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The ASEAN Economic Community and the European Experience

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I. Introduction

In November 2002, it was proposed at the ASEAN Heads of Government meeting in Phnom Penh that the region should consider the possibility of creating an "ASEAN Economic Community" (AEC) by 2020. The name is evocative, for an "Economic Community" immediately brings to mind the European experience. In fact, when APEC was "re-inventing" itself, it was proposed that the words behind the acronym for "Asia-Pacific Economic Cooperation" should be replaced with "Asia-Pacific Economic Community." This idea was rejected explicitly because it would give the impression that APEC was intending to move in the direction of the EC model, which was thought to be too controversial.

That the ASEAN Heads of Government should consider an "Economic Community," even with the baggage the term brings, is in some sense nothing new. ASEAN has always studied carefully European economic integration and has seen it as a sort of "role model," though certainly to be adapted in the Southeast Asian development context. In this paper, we will consider what lessons the European experience might hold for ASEAN, as well as extending some suggestions--based in part on the EU experience--as to how ASEAN might evolve into an AEC. We begin with a contextual consideration of the EU-ASEAN economic relationship and determinants of trade flows in the EU-ASEAN in Section II. The goal of this section will be to consider EU-ASEAN links as well as to underscore the importance of regional integration in stimulating global trade (and investment) flows, which after all is the main objective of the AEC. This is followed in Section III by a review of the evolution of ASEAN economic integration, culminating in the AEC. Section IV then proceeds to delineate some salient lessons of the EU experience for ASEAN. Finally, we give some suggestions as to how the AEC might proceed in Section V.

II. Determinants of Trade in the EU-ASEAN Context

The EU has always been an important trade and investment partner of ASEAN. Table 1 shows that approximately 14 percent of ASEAN exports is destined for the EU market, significantly less than the 18 percent accounted for by the United States but greater than the 12 percent going to Japan. At the bilateral level, the EU market was the most important for Vietnam and Laos and constituted a significant market for essentially all other ASEAN countries save Brunei (the EU gets its energy imports mainly from the Middle East).

Table 1 : ASEAN Exports to Selected Partners: 2002
(% and US$ millions)

OF\ TO	World (US$ mill)	ASEAN-6	ASEAN-10	CH	JA	APT[1]	DA[2]	CER	US	NAFTA	EU
Indonesia	57,144	16.48	17.33	5.08	21.08	52.85	39.06	3.63	13.25	13.95	13.87
Malaysia	93,265	25.01	25.76	5.63	11.29	51.74	47.53	2.61	20.19	21.40	12.40
Philippines	36,502	14.82	15.13	3.71	14.50	43.47	36.15	1.03	23.81	25.67	17.44
Singapore	125,087	28.07	30.09	5.49	7.14	56.06	54.96	3.03	15.27	16.17	12.53
Thailand	68,851	16.53	19.66	5.16	14.52	46.74	36.80	2.68	19.64	21.54	14.82
Brunei	2,109	30.51	19.58	10.42	65.29	115.25	60.92	18.30	13.20	13.38	3.02
ASEAN-6	382,958	22.10	23.77	5.26	12.58	51.98	45.75	2.85	17.75	18.97	13.53
Cambodia	2,476	4.36	5.47	0.90	2.75	9.57	7.06	0.08	42.08	42.62	16.77
Laos	298	28.88	51.44	2.95	2.05	56.49	55.59	0.11	0.89	1.61	38.09
Myanmar	2,629	39.12	39.25	4.73	3.80	50.58	56.80	0.40	13.13	14.26	13.67
Vietnam	15,713	11.85	13.33	6.45	7.46	31.45	27.07	15.78	14.96	16.11	24.20
ASEAN-10	404,074	21.71	23.38	5.28	12.26	50.92	44.87	3.32	17.75	18.96	13.98

Source: IMF, *Direction of Trade Statistics, 2003*

1/ ASEAN-10 plus China, Korea, Japan and Hong Kong
2/ Developing Asia refers to all Asia except for Japan

Given the importance of the EU market, ASEAN countries have an incentive to ensure a level playing field for its exports. In this sense, the EU "pyramid of preferences," that is, the hierarchy of preferential treatment that the EU accords its trading partners, is problematic, as many ASEAN countries stand close to the bottom of the pyramid, with the exception of the Least Developed Countries who benefit from the EU "anything but arms" initiative. In addition, ASEAN countries do compete with each other to varying degrees in the EU market. To capture the degree of competition, we correlate the exports of major ASEAN countries to the EU market using the Spearman Rank Correlations Coefficient (SRCC) technique, which is a non-parametric statistic comparing the correlation of two series. It has a range of –1.0 (perfect negative correlation) to 1.0 (perfect correlations), in which 0.0 would suggest no correlation at all. Hence, we rank the exports of ASEAN countries to the EU market and compare the rankings using this technique. We do this at the 5-digit SITC level (2881 commodities possible) for the exports of Indonesia, Malaysia, the Philippines, Singapore and Thailand to the US and OECD markets for the years 1995 and 1999. The results are presented in Table 2.

Table 2
Correlation of Selected ASEAN and Chinese Exports to the EU Market, 1999 and 1995
(Spearman Rank Correlation Coefficients)

	China	Indonesia	Malaysia	Philippines	Thailand
China					
1999	-	0.24	0.21	0.35	0.31
1995	-	0.22	0.20	0.33	0.29
Indonesia					
1999	0.24	-	0.11	0.13	0.21
1995	0.22	-	0.08	0.08	0.20
Malaysia					
1999	0.21	0.11	-	0.11	0.19
1995	0.20	0.08	-	0.12	0.21
Philippines					
1999	0.35	0.13	0.11	-	0.21
1995	0.33	0.08	0.12	-	0.19
Thailand					
1999	0.31	0.21	0.19	0.21	-
1995	0.29	0.20	0.21	0.19	-

Source: OECD, *International Trade Statistics*, CD-Rom;
Author's own calculations.

While we have no benchmark by which to judge which values are "high," we note that there is positive correlation between the exports of each of these countries (all estimates are statistically significant). Moreover, with the exception of Thailand-Malaysia exports, all SRCCs have been rising over time, in some cases significantly (e.g., the Philippines-Indonesia SRCC increased by 50 percent). Interestingly, while there does exist significant intra-ASEAN competition, each ASEAN country competes more with China than it does with any other ASEAN country. Thus, coupled with that fact ASEAN is currently competing in the EU market at a significant disadvantage, closer economic cooperation with the EU would have important advantages not only in leveling the playing field with countries currently receiving preferential treatment in the EU market but also in establishing a competitive edge over China.

Next, it is perhaps useful to consider the most influential variables in determining EU-ASEAN trade flows. Such an exercise would allow us generally to identify some of the most salient considerations in regional integration. In particular, we are interested in the "revealed" effects of institutional regional integration in ASEAN and the importance of ASEAN in EU trade.

Our approach is a standard augmented "gravity model" of international trade flows. This is an econometric procedure in which trade in a certain year is posited as a function of the GDP of the source and partner country (or their product) as a proxy for *size*, *per capita* income of the source and partner country (or their product) as a proxy for *wealth*,[1] distance between the two countries as a proxy for transportation and other "costs," and an "adjacency" binary ("dummy") variable to control for whether or not the trading countries have a common border. Some models, as we discuss below, use a number of other variables that might be "exogenous" factors relevant to trade flows. This is essentially the "benchmark" model, that is, it is what we would expect to determine trade flows if special relationships—say, in the form of a free-trade area (FTA), or just a heightened tendency to trade with one another—did not exist. In order to test the hypothesis that the region really makes a difference, we add a regional dummy variable. For example, if we are interested in whether or not ASEAN as a group is significant for bilateral trade flows globally, we would include a dummy variable which would take on the value one if the two countries trading with each other are both members of ASEAN, and zero otherwise. If the dummy variable is statistically significant and positive, then we conclude that there does, indeed, exist a special ASEAN effect. If the estimated coefficient on the dummy variable is statistically insignificant, however, we conclude that ASEAN as a regional grouping made no difference, that is, being a member of ASEAN gives no additional explanatory power to the model in determining trade flows.

