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# **The road to an ASEAN Community: How far still to go ?**

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## 1. Introduction

The Association of Southeast Asian Nations (ASEAN) celebrates this year its 40<sup>th</sup> anniversary. Since its establishment, progress was made in several areas, especially in the economic field. In this paper we endeavour to give an overview of the developments in the process of economic integration in the region. After having introduced ASEAN as a regional organization, the importance and difficulties of the ASEAN Free Trade Agreement (AFTA) will be analyzed. The ten ASEAN member states agreed to establish an ASEAN Community by 2015, which will consist of an ASEAN Economic Community (AEC), an ASEAN Security Community (ASC) and an ASEAN Socio-Cultural Community (ASCC). These subjects and the meaning of Free Trade Agreements (FTAs) for ASEAN's global competitiveness will be discussed in the next section. In the last part, an overview of the achievements and impediments on the road towards the creation of a common currency will be presented. Moreover, several empirical studies will be reviewed on the issue whether certain countries will benefit from a currency area.

## 2. ASEAN

The Association of Southeast Asian Nations (ASEAN) was established on 8 August 1967 in Bangkok by the five original member countries, namely Indonesia, Malaysia, the Philippines, Singapore and Thailand. Brunei Darussalam joined on 8 January 1984, Vietnam on 28 July 1995, Laos and Myanmar on 23 July 1997, and Cambodia on 30 April 1999. Consequently, the association consists now of ten member states. The ASEAN region has a population of about 567 million, a total area of 4.464 million square kilometers, a combined Gross Domestic Product (GDP) of roughly 1,073 billion US dollar and a total trade of about 1,405 billion US dollar. (ASEAN Secretariat, 2007a) The ASEAN Secretariat was established on 24 February 1976, almost ten years after the establishment of ASEAN, by the five Foreign Ministers of ASEAN and is based in Jakarta, Indonesia.

The ten ASEAN countries vary in several social and economic indicators. They can be classified into four clusters based on Human Development Index (HDI) rankings and socio-economic indicators. Singapore and Brunei Darussalam belong to the first cluster, the "high human development" countries. The second cluster is categorized as the upper "medium human development" countries and includes Malaysia, the Philippines and Thailand. The third cluster, the medium "medium human development" countries, consists of Vietnam and Indonesia. Laos, Cambodia and Myanmar belong to the fourth cluster referred to as the lower "medium human development" countries. (Balboa, Medalla and Yap, 2007) We could also categorize at least two types of countries according to their economic power. ASEAN-6 is often used for the first group and consists of Indonesia, Malaysia, the Philippines, Singapore, Thailand and Brunei Darussalam. The second group is classified as ASEAN-CLMV and includes the less developed members: Cambodia, Laos, Myanmar and Vietnam.

### 3. Towards economic collaboration

At the moment of the establishment of ASEAN, the aims and purposes were on the one hand to bring about cooperation in the economic, social, cultural, technical, educational and other fields, and on the other hand, in the promotion of regional peace and stability through abiding respect for justice and the rule of law and adherence to the principles of the United Nations Charter. As Baharumshah, Onwuka and Habibullah (2007) rightly stress, one of the fundamental objectives of ASEAN was to unify the Southeast Asian countries to resist the communist ideology from China, and that the creation of ASEAN was a response to hostile external developments such as the escalating and expanding Vietnam War and the reverberations from the Cultural Revolution in China.

