



PECC Trade Forum

ASEAN and the Spread of RTAs

Hadi Soesastro

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Pacific Economic Cooperation Council

4 Nassim Road Singapore 258372 Tel: +65 67379822 Fax: +65 67379824 Email: info@pecc.org
www.pecc.org



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Hadi Soesastro
Centre for Strategic and International Studies

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ASEAN is now entering a new phase in its integration process. Beyond AFTA, it is now preparing a roadmap towards deeper economic integration, namely the creation of an ASEAN Economic Community in 2020.

It still has to decide whether the ASEAN Economic Community is a *Free Trade area plus* (FTA plus) or a *Common Market minus*. The former is an FTA that includes some elements of a Common Market. It suggests a process of integration that is incremental and gradual. The latter is a more ambitious one that aims at creating a Common Market with an explicit formulation of some kind of a “negative list” that can be brought under the umbrella of the integration project. The latter can be more liberalizing.

The ASEAN Economic Community is about deepening ASEAN economic integration. In that sense it can be seen as a logical extension of the regional economic integration projects that ASEAN has embarked upon (AFTA, AIA, etc.). However, creating a Common Market (minus) requires the drafting and crafting of an overall economic blueprint. The end goal will definitely be much broader and deeper than the removal of barriers to trade and investment. And this end goal must be clearly spelled-out. The process to achieving it will need to be clearly defined as well. In this sense, ASEAN may see a break with the past in terms of how it manages the process of regional economic integration.

A Common Market is understood to be an arrangement in which there are complete free flows of trade, including internal trade – as in a Customs Union, as well as free mobility of labor and capital. Full mobility of labor involves the right to reside and accept employment in all member countries, and mutual recognition of professional and technical qualifications. Full capital mobility requires lack of exchange controls, and full rights of establishment for firms in all countries.

Trade and Investment

ASEAN has no problems in achieving completely free flows of trade and investment in 2020. Under the AFTA program the region will achieve completely free flows of goods by 2020 already. The older ASEAN members (ASEAN-6) have adopted a target of zero-tariff AFTA by 2010. The newer ASEAN members have also adopted zero-tariff AFTA, initially by 2018, but subsequently they have advanced the deadline to 2015 for most products. Under the ASEAN Investment Area (AIA) agreement, by 2020 there will already be free flow of investments, not only amongst ASEAN members but globally.

Fast tracking of trade and investment liberalization in specific sectors or areas may help build capacity and constituency for further liberalization.

In deepening and accelerating trade and investment liberalization amongst diverse economies as in ASEAN, some safeguard (or recourse) mechanisms may need to be introduced. It is important to ensure that such safeguard mechanisms do not become obstacles to longer-term liberalization efforts. In addition, some flexibility can be adopted. This principle is known as ASEAN minus X (or 10-X). Perhaps it is more appropriate to formalize a two-speed ASEAN, which can involve different subsets of ASEAN members for different areas of cooperation. ASEAN should also consider introducing the principle of redistribution of income or resources, which can be formalized in the form of either compensation schemes or joint efforts to provide regional public goods that would be mostly beneficial to the less developed members of ASEAN.

Any exclusion, temporarily or even permanently, of some sensitive sectors from the liberalization objective must be brought under the umbrella of the integration project through a common policy approach. Such common policies can focus on managing production and trade. The use of domestic policy instruments (e.g. subsidies) as a substitute for trade policy should also come under some common discipline.

Another important element of the integration project is the adoption of a common external trade policy. ASEAN as a group and individual ASEAN countries have embarked on a series of preferential, discriminatory free trade agreements (FTAs). ASEAN needs to develop a common framework so as to ensure that each of these initiatives can become a building block (and not a stumbling block) for wider regional agreements. It also should ensure that ASEAN as a group can drive the process. Otherwise ASEAN will become a spoke to arrangements that are determined by the trade partner. This will make it difficult to later amalgamate the different initiatives towards a wider regional arrangement. It should also be noted that uncoordinated proliferation can lead to increased tensions between ASEAN members. Some ASEAN countries that are not in the position to participate in the game of forming FTAs may be left out.

It is important to keep in mind that the production networks in ASEAN have become more complex. A common framework helps ensure that business transaction costs are minimized. Rules of Origin (RoO) that are restrictive constrain sourcing of inputs. RoO that vary across products and agreements add to the complexity and costs. ASEAN members should also promote the concept of an ASEAN cumulative RoO.