The database provided by Rose (2003) [2] includes international bilateral trade for almost the entire post-World War II period (1948-1999) for 178 (IMF-delineated) trading entities, and encompasses the standard gravity variables we mention above along with some additional ones, that is (we give the expected sign of the estimated coefficient in parentheses): currency union (+), common language (+), common land border (+), if one of the countries is landlocked (-), if one of the countries is an island (+), and whether or not the two countries were recently colonies of the same country (+).[3] Regressions are first run using "pooled" (or panel) data, i.e., we model bilateral trade flows across countries and time. As the database features bilateral flows for 52 years between the 178 countries, this approach allows us to have almost a quarter of a million observations in the unrestricted (that is, the "full-blown") model.

Our main goals here are three-fold: First, we are interested in knowing to what degree ASEAN economic integration has revealed itself to be an important determinant of trade flows. Second, we can also gauge the degree monetary integration has been an important determinant of real-side (trade) flows. The importance of this latter relationship will be borne out when we discuss monetary cooperation in Section IV. Finally, since we are focusing on the EU and ASEAN, it would be useful to understand to what degree ASEAN has been important in EU trade flows, that is, whether or not a country's being part of ASEAN has any importance with respect to its trade with the EU (and the United States.)

[1] Modern international trade theory suggests that *per capita* income between countries is correlated positively with trade.
[2] In order to exploit data on bilateral flows for as many countries as possible over as long as possible in order to construct our "benchmark" and tests for US-EAI regional relationships, our primary data source is that constructed by Andrew Rose and available from his website as part of research for the article, "Do We Really Know that the WTO increases Trade?, " recently published in the *American Economic Review* (March 2004). The database is available at http://faculty.haas.berkeley.edu/arose/RecRes.htm#GATTWTO.
[3] As Rose explains regarding his sources, the trade data come from the Direction of Trade Statistics CD-ROM data (IMF). Population and real GDP data (in constant American dollars) are obtained from the Penn World Table, the World Bank's *World Development Indicators*, and the IMF's *International Financial Statistics.* Rose uses the CIA's *World Factbook* for a number of country-specific variables, including: latitude and longitude, land area, landlocked and island status, physically contiguous neighbors, language, colonizers, and dates of independence. He also adds information on whether pairs of countries were involved in a currency unions and from the WTO to create his indicator of regional trade agreements.

We begin by running three benchmark-model regressions, in which we add to the traditional approach variables accounting for two specifications of ASEAN partnership: (1) Both trading partners for a given bilateral trade flow are in ASEAN (i.e., if so, the bilateral trade flow receives a "one", zero otherwise); and (2) One of the two trading partners is an ASEAN member. We do this in order to capture not only ASEAN membership in which both ASEAN countries have been members but also to understand how well ASEAN countries have performed in general. We use 1992 as the starting date for the original ASEAN countries, since no major regional trade initiative had been undertaken in ASEAN before AFTA. Finally, we include a variable for participation in the Generalized System of Preferences (GSP) program, in which developed countries give preferential treatment to developing countries in certain manufactured and processed agricultural goods. We express the variables in logarithmic terms where possible (obviously, this is impossible with binary variables), which linearizes the equations and allows us to interpret the estimated coefficients as elasticities.

The results of these first gravity specifications are provided in Table 3. The first column includes the results for the entire model, that is, all countries in the system (the "unrestricted" scenario). The model's "fit" (i.e., how well the independent or right-hand-side variables explain variance in the dependent variable, i.e., bilateral trade flows) is strong, explaining almost two-thirds of bilateral trade flows (R^2=0.64). All variables are of the expected sign (that is, they affect bilateral trade just as we thought they would), and all are statistically significant except the binary variable capturing whether or not countries had common colonizers and two restrictive specifications (i.e., "no industrial countries" and "post 1970") of the "island" variable. It is interesting to note that: (1) the largest effects are derived for the existence of a common currency. This supports the notion that financial integration realities do have an important bearing on the "real" sector (i.e., trade); extreme currency stability obviously has a very strong effect; and (2) distance is critical, supporting the literature on "economic geography."

With respect to our ASEAN binary variables, we note that being part of ASEAN as a regional grouping does indeed matter (the estimated coefficient on the ASEAN binary variable is 0.879); ASEAN countries do tend to trade more with each other, controlling for all other variables. This would suggest that both countries' being in ASEAN, *ceteris paribus*, increases bilateral trade by approximately 140 percent ($\exp^{(.88)-1}$ = 140%) than what we would have expected otherwise. Moreover, just being an ASEAN country makes a difference (estimated coefficient=0.738), though this effect is somewhat less important than the "both in" effect.

We also note that the ASEAN "one-in" coefficient estimate is statistically significant in all regressions, but is especially large in the case of US bilateral trade. This estimated efficient (1.222) in the US market is actually about two-thirds higher than for the unrestricted model (0.738) and about three-fourths higher than for the EU regressions (0.68-0.69). Hence, ASEAN countries as a group is an important determinant of both US and EU bilateral trade, but especially with respect to the former.

Table 4 runs the same essential regressions but focuses on the determinants of individual country/country-group trade, i.e., US trade, NAFTA trade, two specifications of EU-15 trade, and ASEAN trade. Once again, the results are robust; the R^2 is even higher in the individual-country and country-group regressions than in the benchmark test. The estimated coefficients are generally statistically significant and of the expected sign, with the same general exceptions of the benchmark regressions. Of particular interest to us here would be the estimated coefficient on the ASEAN binary in the EU regressions (0.698 and 0.683) and the ASEAN regression (0.959). Both results would suggest that the EU and the ASEAN countries each have a trade bias in favor of trade with ASEAN, with a much stronger favorable effect in the case of the latter (which is what one would expect, given the history of EU integration, which would tend to discriminate against ASEAN, and the history of ASEAN integration, which would tend to discriminate in favor of ASEAN).

Our final series of tests regards how special ASEAN has been important in the determinant of EU (and US) trade *over time*. To answer this question, we estimate our regressions on a yearly basis (rather than including all years at the same time, as in the regressions above) and then focus on our results for the relevant binary variables. We report the magnitude of the estimate coefficients in these regressions over time in the form of a chart, in which the y-axis shows the magnitude of the estimated coefficients and the x-axis the year for which a specific regression was run (we include either the entire sample of 1948-1999 for the ASEAN aggregates, and a somewhat shorter period for the individual countries), indicating whether the coefficient was statistically significant or not. This is done in Chart 1 for US and the EU yearly regressions.

As expected (given the results of the pooled data above), the estimated coefficients are larger for the US market than for the EU market. Moreover, prior to 1970, there were no statistically significant ASEAN binaries for Europe, whereas they were statistically significant for most of the period 1948-1970 for the United States, albeit with considerable volatility. Since the mid-1980s, i.e., when ASEAN countries began to embrace an aggressive outward-oriented development policy, the magnitudes of the ASEAN binary coefficients have been rising for both the United States and the EU, peaking just before the Asian Crisis. Estimated coefficients for the EU and the United States tend to move together over time.