At the time of ASEAN's conception, the region was characterized by instability aggravated by underdevelopment. In the beginning, the five ASEAN pioneer countries pursued particularly political goals, striving for peace and security in the Southeast Asian region. They learned to trust each other, to develop the habit of working together and to foster trust and goodwill. During the 1<sup>st</sup> ASEAN Summit in Bali on 24 February 1976 the member countries signed the Treaty of Amity and Cooperation in Southeast Asia. The importance of this Treaty resides in the definition of the basic principles for their mutual relations, for instance the settlement of differences or disputes by peaceful means and the non-interference in the internal affairs of one another. (ASEAN Secretariat, 1976) From the late 1970s, the ASEAN countries envisaged a closer economic collaboration. They agreed upon a Preferential Trading Agreement (PTA) in 1977. This ASEAN PTA is an agreement to offer preferential tariff treatment to products originating in ASEAN countries. The ASEAN PTA had only a limited impact because the long exclusion lists, the too low preference margins and the little importance of the product groups eligible for preferential treatment. (Cuyvers and Pupphavesa, 1996) At that time, the ASEAN countries were not ready to open up yet, essentially due to the development gap between the member states and the fact that some members consciously stuck to import substitution strategies. Furthermore, the member states did not feel the necessity to undertake more trade liberalization efforts due to the fact that the economic growth rates were high in the region. In the second half of the 1980s trade liberalization seriously started to make way in ASEAN-6. Several facts supported this further trade liberalization, especially the pressure from the IMF and the World Bank to speed up trade liberalization efforts, the desire to arm themselves against the NAFTA and the EU, and the increased self-confidence of the ASEAN-6. (Cuyvers, De Lombaerde and Verherstraeten, 2005) At the 4<sup>th</sup> ASEAN Summit in Singapore in January 1992, the six member states initiated the ASEAN Free Trade Area (AFTA). Since then, several other agreements were signed, including the Agreement on the Common Effective Preferential Tariff (CEPT) Scheme for AFTA in 1992, The ASEAN Framework Agreement on Services (AFAS) in 1995, the Basic Agreement on the ASEAN Industrial Cooperation Scheme (AICO) in 1996, the Framework Agreement on the ASEAN Investment Area (AIA) in 1998 and the e-ASEAN Framework Agreement in 2000.

### 3.1 The ASEAN Free Trade Agreement

The objective of AFTA was to increase ASEAN's competitiveness through trade and investment liberalization, and closer economic cooperation. The AFTA program of reducing regional tariffs should be carried out in phases, to be fully established by 2008. Tariff reductions apply only to the products that satisfy the ASEAN content requirement. This implies that at least 40 % of the value of a product must be created in ASEAN countries. In 1994 however, the ASEAN Economic Ministers decided to accelerate the process and advanced the deadline to 2003. In 1995, the target date was further advanced to 2002. The agreement strived also to the elimination of quantitative restrictions and other non-tariff barriers. (ASEAN Secretariat, 2002; US-ASEAN Business Council, 2003; Cuyvers, De Lombaerde and Verherstraeten, 2005)

The ASEAN Free Trade Agreement is considered to be the centerpiece of the ASEAN economic integration. It is implemented through the Common Effective Preferential Tariff (CEPT) Scheme, a comprehensive tariff listing. The CEPT Scheme includes all manufactured products, including capital goods and processed agricultural products. Liberalization was carried out at different speeds according to the product group. Tariffs on products in the Inclusion List and traded within the ASEAN region had to be reduced to a maximum of five percent by the year 2002. The ASEAN-CLMV countries were allowed to apply a later deadline: 2006 for Vietnam, 2008 for Laos and Myanmar and 2010 for Cambodia. There are three cases where a product may be excluded from the CEPT Scheme: the general exceptions (General Exceptions List), the temporary exclusions (Temporary Exclusion List) and the sensitive agricultural products (Sensitive List). (US-ASEAN Business Council, 2003; MATRADE, 2007)

The General Exception List refers to the products which a member state considers to be necessary for the protection of the national security, public morals, the protection of human, animal or plant life and health, and the protection of articles of artistic, historic or archeological value. Roughly one percent of ASEAN tariff lines fall into this category. The temporary exclusions refer to certain products that need to be protected temporarily by a delay in tariff reduction. This is allowed under AFTA and is spelled out under a protocol. For example, Malaysia invoked this protocol in 2000 in order to protect its local car manufacturing industry. Since 2005, ASEAN-6 had no more products on the Temporary Exclusion List. Besides, a small number of sensitive agricultural products will be integrated in the CEPT Scheme by the year 2010. (US-ASEAN Business Council, 2003; ASEAN Secretariat, 2005a) In addition, the CEPT Scheme seeks to enact zero tariff rates on virtually all imports by 2010 for ASEAN-6 and 2015 for ASEAN-CLMV. (Cordenillo, 2005)

