

EXECUTIVE SUMMARY

Landmark developments in the global trade and investment environment are exerting tremendous competitive pressures on ASEAN. As a response, ASEAN member countries have committed to building an ASEAN Economic Community. Currently, the Economic Community is a vision and a work in progress. ASEAN's progress towards deeper integration could offer significant benefits for Australian firms.

THE ECONOMIC IMPERATIVE

Despite solid growth recorded since the Asian financial crisis in the late nineties, ASEAN's growth rate has not matched those of its giant regional neighbours China and India over this period. Nor have ASEAN's merchandise exports grown as rapidly as China's or India's. Foreign direct investment (FDI) flows into ASEAN as a whole collapsed at the start of the 1997 Asian financial crisis. While they picked up in 2003 and 2004, outpacing the growth in global investment, inflows into China in those years were more than twice those received by ASEAN. Investment inflows have also been gathering pace in India.

Both China and India present as single markets and production bases with national laws and regulations which, at least in principle, apply throughout the country. ASEAN, by contrast, is still an association of ten diverse economies separated by different tariff regimes, customs procedures, product standards and other non-tariff measures. The market is also fragmented by different regulations in the services sector and for investment; other behind-the-border barriers such as the anti-competitive practices of domestic firms; different legal systems and industrial structures; and inadequate connections between national infrastructures.

To renew its attractiveness to investors and to lock in better prospects for economic growth, ASEAN has embarked on a giant step towards closer integration. Based on foundations laid in 1997 in 'ASEAN Vision 2020', on 7 October 2003, at the ninth ASEAN Summit in Bali, leaders agreed to transform ASEAN's ten member countries into an ASEAN Community. This included an ASEAN Economic Community – 'a single market and production base with free flow of goods, services and skilled labour and freer flow of capital by 2020'¹ – with full integration in eleven key sectors by 2010.

A number of other important factors beyond the pressure of competition from the emerging Chinese and Indian economies are also driving the pursuit of an ASEAN Economic Community. It is a response to competitive pressures from other countries more generally in an era of accelerating globalisation. More broadly, the Economic Community is just one aspect of an ambitious agenda to maximise ASEAN's cohesion through the overall ASEAN Community and consequently to maximise its influence in the Asia-Pacific region and its contribution to regional stability.

1 ASEAN Secretariat 2003b.

The combination of these factors makes a strong case for accelerating the speed of integration of ASEAN economies. The critical factor in ASEAN's success in bringing its plans for an Economic Community to fruition will be the extent to which the common perception of external threat – and economic and political opportunity – is able to override the deep-seated concerns of individual members about relinquishing sovereignty. It will be essential to overcoming these concerns that progress in building the Economic Community is accompanied by demonstrated benefits for all members.

THE BUILDING BLOCKS

The building blocks for ASEAN's Economic Community are its ten member states. They have in many respects encouraging fundamentals. The four largest ASEAN economies have achieved sustained periods of rapid growth. The majority are also more integrated in world trade and investment than most other developing countries and are also becoming increasingly integrated with the world's most dynamic region – Asia. This offers scope for ASEAN to be an export platform to non-ASEAN markets. ASEAN's expansion beyond its original members brought in countries with different levels of development and factor endowments. A single production base would facilitate maximisation of the resulting increased complementarities in production. Finally, ASEAN's large and growing market offers scope for economies of scale.

The above factors augur well for integration. The further integration of countries that already have a number of economic strengths could lead to a synergistic result, creating a large and promising trade and investment area. However, the disparities in development levels between ASEAN countries and differences in their individual commitment to pro-growth policies may also lead to differences in political and economic priorities and differences in technical capabilities in implementing integration policies – a significant challenge to further integration.

THE EMERGING PLAN

ASEAN's vision for its Economic Community is wide-ranging and inspiring. The project is an enormous undertaking which will require changes to national policies, legislation, institutions and infrastructure in ten economies.

The ASEAN Economic Community aims to create a seamless production base and an integrated market of over half a billion consumers with a gross domestic product of more than US\$800 billion. This is expected to increase production efficiency, attract more investment and generate more exports. This in turn is expected to help all ASEAN countries, including the least developed, accelerate their rates of economic growth and development and establish ASEAN as a growth area in Asia.

In November 2004, ASEAN leaders directed their ministers and officials to begin implementing the Vientiane Action Programme, a five-year plan to move the ten member countries towards a cohesive ASEAN Community. The Programme brings together previous plans, intensifying some of their goals.

Prior to the Vientiane Action Programme, ASEAN had sought greater economic integration under a range of initiatives including the ASEAN Free Trade Area (1992) and its main instrument, the Common Effective Preferential Tariff Scheme, the ASEAN Framework Agreement on Services (1995), the Framework Agreement on the ASEAN Investment Area (1998), the Hanoi Action Plan (1998) and the Initiative for ASEAN Integration Work Plan (2002).