Table 3: Gravity Trade Regression Estimates: Benchmark Tests

	Baseline Model: All International Bilateral Trade	**No Industrial Countries**	**Trade Post 1970**
Both In ASEAN	0.879 (3.68)**	0.577 (2.32)*	0.612 (2.58)**
One In ASEAN	0.738 (12.98)**	0.785 (10.86)**	0.773 (13.58)**
GSP	0.849 (26.22)**	0.015 (0.15)	0.838 (24.79)**
Log of Distance	-1.188 (53.80)**	-1.296 (40.91)**	-1.303 (53.81)**
Log of Product of Real GDPs	0.917 (96.28)**	0.934 (58.13)**	0.947 (92.26)**
Log of Product of Real GDPs per capita	0.316 (22.14)**	0.196 (8.30)**	0.320 (21.00)**
Strict Currency Union	1.543 (12.75)**	1.348 (9.44)**	1.507 (10.01)**
Common Language	0.536 (13.58)**	0.367 (6.35)**	0.574 (13.31)**
Land Border	0.502 (4.67)**	0.667 (5.41)**	0.663 (5.76)**
Landlocked	-0.288 (9.03)**	-0.281 (5.60)**	-0.325 (9.54)**

Islands	0.073 (1.98)*	-0.056 (0.92)	0.059 (1.49)
Log of Product of Land Areas	-0.108 (13.39)**	-0.179 (13.22)**	-0.111 (12.79)**
Same Nation/Perennial Colonies	1.744 (1.65)	0.000 (.)	1.677 (1.83)
Constant	-26.917	-23.419	-27.797
	(73.55)**	(38.77)**	(68.86)**
Observations	234597	114615	183328
R-squared	0.64	0.47	0.64

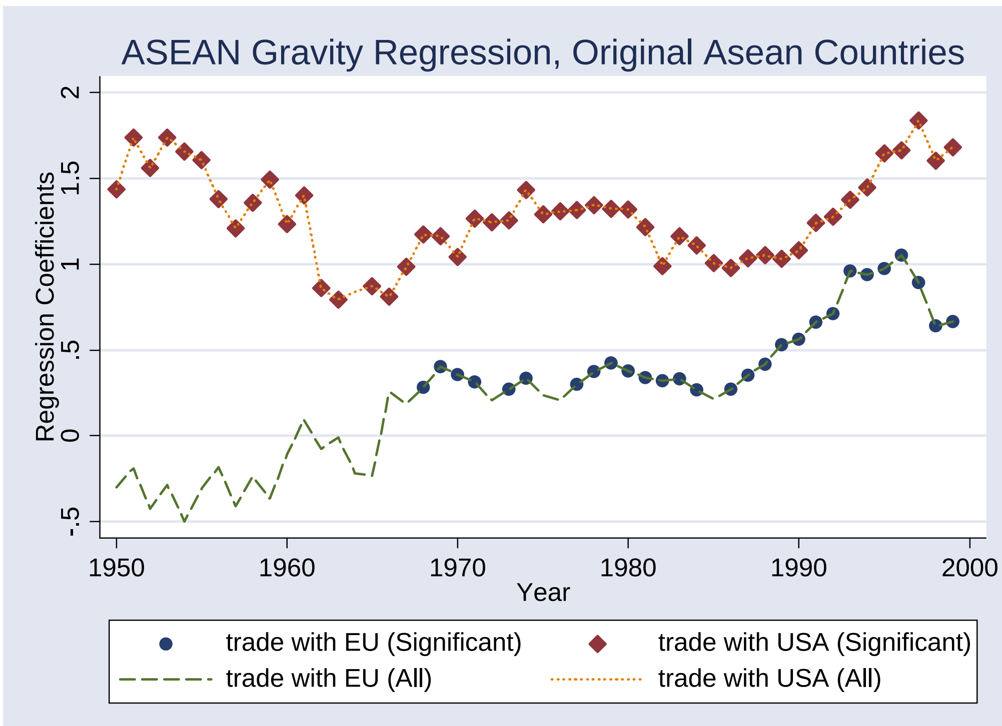
Robust t statistics in parentheses
* significant at 5%; ** significant at 1%

Table 4: Gravity Trade Regression Estimates: Selected Major Markets

	Benchmark: All Countries	**Trade with US**	**Trade with NAFTA Countries**	**Trade with Countries of EU 15, Any Year**	**Trade with EU, limited by Accession date**	**ASEAN Trade**
Both In ASEAN	0.879 (3.68)**	0.000 (.)	0.000 (.)	0.000 (.)	0.000 (.)	0.959 (4.12)**
One In ASEAN	0.738 (12.98)**	1.222 (4.12)**	1.165 (5.67)**	0.698 (8.40)**	0.683 (7.82)**	0.000 (.)
GSP	0.849 (26.22)**	0.260 (1.85)	0.756 (8.58)**	0.312 (7.22)**	0.199 (4.19)**	0.698 (5.38)**
Log Distance	-1.188 (53.80)**	-1.096 (7.82)**	-1.362 (12.37)**	-0.949 (28.63)**	-0.948 (26.17)**	-1.175 (11.77)**
Log Product of Real GDPs	0.917 (96.28)**	0.881 (16.94)**	0.944 (30.49)**	0.859 (55.89)**	0.860 (47.33)**	0.962 (21.97)**
Log Product of Real GDPs per capita	0.316 (22.14)**	0.392 (5.22)**	0.594 (11.90)**	0.385 (15.21)**	0.339 (12.25)**	0.287 (5.12)**
Strict Currency Union	1.543 (12.75)**	0.612 (2.29)*	0.854 (2.64)**	2.037 (7.75)**	1.795 (3.39)**	0.000 (.)
Common Language	0.536 (13.58)**	0.588 (5.23)**	0.875 (9.45)**	0.879 (11.86)**	0.909 (11.74)**	0.436 (3.48)**
Land Border	0.502 (4.67)**	-0.287 (0.72)	-0.235 (0.48)	-0.231 (1.50)	-0.244 (1.93)	0.013 (0.03)
Landlocked	-0.288 (9.03)**	-0.531 (2.84)**	-0.163 (1.29)	-0.440 (9.69)**	-0.575 (9.86)**	-1.015 (7.08)**
Islands	0.073 (1.98)*	0.128 (0.70)	0.434 (2.88)**	0.004 (0.05)	-0.035 (0.45)	-0.459 (4.44)**
Log Product of Land Areas	-0.108 (13.39)**	0.024 (0.50)	0.064 (2.13)*	-0.016 (1.11)	-0.017 (1.01)	-0.218 (7.00)**
Same Nation/Perennial Colonies	1.744	0.000	0.000	1.264	1.444	0.000

	(1.65)	(.)	(.)	(1.47)	(1.68)	(.)
Constant	-26.917 (73.55)**	-29.934 (16.16)**	-36.347 (29.77)**	-28.843 (50.18)**	-28.136 (44.65)**	-25.570 (13.41)**
Observations	234597	6077	15781	71979	42627	5478
R-squared	0.64	0.83	0.79	0.79	0.82	0.68
Robust t statistics in parentheses * significant at 5%; ** significant at 1%						

CHART 1



In sum, ASEAN as a group has been a statistically-significant determinant of international trade flows, including for ASEAN and EU trade. Whether or not this is due to ASEAN economic integration is not exactly clear, but the increase in magnitudes of the estimated coefficients on the ASEAN binary variables when serious ASEAN economic integration began to take off (interrupted by the Asian Crisis) would give some *prima facie* support to this argument. Second, we underscored the fact that monetary integration is one of the chief determinants of trade flows, a notion to which the Europeans have long subscribed. Finally, like with respect to trade over time, ASEAN has been an important determinant of European trade, though consistently to a less extent than in the case of US trade.