Tariffs on 98.67 % of the products in the Inclusion List of ASEAN-6 are in the 0-5 % range. Additionally, 98.58 % of the total products in ASEAN are brought on the CEPT Inclusion List and tariffs of 93.67 % of these products are within the 0-5 % range. Most of the products in the Inclusion List which have tariffs above 5 % are those which have been transferred from the Sensitive List and General Exception List. The four less developed ASEAN countries contribute also to this progress as 97.32 % of their products have been brought in the Inclusion List and tariffs of 86.21 % of these

products have been reduced to a maximum of 5 %. There are no more products in the Temporary Exclusion List of the CEPT since Myanmar and Cambodia have transferred the last remaining products in this list into the Inclusion List on 23 November 2006 and 14 August 2007 respectively. At the 5<sup>th</sup> Meeting of the AFTA Council in 1994, the Ministers announced that the average tariff of CEPT products would decline from 13.40 % in 1993 to 2.63 % in 2008. The previous years, the average tariff rate followed a downward trend. In 2007, the average tariff for ASEAN-6 decreased to 1.59 %, compared with 12.76 % in 1993 while the average tariff for ASEAN-CLMV was 4.4 %, compared with 4.65 % in 2006. (ASEAN Secretariat, 2007b) The ultimate objective is to eliminate all import duties, for ASEAN-6 by 2010 and for ASEAN-CLMV by 2015. At present, tariffs on only 71.44 % of the products in the Inclusion List of ASEAN-6 have been eliminated. It is obvious that the road to obtain zero tariff rates is still very long and additional efforts are necessary. (ASEAN Secretary 2002 and 2007b)

Although the ASEAN Secretariat claims that AFTA is virtually established, there were/are many difficulties. No doubt, a lot of trade liberalization initiatives have been taken, which have led to a more integrated ASEAN economy during the past decades. However, this integration has not only occurred due to AFTA and other ASEAN agreements which were signed thereafter. Many other factors have contributed to ASEAN economic integration, including binding liberalization measures under the WTO and decisions of multinational companies to establish global production networks in response to market signals. (Reyes, 2005) Furthermore, economic openness does not necessarily lead to economic opportunities. For example, despite the economic reforms in the Philippines, the unemployment rate in the country remains very high and a dichotomy has developed between the domestic manufacturing sector and the export sector. Therefore, to become an instrument for development, trade cooperation should be accompanied by macroeconomic policies and sustainable financial reforms. (Balboa, Medalla and Yap, 2007) According to Dee (2007), AFTA created not much preferential trade. Many producers did not consider it worth the while to retool in order to meet the ASEAN content requirement. Furthermore, some member countries were reluctant to lower their tariffs on certain products. Vietnam e.g., decided in 2004 to delay import tax reductions on 14 products until 1 January 2006, to transfer these products to the Inclusion List at the postponed date. (Xinhua, 2004; ASEAN Secretariat, 2006a)

Further trade liberalization poses economic challenges to the ASEAN-CLMV countries. Cambodia e.g., received until recently about 70 % of its government income from import taxes. The last years however, the reliance on these import taxes has considerably decreased. Besides, the ASEAN-CLMV countries have several concerns, including the possibility of becoming marginalized during the regional integration process due to their resource limitations and the weakness of their institutions, the widening development gap with ASEAN-6 and the high social costs due to necessary structural adjustments. The reaction of the ASEAN-CLMV countries to these challenges should be a positive one. They have to accelerate the reform process which includes structural reforms, poverty reduction, macroeconomic policy improvement, institutional development and human resource development. In other words, there is reason for optimism about the four less developed countries of ASEAN being

able, over time, to participate fully in the world's economic growth and prosperity. (Plummer, 2006a; Thanh, 2006)

Since 1 January 2004, the revised CEPT Rules of Origin and the Operational Certification Procedures have been implemented. This revision was necessary to make the CEPT Scheme more attractive to regional businesses and prospective investors. (ASEAN Secretariat, 2007c) The changes include:

- a standardized method of calculating local/ASEAN content
- a set of principles for determining the cost of ASEAN origin and the guidelines for costing methodologies
- a specific treatment of locally-procured materials
- an improved verification process, including on-site verification

In spite of the value-added rule appearing simple and transparent, the difficulties associated with its application had proved to be a factor that delayed the integration process. At the 17<sup>th</sup> Meeting of the AFTA Council on 1 September 2003, the Ministers agreed to improve the CEPT Rules of Origin by creating an alternative criterion in determining origin. The Substantial Transformation Rules were adopted as an equal or general alternative rule to the 40 % ASEAN value-added rule. The purpose of the Substantial Transformation Rules was to encourage the business sector in the region to make use of the CEPT Scheme and to facilitate intra-ASEAN trade. As a result, in 2005, the Ministers endorsed the Substantial Transformation Rules for wheat flour, wood based products, aluminum products, iron and steel. Currently, the ASEAN Task Force on Rules of Origin is working on the further development of the alternative transformation rules for the remaining CEPT products. This report should be finalized by the end of 2007. (ASEAN Secretariat 2005a, 2006a and 2007b)

After the member countries made commitments on the program of tariff reduction, their attention shifted to non-tariff barriers (NTBs). It is essential to eliminate NTBs to ensure the free flow of goods within ASEAN. The last years, great progress was made in the elimination of these barriers. In 2005, criteria which would serve in the identification of NTBs for priority elimination were endorsed. These criteria include the number of private sector complaints, the difference between domestic and world prices, and the trade value. In 2006, the Ministers endorsed the Work Program on the Elimination of NTBs. This Work Program aims to align the elimination of identified NTBs with the elimination of tariffs that would ensure the realization of a free flow of goods. Currently, ongoing verifications are undertaken to identify measures that are trade barriers. Another potential difficulty for the free movement of goods is the divergence in the product standards and technical regulations. The implementation of the Framework Agreement on Mutual Recognition Arrangements and the harmonization of standards and technical regulations have resulted in 140 standards and 24 additional standards for electrical and electronic equipment. Currently, progress is made in the harmonization of product standards and technical regulations in several sectors. (ASEAN Secretariat 2005a, 2006a, 2007b and 2007d)

Many empirical studies have dealt with the question whether the creation of AFTA has led to a net trade creation or a net trade diversion effect. If regional costs are above international price levels, trade liberalization at the regional level tends to give rise to trade diversion. Otherwise, if economic integration, by lowering barriers to trade among members, causes regional costs to fall under international prices, preferential trade arrangements could give rise to trade creation. (Chirathivat, 2004) According to Van Tho (2002), there are two conditions to find a strong trade creation effect: the members of the Free Trade Area are key trading partners and the tariff rates applied in intra-region trade prior to the establishment of the FTA are high. The first condition is critical and the second is only important if the first is met. Total trade statistics from the ASEAN Secretariat (2006b) show that in 2005 intra-ASEAN trade accounted only for 24.9% of their total trade with Laos (58.2 %) and the Philippines (18.1 %) as the two extremes. Moreover, intra-ASEAN imports as a percentage of total ASEAN imports went up from 16 % in 1985 to 24.5 % in 2005 while the share of intra-ASEAN exports as a proportion of total ASEAN exports increased from 18 % in 1985 to 25.3 % in 2005. In spite of the expansion of intra-ASEAN trade, ASEAN trade with non-partner countries in East-Asia has expanded at a higher rate. However, the many empirical studies did not produce univocal results on this issue. (Cuyvers, De Lombaerde and Verherstraeten, 2005; Coulibaly, 2007)

The previously mentioned analyses have a static character and do not take dynamic effects into account, such as the presence and development of economies of scale, skill improvements and technological adjustments. These effects could lead to technological improvements, giving ASEAN economies a new competitive edge. Besides, the liberalization of trade results in a more efficient allocation of resources in each ASEAN country. (Intal Jr., 1997; Van Tho, 2002; Cuyvers, De Lombaerde and Verherstraeten, 2005)