These earlier initiatives made some progress towards greater integration. Singapore, Malaysia, Thailand, Indonesia, the Philippines and Brunei Darussalam have reduced most tariffs on intra-ASEAN trade. Cambodia, Laos, Burma (Myanmar) and Vietnam have also made progress on reducing tariffs on intra-ASEAN trade. ASEAN has also embarked on a program for reducing the delays and costs of customs clearance. It has harmonised a small proportion of the huge number of differing technical standards. It has agreed to mutual recognition of standards and certification processes in a handful of sectors. It has removed restrictions to intra-ASEAN FDI in manufactures in Singapore, Malaysia, Thailand, Indonesia, the Philippines, Brunei Darussalam and Burma.

But much still remains to be done if the vision is to be fulfilled. The goals of the Vientiane Action Programme include eliminating the remaining intra-ASEAN tariffs and the large number of non-tariff barriers, creating an effective intellectual property rights regime, fully liberalising trade in services and FDI and relaxing barriers to flows of skilled labour in all sectors.

The Vientiane Action Programme is not an exhaustive blueprint for a unified market and plans for the Economic Community are expected to evolve over time. There are many other dimensions of deeper economic integration that are not included, such as government procurement, export incentives, competition policy, the harmonisation of business laws and taxes, and the harmonisation of exchange rates, and fiscal and monetary policies. Moreover, the Vientiane Action Programme does not aim to develop a common external tariff or common commercial policy.

THE IMPLEMENTATION CHALLENGE

In building an ASEAN Economic Community, ASEAN will face some major implementation issues and challenges. Four key implementation issues are

- formulating the operational steps for moving towards its targets. Many of its current goals are broad and aspirational rather than precise and quantifiable
- ensuring the implementation of those steps through changes in national legislation and their enforcement in practice
- ensuring that the time-frame for building the Economic Community is short enough to meet the competitive challenge of China and India, which are currently growing rapidly and integrating globally
- ensuring that the plan is comprehensive enough to result in a seamless production base and market. As noted above, a number of important aspects of creating an integrated market are not addressed in current plans.

These implementation issues, in turn, throw into sharp relief three major challenges for ASEAN.

(i) Political will

At a fundamental level, ASEAN countries face the challenge of sustaining the political will to integrate their economies. This may be an awkward challenge for a group of countries where national sovereignty has been jealously guarded. Also, ASEAN members have sometimes focused more on economic competition with other ASEAN countries rather than cooperation, in part due to rivalry in exports. The level of political will to achieve greater integration could also be influenced by the development gap between ASEAN members, which has grown with the inclusion of the least developed countries, Laos, Cambodia and Burma.

The degree of political will that ASEAN members will be able to generate will be driven by their assessment of the benefits of an ASEAN Economic Community. This depends on the extent to which they perceive the rise of China and India and other globalising countries as an economic threat and the extent to which they see an Economic Community as an answer to that threat. It depends also on the extent to which they see an Economic Community increasing ASEAN's regional influence and promoting regional stability.

(ii) Institutional change

ASEAN is also facing the challenge of adapting its processes and institutions so that they better suit the task of deep integration. ASEAN's traditional approach to decision-making is characterised by consensus, voluntarism, informality and mutual trust to implement commitments. Its small secretariat has a limited mandate to manage integration and does not include a comprehensive mechanism for continuous, detailed monitoring and effective evaluation of progress towards integration.

Some argue that while this approach has promoted stability, goodwill and cohesion in the region, it has delayed economic integration. Consensus decision-making has led to broad general agreements without any clear mechanisms for reaching precise goals, leaving individual members with considerable scope for unilateral interpretation of agreements. It has also led to goals that, because they accommodate the lowest common denominator, lack ambition in terms of timing and scope. The absence of monitoring, evaluation and penalties for failure to meet commitments means that there is a risk that commitments may not always be followed through.

ASEAN has started to make some significant changes to its institutions and processes. It has shifted away from consensus in some areas of decision-making by applying the 'ASEAN minus X' and the 'two plus X' formulas. ASEAN has also recently moved towards a stronger and more rules-based dispute settlement mechanism, although this remains untested as yet.

ASEAN has recently established an Eminent Persons' Group to examine the nature of an ASEAN Charter. The ASEAN Charter would aim to give ASEAN a legal status and to support the goals of the Economic Community. The drafting of an ASEAN Charter provides an opportunity to modify ASEAN decision-making processes and institutions, and further address the development gaps between members. These developments bear watching as indicators of ASEAN's commitment in regard to its goal of creating an ASEAN Economic Community.