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).[4] ASEAN tends to stand at the core of Asian integration, at least from an institutional perspective. We provide in this section a brief contextual review of the evolution of ASEAN in a regional context.

Briefly, we would first suggest several factors influencing the regionalism trend in East Asia that stem directly from the Asian Financial Crisis, including: (1) the obvious contagion relationships, which demonstrated the policy externalities across countries in ASEAN and the NIEs; (2) major disappointment with respect to the US reaction to the Crisis, leaving the feeling of "being in it alone together"; (3) disappointing progress in APEC in achieving closer trade and financial cooperation, as well as development assistance cooperation ("ECOTECH"); (4) Japan's offer to create an Asian Monetary Fund during the Crisis—opposed by the IMF and the United States—gave the impression that Japan wanted to be pro-active in the region; (5) arguably, China's decision not to devalue during this period also created a sense of solidarity; (6) the "New Miyazawa Plan," launched in October 1998 which dedicated $30 billion to help spur recovery in East Asia (and deemed highly successful)[5]; and (7) the policies promulgated by the IMF to solve the Crisis were deemed inappropriate, giving greater credibility to the "Asian approach."

Hence, the Crisis itself set the stage for serious and durable East Asian regionalism. There are many other internal and external forces at work that have expedited the 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, eventually, monetary union; general pessimism regarding what can be achieved at the WTO in light of failure to move forward at the Seattle and Cancun WTO Ministerials; and the potential inherent benefits of FTAs.

Table 5 gives a chronology of arguably the most important Asian initiatives in terms of preferential trading arrangements, with a focus on ASEAN and "ASEAN Plus Three" (APT), that is, ASEAN, Japan, China, and South Korea.[6] Despite the many early agreements in ASEAN's history that were mainly political and token in nature[7], its first major initiative was AFTA (1992). With the exception of the Japan-Singapore FTA ("Japan-Singapore Economic Partnership Agreement", or JSEPA), which began implementation over ten years later, AFTA is the only example of cooperation in Asia that is similar in concept to NAFTA. However, in true ASEAN fashion, rather than overly commit to regional integration in sensitive areas, the specifics of AFTA were purposefully left somewhat ambiguous, with the agreement basically committing the ASEAN members to free trade in a 15-year timeframe. Also, the definition of "free trade" was somewhat loose, as it included tariffs in the range of 0-5 percent, rather than the traditional zero percent.[8] After the original agreement, ASEAN broadened the scope of goods covered by AFTA and the period of implementation has been shortened

[4] This brief review of ASEAN integration borrows from Plummer (forthcoming, ADB).
[5] Kawai (2005).
[6] This review is based in part on material in Naya and Plummer (forthcoming).
[7] For example, the Preferential Trading Agreement (PTA), was a positive-list approach to trade liberalization with small margins of preference and limited product coverage, expanded somewhat during the 1980s but with no real impact on trade. Industrial cooperation, such as the ASEAN Industrial Project (AIP) system, never really got off the ground.
[8] 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.

such that AFTA was technically in full effect at the beginning of 2004 for the original ASEAN countries and Brunei, 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 Vietnam, 2008 for Laos and Myanmar, and 2010 for Cambodia. Recently, ASEAN decided to speed up the process such that AFTA will be fully completed in 2007. ASEAN has also made important strides in the area of investment cooperation, e.g., in the form of ASEAN "one-stop investment centers" and the ASEAN Investment Area (AIA).[9] These efforts at industrial cooperation have been designed with essentially the same goal in mind as AFTA: reduce transactions costs associated with intra-regional economic interaction.

As was noted above, in November 2002 the ASEAN Heads of Government proposed that the region should consider the possibility of creating an "ASEAN Economic Community" by 2020. This explicitly put the European experience front and center in terms of design, though clearly the ASEAN Leaders had in mind an Economic Community with ASEAN characteristics. The ASEAN leaders actually agreed, at the Bali ASEAN Summit in October 2003, to create a region in which goods, services, capital and skilled labor would flow freely, though the details remain to be worked out. We offer our own recommendations in this regard in the penultimate section, colored by the EU experience.

The reasons behind the decision to create the AEC are many, including: (1) desire to create a post-AFTA agenda that would be comprehensive; (2) perceived need to deepen economic integration in ASEAN in light of the new international commercial environment, especially the dominance of free-trade areas (FTAs); (3) given (2), the possibility that bilateral FTAs could actually jeopardize ASEAN integration since all member-states were free to pursue their own commercial-policy agenda; and (4) the recognition since the Asian Crisis that cooperation in the real and financial sectors must be extended concomitantly, and that free flows of skilled labor will be necessary to do this.[10]

In addition to an ebb in progress related to the APEC "Bogor Vision" of open trade and investment, there have been several events that have shifted the ASEAN focus to its East Asian neighbors. First, even with the successful APEC Summits at Blake Island and Bogor, the East Asian Economic Grouping (EAEG) concept never faded away. On the contrary, it began to grow in substance. Strangely, the initiative came from ASEAN's effort to expand economic cooperation with the EU, but the EU's desire to deal with all of East Asia led to ASEAN's asking China, South Korea, and Japan to participate. The first Asia-Europe Meeting (ASEM) was held in Bangkok in March 1996, and officials from ASEAN and the rest of East Asia met with EU representatives—a format which was regularized and has continued twice a year since. Even though the initial impetus for these meetings was economic cooperation with the EU, the significance for East Asian regionalism lies in that these meetings brought officials from ASEAN, China, South Korea, and Japan together, to discuss issues of economic cooperation. In 1997, these meetings culminated in an informal summit of the APT Heads of State in Kuala Lumpur.

[9] A salient component of the AIA is the ASEAN Industrial Cooperation (AICO) Scheme, which offers more in terms of tariff (0–5 percent) and non-tariff incentives than the traditional industrial cooperation programs. Moreover, the ASEAN countries created the ASEAN 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.

[10] The free flow of all labor, including unskilled labor, was deemed too politically difficult to consider in the AEC.

The original “Miyazawa Plan” was initiated by Japan during the Asian Crisis to create an Asian Monetary Fund to supplement the IMF. It was opposed by the IMF and the United States, but eventually led to the establishment of currency swap arrangements among East Asian countries (basically bilateral swaps between Japan and individual countries) during the annual meeting of the Asian Development Bank in May 2000 (the “Chiang Mai Agreement”).

However, financial integration in general is a complicated process. Usually it occurs well into the process of regional integration, as suggested by the experiences of the EU and the creation of the euro (discussed below), which was only possible after decades of a customs union and a common market. Because the benefits of monetary cooperation are less clear--particularly in the Asian case, since exchange rate stability among Asian countries is of limited value for the many countries that trade heavily outside the region--and the political benefits are far less obvious than in the EU case, countries have begun to focus more on FTAs, at least as a first step.