The common policy framework for ASEAN may also involve harmonization of external tariffs. Subsets of ASEAN can do this by forming separate Customs Unions that will help accelerate the reduction of MFN tariffs.

In fact, by 2020 most intra-ASEAN liberalization in trade and investment will be multilateralized. ASEAN members of APEC may have introduced zero MFN (most favored nations) tariffs by 2020. Other ASEAN members may have already brought down many of their MFN tariffs to zero. In view of this, ASEAN has the potential to embark of a program to harmonize its external tariffs. This can be undertaken through progressive reduction of MFN tariffs by subsets of ASEAN members, especially those with higher tariffs. In the context of the WTO round, ASEAN members can develop

common strategies to reduce their MFN tariffs. These efforts help accelerate the free flow of internal trade (as in a Customs Union) and will significantly reduce transaction costs due to the progressive elimination of rules of origin (RoO) requirements.

Services

The liberalization of trade in services in ASEAN is pursued under the ASEAN Framework Agreement on Services (AFAS). The intention is to move more progressively than under the GATS (General Agreements on Trade in Services) of the WTO. Hence GATS Plus. This has yet to be demonstrated by the ASEAN members.

In the area of services liberalization ASEAN members need to examine two questions of policy importance. First, ASEAN should give serious attention on the sequencing of its services liberalization, giving priority to cooperation in strengthening the regulatory environment and institutional capacity. Second, ASEAN should seriously examine whether in the liberalization of services is more beneficial for ASEAN to adopt a policy of global opening.

Free Flow of Labor

The ASEAN Vision 2020 proposes to accelerate the free flow of professional services. In the meeting of ASEAN Ministers of Labor (or Manpower) held in Indonesia last May, some ASEAN members have raised the possibility of a free flow of labor in the region. It should be noted that significant flows of unskilled labor are already happening in the region. Regularized flows can be a means to creating a progressively liberal environment in this area. A common policy approach to regularize these flows should be brought under the umbrella of the integration project. The agreement reached at that meeting was to give priority to the free flow of skilled professionals. ASEAN members agreed to begin to develop standards of quality for professionals. Rather than developing a common standard, it seems that ASEAN members will develop national standards and later adopt some kind of a mutual recognition agreement (MRA).

Free Mobility of Capital

Free mobility of capital in ASEAN is another important element of investment liberalization in the region. Financial sector liberalization in the region should be focused on its appropriate sequencing. Accordingly, in this area as well priority should be given to strengthening the regulatory environment and institutional capacity. With a few exceptions the region already has liberal exchange regimes. Concerns over the volatility of short-term capital flows are legitimate and can be addressed also through the development of a common policy approach. Beyond this, it is felt that financial cooperation and integration are better pursued in the wider regional setting of East Asia or the Asia Pacific. Indeed, this one of the core agenda items in the ASEAN Plus Three (APT) process.

Financial Integration

East Asia may become an interesting laboratory to test whether monetary and financial, rather than trade and investment, cooperation can become the main drivers for regional economic integration. The prevailing wisdom suggests a sequencing with trade

cooperation far preceding monetary and financial cooperation. The argument for focusing on trade cooperation is that the benefits from monetary and financial cooperation increase with the level of trade integration. The counter argument is that joining a monetary union could have significant multiplier effects on trade. This argument is supported by a study that shows that trade between countries that share a common currency is on average more than three times what would be predicted from a gravity model of trade.

Proponents of monetary and financial cooperation also argued that that monetary and financial cooperation provide participating members more opportunities for “win-win” situations, since it does not involve loss of competitiveness vis-a-vis trading partners and trade diversion as could cooperation in trade and investment.

East Asian Initiatives

The East Asian Vision Group proposed that East Asian governments adopt a staged, two-track approach towards greater financial integration: one track for establishing a self-help financing arrangement and the other for coordinating a suitable exchange rate mechanism among countries in the region. Key recommendations by the Group included the following:

- • Establishment of a self-help regional facility for financial cooperation.
- • Adoption of a better exchange rate coordination mechanism consistent with both financial stability and economic development.
- • Strengthening of the regional monitoring and surveillance process within East Asia to supplement IMF global surveillance and Article IV consultation measures.

Two main areas of financial cooperation are currently being pursued in East Asia, namely: (a) information exchange and surveillance processes; and (b) resource provision mechanisms. The former is seen as a weaker form of cooperation, allowing individual countries to make policy choices in a more informed environment. The latter is in contrast a stronger form of cooperation, ranging from the negotiation of bilateral swaps to the creation of a permanent common reserve pool administered by a secretariat.