(iii) The development gap

In integrating its economies, ASEAN faces a major challenge in the disparate development levels of its members. At one end of the spectrum Singapore is an advanced economy with a per capita income of US\$24 220 in 2004, while at the other end Laos, Burma and Cambodia are among the United Nations' least developed countries. As noted earlier, the complementarities introduced by the new less-developed members provide a greater incentive to integrate but also make the process more difficult. As well as impacting on political will this has technical implications for the ability of some ASEAN members to participate fully.

Given that ASEAN is taking a largely sectoral approach to integration, that it has already achieved some measure of integration in various areas, and that its plans are not exhaustive, it is expected that deeper integration will happen in some sectors before others and that some elements of an Economic Community will materialize before others. Such elements might include a zero-tariff trade area, harmonisation of customs procedures and minimisation of customs requirements, harmonisation of standards consistent with international standards, and possibly the unrestricted movement of some forms of skilled labour. And given the challenges ASEAN faces, it is also possible that integration will happen faster between some ASEAN countries than others.

ASEAN'S TRADE AND INVESTMENT PATTERNS

The commitment to create an Economic Community recognises the importance of continued expansion in trade and investment for ASEAN's overall growth. Many ASEAN countries have benefited from rapid growth in exports and foreign investment. Today, some of them are among the most highly integrated countries in world trade and direct investment flows. The Economic Community is intended to renew ASEAN as a magnet for export-oriented investment.

The ASEAN Economic Community is intended to be outward-looking. This recognises ASEAN's strong dependence on non-ASEAN partners in trade and investment. Non-ASEAN partners accounted for almost 80 per cent of ASEAN's trade in 2004. Reflecting the trade-foreign investment nexus, ASEAN is also highly dependent on non-ASEAN investors, which provided almost 90 per cent of FDI inflows in 2004. These links will stay important even if intra-ASEAN trade and investment is boosted by deeper integration.

A key source of foreign investment and trade growth in ASEAN has been ASEAN's participation in international production networks set up by foreign investors. These products currently figure prominently in the region's trade flows. However, ASEAN faces increasing competition from other developing countries, including China, in being a host for production networks, reflected in the rise in foreign investment inflows to China. Greater integration through the proposed Economic Community will increase ASEAN's attractiveness in this regard.

AUSTRALIA'S COMMERCIAL LINKS WITH ASEAN

ASEAN is an important trading partner for Australia with two-way trade in goods and services in 2005 valued at A\$55 billion or around 15 per cent of Australia's total trade. In contrast, Australia's investment links with ASEAN are relatively small. ASEAN's attempt to build an Economic Community could have significant implications for the Australia–ASEAN economic relationship. Australian companies interested in ASEAN will need to anticipate changes in cost structures resulting from ongoing integration in ASEAN over the next two decades in order to maximise their opportunities.

A stronger ASEAN is good news for Australia and the global economy. A cohesive ASEAN Economic Community should be a potent force for regional stability and economic vitality in the Asia-Pacific region. Moreover, the expected boost to ASEAN's growth should lead to greater opportunities for Australian exports of goods and services and for investment. ASEAN production may also become more efficient, leading to more competitive products and greater choice for Australian consumers.

The possible increase in ASEAN's productive efficiency could lead to new business possibilities for Australian firms. Most Australian firms treat the ASEAN market as separate economies and work to meet demand in each country individually or put production operations within a single economy. ASEAN's integration could mean that Australian exporters would find it easier to service the different country markets, for example due to harmonisation or greater commonalities in the regimes affecting standards and technical regulations. This could open greater opportunities for specialisation and economies of scale. Australian investors would have more scope to set up production networks across ASEAN. But even if ASEAN's conception of an Economic Community is realised, Australian goods will continue to face different duties for the same good in the different ASEAN countries.

Apart from being a significant market in its own right, a more dynamic integrated ASEAN could loom larger in the wider Asian strategies of Australian firms. It could be an alternative to China as a regional production base for transnational corporations. ASEAN may also be a platform to other countries' markets: ASEAN is strengthening its economic links and seeking trade and investment agreements with other major regional and global players and Australian firms with production facilities in ASEAN may be able to take advantage of these developments to enhance their access to third markets.

Australian companies currently face a range of trade and investment restrictions in ASEAN, particularly in the services sectors. However, the Australian Government is seeking closer economic cooperation with ASEAN to help Australian firms maximise their opportunities. Australia, ASEAN and New Zealand launched negotiations in 2005 to develop a free trade agreement, aiming to complete this by 2007. A free trade agreement would enhance productivity, trade, investment, income and welfare for all countries involved. It would complement Australia's existing bilateral free trade agreements with Singapore and Thailand, as well as the free trade agreement now being negotiated between Australia and Malaysia. The synergy between the Australia–ASEAN–New Zealand Free Trade Agreement and the creation of an ASEAN Economic Community has the potential to be an important contributor to economic prosperity across the region.