Table 5
Chronology of Asian Integration: ASEAN and ASEAN+3

Main Points: ASEAN	ASEAN Summit	Year	APT Summits	Main Points: APT
ASEAN Concord 1. Established ASEAN Secretariat 2. Treaty of Amity: Mutual Respect for independence, sovereignty, equality, territorial integrity and identity of nations, i.e. non inference 3.Establishment of Zone of Peace, freedom, and neutrality	1st-Bali	1976		
1. ASEAN Industrial Project agreed upon 2. Preferential Trading Agreement (PTA)	2nd-Kuala Lumpur	1977		
1. Accelerate PTA 2. Accelerate and make more flexible ASEAN Industrial Joint Venture (AIJV)	3rd-Manila	1987		
1. ASEAN Free Trade Area (AFTA) 2. Common Effective Preferential Tariff (CEPT)	4th-Singapore	1992		
	5th-Bangkok	1995		
1. Proposal for ASEAN Vision 2020	1st informal-Jakarta	1996		
2. ASEAN 2020 presented, a broad long term vision for ASEAN in 2020 (with ASEAN Economic Community in mind)	2nd informal-Kuala Lumpur	1997	1st-Kuala Lumpur	1st ASEAN+3 (China, Korea and Japan)
Hanoi Plan of Action adopted to move towards Vision 2020: 1. Advance AFTA to 2002, 90% intra-trade subject to 0-5% tariff 2. ASEAN Investment Area (AIA)-goal investment liberalization within by ASEAN 2010, outside ASEAN by 2020	6th- Hanoi	1998	2nd-Hanoi	-East Asian Vision Group (EAVG) proposed by Kim Dae Jung, President of Korea to look into East Asian Integration

3. ASEAN Surveillance 4. Eminent Persons Group (EPG) proposed to come up with plan for ASEAN Vision 2020				
EPG develops plan for Vision 2020: 1. Concern that ASEAN not effective in responding to Asian Crisis, so proposed financial cooperation. 2. Speed up AFTA 3. Accelerate AIA 4. To respond to surge of China, need to become more competitive, attract investment, faster integration, and promote IT	3rd informal-Manila	1999	3rd-Manila	
Adopted Initiative for ASEAN Integration (IAI): 1. Framework for more developed ASEAN members to assist those less-developed members in need 2. Focus on factors to enhance competitiveness for new economy: education, skills development, and work training	4th informal-Singapore	2000	4th-Singapore	-East Asian Study Group (EASG) to consider EAFTA and agree to hold East Asian Summit -Two big ideas: 1) Development of institutional link between Southeast Asia and East Asia 2) Study group for merit of an East Asian Free Trade Area (EAFTA) and investment area -Begin financial cooperation, ex. Chiang Mai Initiative May 2000 -Propose Expert Group Study on ASEAN-China FTA
-Challenges facing ASEAN: Declining FDI, erosion of competitiveness. -Road map for Integration for ASEAN to achieve 2020 -Go beyond AFTA and AIA by deepening market liberalization for both trade and investment	7th-Brunei	2001	5th-Brunei	-Endorse EAVG recommendation for EAFTA but overshadowed by China-ASEAN Free Trade Agreement proposal within 10 years, with the adoption Early Harvest Provision to speed up FTA -Prompted by China-ASEAN FTA proposal, Prime Minister Koizumi proposed Japan-ASEAN Economic Partnership in reaction to China-ASEAN proposal -Japan-Singapore Agreement for a New Age Partnership singed January 2002 and enforced Summer 2002
-AEC end goal of Vision 2020	8th-Phnom Penh	2002	6th-Phnom Penh	Adopt EASG recommendations of deepening and broadening of East Asian integration
	9th-Bali	2003	9th-Bali	
-Vientiane Action Plan -Australia attends for 1st time	10th-Vietianne	2004	10th-Vietianne	China speeds up FTA with ASEAN from 2015 to 2010

Notes:

1. In 1998, 1999 and 2000 China speeches always contain idea of giving advice to ASEAN. Difficult to imagine this from leaders of other countries, like Japan and Korea.
2. *Source:* Adopted from Naya and Plummer (2005).

The lack of influence of APEC in the Asian Financial Crisis has served to solidify East Asia's move in favor of an APT approach. The current spate of agreements, however, have not been extended to the entire APT, but rather have come 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 2001 APT meeting in November, ASEAN and China 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

In trying to glean EU lessons for the AEC, we might begin with several *caveats* regarding the differences in the subjective environments facing the EEC in the 1950s and ASEAN today:

1. The institutional environment facing ASEAN in the first decade of the 21st Century is much different than that of the EEC of the 1950s. European integration was clearly pushed both by memories of a devasting war and emerging Cold War concerns. Political and social motivations for economic integration were, thus, far different than those of ASEAN today, though, it should be added, ASEAN has been instrumental in keeping Southeast Asia a peaceful region, an important contribution that is often underestimated. The "European Good" is interpreted much differently in Europe than the "ASEAN Good" in ASEAN; this puts considerable limitations on institutional development at many levels. Importantly, it reduces the possibility of relinquishing power to supranational organizations. Besides, such institutional development is difficult in the ASEAN context anyway, given that: (1) nation-state formation is much younger than was the case in the European context, and in some countries this still requires a strong priority; (2) divergence in socio-political institutions are far greater than they were in the European context, especially since in some European countries these institutions were being created anew after the war; (3) it is not clear that European institution-building has been particularly successful in all areas, though it would receive high marks for economic-related matters (though this, too, is a testible hypothesis); and (4) these European institutions are quite expensive and ASEAN government budgets are much smaller (fortunately, ASEAN would not have to employ an army of translaters, as the EU does) .

That said, it is important to note that the notion of the "ASEAN Good," though viewed differently in the ASEAN context, has been changing over the past 10 years. For instance, 10 years ago, few in the region (or the rest of the world) knew what ASEAN was; today, it is well-known.

2. 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. This is true because of extensive reductions in trade barriers internationally, due to the GATT/WTO rounds as well as unilateral liberalization and huge increases in international capital flows (including foreign direct investment, or FDI), which have increasingly been knitting an integrated global marketplace. The costs of using regional integration as a form of "Fortress," that is, to maximize trade diversion, are consequently much higher than they were in the past. Second, regionalism has grown by leaps and bounds recently; trade groupings reported to the WTO come to well over 200, with a majority being established after 1995. Some of these groupings include ASEAN's most important trading partners and could potentially isolate ASEAN, as well as forcing it to pay costs of trade diversion. These trends further underscore the need for the AEC to be open as well as for the organization to be engaged in the regionalism movement. The more integrated the ASEAN marketplace is, the easier this will be. These considerations were far less important in the EEC context.

3. ASEAN features far greater diversity in terms of economic development. While the expansion of the EC to include the 10 Central and Eastern European countries in May 2004 increased significantly diversity within the EU, the region is still 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. The Asian Development Bank in its *Asian Development Outlook 2002* notes that the coefficient of variation (standard deviation divided by the mean) on income levels within ASEAN is 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 AEC, and even the ability of ASEAN to be completely inclusive for all member-states, will be complicated and difficult. Phased "10-X" strategies, which is what AFTA in effect embraces, may not only be desirable but necessary.

4. ASEAN countries are far more open than was the case of Europe in the 1950s. ASEAN countries are (economically) small and very open relative to the EEC of the 1950s (and even with respect to most EU countries today), with the exception of a few of the transitional CMLV (Cambodia, Myanmar, Laos, Vietnam) countries. ASEAN countries are closely integrated with international markets through international trade as well as multinational networks. Not only is this a reality but also a policy focus for ASEAN governments. This is another reason why one would expect the AEC to embrace openness much more than the EEC/EC might have. In addition, even as an integrated market, ASEAN countries together still could not influence international terms of trade (the AEC would still be relatively "small"), suggesting that the "optimal" Common External Tariff would be zero. This was not the case in the EEC.