Surveillance

The first regional surveillance process was established in November 1997, the Manila Framework Group (MFG). The Group, consisting of deputies from the finance ministries and central banks of 14 Asia Pacific countries, meets twice a year. The ADB, IMF and World Bank provide surveillance reports to these meetings. In addition to surveillance, the Framework included other initiatives: (a) economic and technical cooperation in the financial area (“financial ecotech”); (b) measures to strengthen the IMF’s capacity to respond to financial crises; and (c) development of cooperative financing arrangements to supplement the resources of the IMF and other international financial institutions. In its meeting in December 2001 the MFG discussed the proposal by a working group (led by Australia) to establish a “regional financing facility” under this Group.

The MFG is seen by some observers as the preeminent forum for regional surveillance

and peer pressure. It has not been very successful as a mechanism for regional financial cooperation. First, because the MFG has not yet clearly specified the objectives of information exchange and surveillance. Second, there is no actual peer review process in the MFG. Third, issues related to financial sector reform are only discussed cursorily.

In October 1998, eight months after it was agreed on, when the ASEAN finance ministers signed a Terms of Understanding that established the ASEAN Surveillance Process. In fact, the agreement to develop a surveillance mechanism was watered down to a surveillance process. This process is based on the principles of peer review and mutual interest. ASEAN finance ministers meet twice a year for policy coordination under this Process. The ADB provided the surveillance report, but the reports as well as the results of the meeting are kept confidential. The effectiveness of the surveillance process has been questioned.

Under the APT process, a peer review meeting, the Economic Review and Policy Dialogue Process, was first held in May 2000 in the sidelines of the ADB annual meeting. This process is similar to the ASEAN Surveillance Process. Finance Ministers of the 13 countries also meet twice a year for policy coordination. A template to monitor short-term capital flows has been finalized and implemented by several countries under a Japan-ASEAN technical assistance. In May 2001 a study group was established to enhance the process. It recommended a two-phase approach: the first phase is to strengthen the existing process by organizing an additional informal meeting of the APT deputies, and in the second phase an independent surveillance unit is to be established.

The latest development is the establishment of an APT Early Warning System (EWS). This was agreed upon at the APT finance ministers meeting in Honolulu in May 2001. An EWS is being developed with the assistance of the ADB.

Regional Financing Facility

The idea of a regional financing facility was first proposed by Japan. It was at the ASEM finance ministers meeting in September 1997 that Japan's concept of an Asian Monetary Fund (AMF) was first discussed. It was also informally discussed at the joint annual meeting of the IMF and the World Bank in Hong Kong in that same month. Opposition to this idea came from the United States, China, and the IMF. As a result Japan was unwilling to pursue the idea further. Instead, the Manila Framework, adopted by a subset of APEC economies in November 1997, was seen as a substitute for the setting up of a regional monetary institution.

The desire to develop mechanisms for resource provision within the region led to the adoption of the Chiang Mai Initiative (CMI) by the APT finance ministers in May 2000. In addition to reiterating the need for strengthened policy dialogues and regional cooperation activities, the CMI called for:

- • An expanded ASEAN Swap Arrangements (ASA) that would include all ASEAN countries and a network of bilateral swap and repurchase agreement (BSA) facilities

among ASEAN countries, China, Japan, and Korea.

- • Use of the APT framework to promote the exchange of consistent and timely data and information on capital flows.
- • Establishment of a regional financing arrangement to supplement existing international facilities.
- • Establishment of an appropriate mechanism (the EWS) that could enhance the ability to provide sufficient and timely financial stability in the East Asian region.

The ASEAN Swap Arrangement (ASA) was expanded in November 2000 to cover all ASEAN members and the total amount was increased from US\$ 200 million to US\$ 1 billion. The network of Bilateral Swaps and Repurchase Agreements (BSA) is designed to provide short-term liquidity assistance in the form of swaps of US dollars with the domestic currencies of a participating country. The disbursement of funds under the BSA is tied to IMF conditionality.

ASEAN has moved beyond this stage when they agreed to institute surveillance based on a peer review process, to monitor “developments in ASEAN member countries and in the international economy that could affect individual ASEAN economies and the region”. For ASEAN this was the first instance in which ASEAN members will make comment on internal developments. This was seen as a first step in ASEAN’s transformation as a regional organization. However, the ASEAN Surveillance Process has been poorly implemented thus far.

Strengthening the surveillance mechanism is a key task for further financial cooperation and integration.