along with a large and vibrant domestic market and a growing middle class, is a potential source of resilience to global demand shocks. Intra-ASEAN trade has surged rapidly with regional trade liberalization, which needs to be sustained. Intra-ASEAN trade stood at about 25% of total ASEAN trade compared to more than half of intra-regional trade in the EU, which is attributed to NTMs in ASEAN. Therefore, the gradual removal of the NTMs could facilitate the creation of a single ASEAN market.

AEC represents a significant step toward ASEAN economic integration. ASEAN 2030 needs to further deepen regional integration by creating a truly borderless economic community. To realize ASEAN 2030 growth aspirations of tripling per capita income and raising the quality of life, appropriate national and regional policies are needed. ASEAN countries need robust domestic structural reforms and deep regional integration to eliminate any remaining barriers to the free flow of goods, services, and factors of production. ASEAN economies also need to increase resilience to macroeconomic shocks by reorienting policies to ensure flexibility in adjusting to shocks and financial crises, manage risks and volatilities to short-term capital flows, upgrade technical regulatory and supervisory capacity, and pursue fiscal and monetary discipline. Robust institutional reforms should focus on shifting powers from national to regional institutions. However, ASEAN should not transform itself into a highly bureaucratic organization, or a structure similar to the EU. ASEAN has managed to break through the barriers hindering cooperation and has become a unique model for socioeconomic integration.

ASEAN has robust track records in regional cooperation, economic integration, and growth, and is able to deal with its great regional diversity. Although ASEAN's open regionalism has succeeded, there remain significant challenges and opportunities for deeper economic integration within ASEAN and other subregions and rest of the world. ASEAN has a combined market of over 2.5 billion people on its borders, which offers opportunities to serve the PRC and India. In the future, ASEAN's economic opportunities will be enormous due to economies of scale and huge potential for increasing trade to meet new domestic and regional demand. Nearly 5% gain in ASEAN's aggregate income is likely to be realized once the AEC is in place, for which ASEAN members should implement strong domestic structural reforms to boost productivity and strengthening initiatives for regional cooperation, failing which ASEAN economies would not be able to achieve their growth potential. There exists a huge potential for closer economic integration and cooperation between South Asia and Southeast Asia, which requires the market for goods and services to be expanded to increase the economies of scale and greater competition, enhance regional competitiveness through specialization in regionally competitive industries, extend the movement of production networks from Southeast Asia and South Asia to take better advantage of wage differentials, lower import prices to the region and improve its terms of trade, increase export-oriented FDI to connect firms with regional production networks and supply chains, and large and

comprehensive FTAs would reduce the trade costs for the spread of production networks.

Despite their achievements, the performance of South Asian countries in economic integration is not strong under the institutional arrangements of SAARC. Over the period, South Asia has emerged as one of the fastest growing regions in the world. The average rate of growth has been estimated at above 7%, which is expected to reduce poverty and unemployment. However, SAARC has not been able to leverage the drivers for economic growth in the member countries through regional cooperation, which is evident from the fact that the South Asian countries are better integrated with countries outside the region compared to their own neighbors. Therefore, robust regional integration calls for more integration within the countries of the South Asia. Like Southeast Asia, comprehensive approaches are needed to enhance competitiveness and create attractive markets in South Asian region by enabling economic environment to increase industrial cooperation and strengthen production networks, sustain the synergies between liberalized trade and investment across countries, strengthen the financial system to enterprise development, remove infrastructure bottlenecks to gain from conducive policies, improve energy efficiency and cooperation, and collaborate for R&D through improved quality of human capital.

In summary, South Asia should firmly promote SAARC as truly regional organization focusing on deeper economic integration focusing on promotion of regional trade and economic issues. The SAARC Secretariat should be built into a powerful and knowledgeable body in trade, economics, and non-traditional security threats. SAARC should focus on a common vision for future trade and economic integration. South Asia should implement SAARC-wide FTA for all members by 2022. South Asia should collaborate to speed up the construction of new physical infrastructure and settle all border disputes among member nations. Finally, the core issues related to economic liberalization, regional integration, and non-traditional security threats should be given high priority.

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