Having noted these *caveats*, we can delineate at least three major lessons that can drawn from the real-side integration experience of the EU. First, we might begin with a *negative* lesson: ASEAN should avoid some of the pitfalls of inward-looking discrimination from which the EU continues to suffer (especially in agriculture), but which would be potentially catastrophic in the context of the ASEAN countries. Intra-ASEAN trade is only about one-fourth its global trade (compared to two-thirds in the case of the EU) and ASEAN member states are highly integrated globally. Hence, any real-side economic cooperation needs to be outward-looking. In fact, this approach is exactly what the ASEAN leaders ostensibly have in mind, that is, using 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 intra-regional transactions costs and presents to multinational corporations a vertically-integrated market.

The AEC should never lose this vision, even when, as in the European case, compromises may have to be made. The EU countries are developed, high-income countries that together form a large economic space. They were able to push economic integration behind relatively protected markets, in the context of an international economy that was still fairly closed. Today, the GATT/WTO has opened up markets considerably and most of the world, the EU and ASEAN included, have internationalized extensively. It could be argued that such a protected approach was not necessary to begin with and should have been avoided (the CAP has been, by many measures, a disaster); however, the cost of an inward-looking approach has increased exponentially. It is not a viable option for the AEC.

Second, and partly related to the first, the European experience teaches us that trade-investment links matter and these relationships are shaping in large part the economic structure of the ASEAN economies. While the transitional ASEAN countries are still at early stages of the economic development process, the original ASEAN countries have experienced tremendous changes in their economic productive structures in general and trade in particular. Primary-based exports (roughly estimated as SITC 0-4) have fallen in all original ASEAN economies.[11] Only Thailand of the original ASEAN countries continues to have a large agricultural-export base (it is, for example, the largest exporter of rice in the world) but it, too, is falling in importance. Energy (SITC 3) continues to be important to Indonesia and Malaysia, with the former being at present a marginal oil importer. The big change throughout the region has been the impressive—in some cases, spectacular—increases in the share of SITC 7, that is, electronics and transport equipment (for ASEAN, this means mainly electronics). Over the 1990s, the share of SITC 7 increased in all ASEAN countries. Indeed, in most countries it is the largest export sector; it constituted 58 percent, 41 percent, 72 percent, and 68 percent of total exports, in Malaysia, Thailand, the Philippines, and Singapore, respectively.[12]

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 decompose the effect of external demand (by country) on production, using electric/electronics as a case study. He finds that, for 1995 (his latest year), in every (original) ASEAN country, external demand induced more production than domestic demand except (marginally) Indonesia, where, however, domestic demand fell in relative importance from 87 percent to 52 percent. Most countries followed a similar pattern of internationalization of electronics production. The most extreme case of the ASEAN countries was Malaysia, where domestic demand induced only 6 percent production.

Next, it is noteworthy that most of the directives that led to the creation of a tightly-integrated market for FDI in Europe came with the Single European Act, which commenced in 1986-87 and essentially created what is mostly a common market by 1994. The European experience teaches us that accomplishing such a feat goes well beyond mere national treatment/most-favored-nation treatment in the regional marketplace: economic cooperation needs to reduce myriad transactions costs associated with FDI, including with respect to the labor market, mutual recognition of product standards, and the like. The AEC will have to focus *per force* on many of these areas.

A third lesson relates to how the EU has been able to gain from intra-regional 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 Commerical Policy, was able to do much more by keeping real-side transaction costs within the EU to a minimum, and producing a truly regional marketplace, resulting in a more efficient division of labor in most markets.

It should be stressed, however, that the AEC should be concerned not merely with increasing *intra-regional* but rather *global* economic interaction more generally, of which the ASEAN market is only one part…in fact, a part that can be used as an international springboard. Trade and investment integration policies in ASEAN should be expected to achieve the same general results as they did in the EU case, but this increased interaction might actually manifest itself in a different way, given the fact that ASEAN countries are so diverse and most are still developing countries. To reiterate: the AEC

[11] Data for this structural-change analysis come from Plummer (2003).
[12] The Philippines case is the most drammatic and surprising. The value of SITC 7 exports increased over this peroid by over 100 percent, with the largest changes 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).

should be a means of increasing economic prosperity and the social good rather than focusing on, say, increases in (sometimes, misleading) indicators such as shares of intra-regional trade and investment. A successful integration program could theoretically lead to a decrease in regional integration, as measured by trade and investment shares, for example.[13]

A final point would regard the European experience with respect to financial and monetary cooperation and integration, though in part this goes beyond the traditional interpretation of the AEC (discussed below). ASEAN Member Countries have considered the formation of an ASEAN Bond Market, though problems related to liquidity, potential market depth, and the like have led ASEAN to think more in terms of an Asian Bond Market. This will be a long process.[14] Nevertheless, it is worthwhile considering the European experience as well, 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, just about every regional economic integration program has focused in the beginning almost exclusively on the real-side of the economy. Financial integration was always treated as something separate, to be taken up at a later date. In many ways, this is less true for European integration, though the point is debatable. While the European Payments Union (EPU) was a financial arrangement, it was only *ad hoc*, and was quickly phased out, that is, as soon as European currencies became convertible. This was just as the Treaty of Rome actually began implementation. The EC did publish the Werner Report, which mapped out a plan for monetary union at a time of great turbulence in the Bretton Woods System (1968), and after the Bretton Woods System collapsed, it tried to create the (short-lived) 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: the main goal of the CAP was to stabilize farmer incomes and flexible exchange rates put this at risk, as the country with a depreciating currency had an advantage over an appreciating-currency country, which was incompatible with the *acquis communautaire*. Hence, the EC had to develop a "green" exchange rate system, called "monetary compensation amounts" (MCAs), which prevented this "adverse" structural change from happening. However, this system was very expensive: Pomfret (1997) suggests that the MCAs constituted over 15 percent of the CAP's huge 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 far back as 1972 (it was still-born), still 15 years after the Treaty of Rome, and in

[13] This is because, for example, a successful AEC that brings in higher FDI flows from abroad—a key aim of the AIA—this will not only reduce intra-regional FDI but also could reduce intra-regional trade, if multinationals take advantage of the attractive regional division of labor offered by ASEAN. For example, 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 intra-regional 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 percent, whereas extra-regional trade would have increased by 65 percent. The point is that this could be a successful economic activity for all parties involved, but intra-regional trade shares might fall anyway.
[14] See, for example, Plummer and Click (2005).

1977 the European Council established the First Banking Directive (it did very little to integrate the markets[15]), but these and other attempts only marginally integrated the regional markets until the SEA initiatives. Today, the European banking system is far more integrated but some aspects of finance continue to be among the few areas in which the Single Market is still incomplete. Capital controls were removed as part of the SEA program.

In sum, even in the case of the EU, financial integration did not keep pace with integration in the real sector. The tendency seems to be to let financial issues wait, but experience shows that this is an unwise policy. The Asian Crisis might also be seen in this light. Prior to the Crisis, APEC, for example, all but ignored financial and monetary cooperation, and ASEAN itself did little. In creating the AEC, therefore, ASEAN leaders would do well to focus on financial issues *in tandem* with real-sector integration.

Regarding EU lessons in monetary cooperation, we must again underscore that comparisons are difficult, as relative economic-divergence problems continue to be critical. Nevertheless, even the EU is a diverse group, especially if one considers regions rather than countries. Moreover, ASEAN's needs in economic cooperation are obviously quite different from those of the EU. While ASEAN integration may be popular in the region, it is less than that in Europe, particularly among government leaders. In addition, various EU states had perennial macroeconomic (especially, fiscal) problems; Economic and Monetary Union (EMU) allowed these member-states to implement necessary austerity measures in the name of European integration. Yet, the credibility of most of the original ASEAN countries in terms of monetary and fiscal policies is actually quite high, especially for developing countries: inflation tends to be quite low in the original ASEAN countries and most countries had either budget surpluses or essentially balanced budgets prior to the Crisis. Today most have large current-account surpluses.

Hence, neither the political nor political-economy dynamics, which were favorable in the case of most eurozone countries, could be considered as important in the case of ASEAN. Nevertheless, in the aftermath of the Asian Crisis, things are changing. It has been clear to ASEAN leaders that there exist "policy externalities"; some sort of restrictions on the conduct of monetary and fiscal policy could not only improve the macroeconomic environment in the ASEAN countries but also promote regional economic stability. Moreover, the possibility of competitive exchange-rate devaluations could be damaging to the implementation of the AEC. Political arguments for wanting to be part of Europe for European countries would be replaced in the ASEAN context by a fear to repeat the economic disaster of the Crisis. Such cooperation could be formally arranged within or outside the AEC framework, without any pretension to initiatives leading to monetary union.

Based on the EU experience, closer financial and monetary cooperation in ASEAN could have the following benefits: (1) 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, that would go along with such cooperation would create a more stable macroeconomic environment in the region, thereby producing significant positive policy externalities; (2) as monetary policy would likely be driven by the most credible country/countries, less credible countries would be able to "import credibility," much as, for example, Italy was able to import German monetary credbility; (3) interest-rate spreads would converge, making it easier to price risk at the regional level and lower the cost of capital; and (4) harmonization of rules,

[15] Story and Walter (1997) note (p.14) that of the EU's 9,434 credit instutitions 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.

accounting standards, and the regulatory framework that might accompany regional integration as part of the AEC and in associated financial initiatives would render the region more attractive to foreign investors, as well as stimulate intra-regional capital flows. It would also make cooperation and even institutional integration of ASEAN equity and fixed-income markets easier, something that has happened partially in the EU (e.g., smaller stock markets have integrated but the larger markets continue to function separately).

The process of financial and monetary cooperation is complicated, and effective integration demands a steady pace of progress, rather than abrupt changes, which can actually be counterproductive. The EU process of financial integration and exchange-rate cooperation, leading up to monetary union, is instructive. The European Currency Unit (ECU) was a basket of the currencies of the member countries of the EC, weighted in line with each country's GDP and foreign trade (and therefore subject to change periodically). It was introduced in 1979 as part of the European Monetary System (EMS), to be used as the benchmark for determining the overvaulation/undervaluation of individual currencies and to serve as a unit of account among the central banks participating in the EMS. No physical ECU notes or coins ever circulated, so the ECU was strictly an artificial denomination. However, certain European banks established a banking product so that lenders and borrowers could carry out transactions in ECU. At first, an ECU transaction was just a portfolio of transactions in the separate underlying currencies; a deposit or loan in ECU typically was recorded as separate deposits or loans in the individual currencies. However, banks soon established a clearing mechanism for the ECU, thus enabling the transfer of ECU without necessarily having to make separate transactions in each of the component currencies. This facilitated growth of the ECU for private commercial transactions; residents could use the ECU as a unit of account for bank deposits and companies could use it for invoicing sales or maintaining their accounting records. The first ECU-denominated bond was issued in 1981, just two years after the introduction of the currency basket. The ECU subsequently became a significant "currency" denomination in the Eurobond markets, outranked only by the US dollar and the German mark. A substantial amount of ECU-denominated bonds were placed privately as well.

The use of the ECU in private transactions developed rapidly because the ECU exchange rate tended to be more stable than those of its component currencies. For European investors and borrowers, a depreciation of an individual home currency against other European currencies is offset by an increase in the home-currency value of the ECU, so there is an incentive to hold ECUs to diversify a portfolio. Similarly, non-European investors and borrowers were drawn to the ECU because it was less risky than the underlying individual currencies. In short, the ECU was an attractive alternative to single foreign currencies because it was less sensitive to the volatility of a single currency.

On January 1, 1999, the euro replaced the ECU on a one-for-one basis as part of the first stage of European Monetary Unification (EMU). The fact that the ECU existed for twenty years prior to EMU suggests that the simple introduction of a currency basket serves as a useful precursor to closer monetary cooperation. The success of the ECU was partially because of its official status within the EMS binding the central banks of the participating countries together. Its success was also partially because the private sector found a pan-European currency denomination quite useful, and because the banking system was able to accommodate the demand.

IV. On Building the ASEAN Economic Community

Given the tremendous diversity of ASEAN, how will it be able to create its own "customs union plus", even by 2020? Tariff dispersion rates across ASEAN countries are, indeed, impressive: while ASEAN members tend to have fairly low tariffs and NTBs relative to other developing countries (except for the transitional ASEAN economies), they still vary considerably across the region. Moreover, Singapore is unique: it essentially has no tariffs. The EEC did not face this problem. Given the openness of its economy (over 300 percent of GDP), Singapore cannot raise tariff rates to accept a ASEAN Common External Tariff that is not equal to zero. Likely options here would 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 through negotiations similar to those of the EEC but not all ASEAN countries would join.

It is not clear exactly what form the AEC will take. Some scholars have suggested a less-ambitious approach to the AEC, 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 intra-regional trade, but would not have a Common External Tariff. Noting that the European example teaches that, without integrated external tariffs, markets continue to be segmented and key benefits of integration are stymied, Plummer 2005 recommends a more ambitious approach: a 0-5 percent Common External Tariff in an AEC should at least be explored for the more developed ASEAN countries. ASEAN might accept to make exceptions in very few industries that might be integrated later on (this was done in MERCOSUR with automobiles, yielding mixed results). While perhaps more difficult to implement, this option would have the effect of reducing transactions costs in the region substantially; mitigating any trade diversion potential of regional integration; increasing the ability of ASEAN to negotiate integration accords with other trading partners; and augmenting its clout in international organizations. It could be a critical step in turning ASEAN into a truly open marketplace.

This approach is not really foreign to ideas that ASEAN leaders have proposed in the past, e.g., the Philippines-tabled proposal to multilateralize AFTA cuts. Moreover, many ASEAN countries have committed themselves to "open trade and investment" by the year 2020 as part of the Bogor Vision of APEC. True, it is unclear exactly how the Bogor Vision will be achieved, or even what it means: APEC has not completely spelled out the details, and many ambiguities persist. However, tariffs and NTBs in ASEAN have been falling over time anyway and will continue to do so, as part of Uruguay Round Commitments, likely commitments under Doha (if successful, which at the time of this writing in November 2005 looks increasingly unlikely), and the liberal posture of the ASEAN leaders.

In this sense, the AEC could be recognized as a purely outward-oriented endeavor. 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 have recognized. Some might continue to adhere to the infant-industry argument. But this argument has been more of an excuse for protection than a true means of efficient industrialization in ASEAN and elsewhere. We have 17 years between now and an AEC 2020: this is plenty of time for any industry to go through its transition. Besides, in order to make the infant-industry argument convincing, one must identify financial bottlenecks that prevent firms from setting-up comparative advantage industries. Given the state of financial markets in at least the original ASEAN countries, this is not a problem. Moreover, this open-market solution does not mean that governments would have to throw away their ability to foster industrialization directly, should they desire to do so. Regardless of the merits of an active industrial policy, it is still possible even in an open customs union. This is something that the European experience clearly shows. Even today, almost a decade after the completion of the SEA and four years after monetary union, governments tend to have active industrial policies, e.g., through direct subsidies, special financial and tax credits, and even *de facto* administrative rules. The EU has formal restrictions on these 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.

Of course, the transitional economies pose an important problem here. Cambodia, for example, until recently received about 70 percent of its government income from import-related taxes. However, it is reducing reliance on international-trade-based taxes as part of its reform program, and this has also been the case in the other CMLV countries. Vietnam has made tremendous progress in its transition program and should be on-line with AFTA in 2006. Allowing the logical progression of this reform program to continue to 2020 will not be easy but would be quite desirable from an economic-development perspective. Again, 2020 is a long way off and much can happen; Vietnam has reinvented itself from a non-market, closed, and state-directed economy into an increasingly outward-looking, market-oriented economy in less time than than it will have for the AEC. It may even be possible for ASEAN to allow for a longer-term transition period for Cambodia, Myanmar, and Laos, especially since there remain political uncertainties in these countries.

Regarding labor flows, we note that it would be politically difficult to adopt the SEA approach of (technically) free labor mobility. Moreover, this would not be necessary in the ASEAN context, at least from the point of view of multinationals and integrating the region with the global marketplace. Yet, the free flow of skilled labor would be important, as would be facilitation of visas for non-ASEAN nationals in the context of a regional framework.

However, the process will be difficult, as it was in the European case. Mutual recognition of professional qualifications, university and technical eduation preparation, and the like will require a great deal of work. Yet, this process actually presents a good opportunity for the region, and especially for the CLMV countries, to embrace “best practices.” It may well be that the process will be easier for ASEAN than it was for the EU, as fewer entrenched special interests and general resistance to reform in this area are present. Many would 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, and the like. Mutual recognition will be necessary in these areas and, hence, harmonization of at least minimum acceptable standards will have to be developed. Codes should borrow from internationally-accepted standards wherever possible.

Attracting FDI is an important priority of the ASEAN leaders. The usefulness of a regional approach has been recognized from the beginning, with the (generally, failed) 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; once the exclusion lists are incorporated into the mainstream, it will have gone a long way in creating an integrated ASEAN market, though national policies will have to be increasingly harmonized in order to create a truly regional market. No doubt FDI will be a high priority in the AEC, and that this vision of an integrated market for FDI will not be attainable without the transaction-costs-reducing liberalization and facilitation initiatives under other aspects of the AEC.

Free-flow of services will also be necessary, especially since services are becoming increasingly important in the ASEAN countries, a process that will continue as ASEAN countries develop. The ASEAN Framework Agreement on Services (AFAS), which takes a "GATS-plus" approach, is an important step forward in creating an integrating market. Services in the AEC will not take a radical change in policy since the third round of AFAS negotiations, which began in 2001, should at least in theory cover all sectors and "modes" of service provisions defined by the OECD, that is: (1) cross-border supply, in which a company exports the service from home, e.g. by fax or email; (2) consumption abroad, in which the user of the service consumes it outside his/her home country, e.g., tourism; (3) commercial presence, in which a company directly supplies the service to foreign customers (this involves establishment of an affiliate abroad and constitutes over three-fourths of all trade in services); and (4) presence of natural persons, in which the service-exporting country sends personnel abroad to supply services. The AEC will ultimately have to ensure a generally open market in services, including no policy-induced discriminatory restrictions (including trade taxes), national treatment, mutual recognition, and the like. This was a difficult process in the EU, as some of these sectors remain quite sensitive. For example, in the financial services area, the SEA stipulated three principles for integration: (1) specific minimum requirements; (2) mutual recognition of member states' legislation; and (3) the "home country principle" would prevail, in which regulations of the country in which business was taking place would take precedence (rather than the host country). (Story and Walter 1997). However, not even the SEA has succceded in fully integrating the financial-services sector; retail banking services in particular continue to be segmented and protected on a national basis. Moreover, the "Services Directive," which would service to create a more integrated market in EU services (particularly in light of the EU 2004 expansion), was rejected in early 2005.

Hence, as AFAS is expanded as part of the AEC process, it will be necessary to integrate services sectors carefully, for it is by its very nature more complicated than the goods sector. Moreover, the AFAS progress to date has been weak, and there is a reason for this: certain services are sensitive politically. Most likely it will be necessary to exclude certain sectors from complete liberalization, but these should be kept to a minimum. .

Developing appropriate institutions under which the AEC can evolve will be necessary. In the early 1990s, a number of us were involved in a project directed by Amnuay Viravan, Cesar Virata, and Seiji Naya that proposed that the ASEAN Secretariat enhance its technical abilities. Many of our proposals were adopted; the Secretariat has come a long way. However, it will have to be enhanced drastically in order to facilitate the creation of the AEC. It will need to have a much larger professional staff recruited from throughout the region and with a regional—rather than national—commitment, as is the case in the EU. Many of the directorates of the EU could be emulated in the ASEAN context. But it is our view 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 the ASEAN context would be detrimental to other domestic policy priorities, an important consideration especially for the CLMV countries. Third, at least in the first stages of creating the AEC, ASEAN could keep the "social bureaucracies," which are fairly substantial in the EU, somewhat of a separate project. While these institutions were important in making the EU what it is today, ASEAN, as noted above, is characterized by a very different socio-political context. A fourth and related point relates to the creation of a "mini-state" in ASEAN, as has been done in the case of the EU, e.g., in developing an integrated executive, legislative, and judicial system. Because the willingness in the EU to develop supranational institutions is more the exception than the rule, in our view ASEAN should try to minimize the supranational character of

AEC, taking the idea of "subsidiarity" to the greatest extent possible. The executive component of ASEAN integration would have to be enhanced considerably, but this could arguably be done by adapting and expanding current institutions. On the other hand, the creation of some sort of judicial authority to "enforce" (hitherto a bad word in ASEAN) AEC rules will be necessary. No doubt this will be difficult; the EU continues to have its own problems (e.g., the Alstom case in France is a good example but there are many more). As in the case of the EU, it would have to be an evolutionary process.

V. Concluding Remarks

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

The EU integration experience is remarkable. It took a great deal of time before it became a truly integrated market, that is, about 37 years, from the Treaty of Rome in 1957 until the implementation of the SEA, which was essentially complete in 1994. Once the process was given a big push in the mid-1980s, however, integration initiatives picked up steam, culminating in monetary union only five years after the completion of the SEA.

At times, some leaders and experts gave up on the EC; 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 to retreat. After the September 1992 Crisis in the EMS, it was very easy to be pessimistic about the future of monetary union. There were even skeptics up to the end.

But the EU was able to persevere due to the commitment of its leaders and critical social elements. This is a very basic lesson: given the fact that the AEC will have to be far more comprehensive and "intrusive" in national markets than has ever been the case before, it will take strong commitment indeed in order to move the process forward.

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, many pundits were speculating that since the region's political exigencies had changed, ASEAN had no future as a regional organization. Instead, the ASEAN leaders responded by pushing forward impressively on the economic front, and AFTA became the first major initiative in this process. Since then, AFTA has expanded and deepened; cooperation has advanced significantly in the area of investment (AIA); liberalization of services is being actively pursued in the AFAS; other "deepening" measures are being spearheaded; and horizontal integration has expanded about as far as it can go, as ASEAN is now composed of all 10 Southeast Asian nations. While the AEC will take a much more extensive commitment, it certainly is possible if the ASEAN leaders have the political will to see it through.

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