### 3.2 Other ASEAN economic agreements

On 15 December 1995, at the 5<sup>th</sup> ASEAN Summit in Bangkok, the ASEAN Economic Ministers (AEM) signed the ASEAN Framework Agreement on Services (AFAS). The three main objectives of this framework agreement are to enhance cooperation in services among the ASEAN member states, to eliminate the restrictions to trade in services among them and to liberalize the trade in services. The AEM signed on 2 September 2003 the Protocol to Amend the ASEAN Framework Agreement on Services to accelerate the liberalization of trade in services. Between 1996 and 2006 ASEAN concluded 5 packages of commitments. In addition, they signed also two additional packages of commitments in financial services and one in air transport. Air services should be fully liberalized among ASEAN capital cities by December 2008. The objective is to achieve a free flow of services by 2015. (ASEAN Secretariat, 2007e and 2007k)

The Basic Agreement on the ASEAN Industrial Cooperation Scheme (AICO) was introduced in 1996 to enhance ASEAN's industrial competitive edge and maintain the attractiveness of the region as an investment area and a leading global production base. These objectives would be attained by production integration across borders facilitated by preferential tariff rates of maximum 5 %. The member states decide upon each AICO application individually. On 21 April 2004, the ASEAN

Economic Ministers signed the Protocol to Amend the AICO Agreement providing new preferential rates. (ASEAN Secretariat, 2006c) According to Lau (2006), AICO was concentrated on the car manufacturing industry, and more specifically the Japanese. Today, car manufacturers such as Ford, Toyota and Nissan are taking advantage of this mechanism.

Foreign Direct Investments are very important for economic growth of the economies in the Southeast Asian region. Under The Framework Agreement on the ASEAN Investment Area (AIA), signed in 1998, ASEAN agreed to promote itself as a liberal investment area. By granting national treatment to all investors, with some exceptions as specified in the Temporary Exclusion List and the Sensitive List, the political leaders hoped to increase the confidence of investors in the ASEAN region. The AIA Agreement encompasses several sectors, including manufacturing, agriculture, mining, forestry and fishery, and the services incidental to these sectors. Moreover, as table 1 shows, the member states are continuously trying to phase out their Temporary Exclusion List. (ASEAN Secretariat 2006d and 2006e)

**Table 1: End dates for phasing out the Temporary Exclusion List for ASEAN Investors**

<b>End Date</b>	<b>Manufacturing</b>	<b>Agriculture, mining, forestry and fishery + services incidental to these sectors</b>
01/01/2003	ASEAN-6 and Myanmar	
01/01/2010	Vietnam, Laos and Cambodia	ASEAN-6 and Cambodia
01/01/2013		Vietnam
01/01/2015		Laos and Myanmar

Source: ASEAN Secretariat (2006d)

The e-ASEAN Framework Agreement was signed in 2000 to liberalize the trade in ICT products and services and to promote investment in the ICT sector. The ASEAN governments committed themselves to foster a favorable legal and policy environment for the development and use of ICT. The member countries will eliminate duties and non-tariff barriers on intra-ASEAN trade in ICT products. Furthermore, the ASEAN countries have taken up the challenge to eliminate tariffs on ICT products under the World Trade Organization Information Technology Agreement by 2005 for ASEAN-6 and by 2010 for ASEAN-CLMV. Taking into account the importance of the ICT sector as a catalyst for the growth in all industries, the impact of this agreement should not be underestimated. Besides, it is also a significant economic sector in itself. (Tong, 2003 and ASEAN Secretariat 2003a)

#### 4. Towards an ASEAN Community

During the past decades, the world has witnessed a marked tendency towards increased regional collaboration. Regionalism promotes regional cooperation and integration, and allows a region to achieve a better position in the world economy. The increase in regionalism in Asia should be interpreted in this context. Since the end of the Cold War, there has been a growing awareness of regional identity in Asia. Sub-regional and functional institutions are playing an important role in economic, security and political cooperation between Asian countries, with ASEAN as a good

example. More recent efforts to encourage regionalism in East Asia have several reasons, including a response to the financial crisis of 1997, the successes of NAFTA and the EU, the reduction of political factors that prevented closer cooperation in the past, and the perception that ASEAN economic integration will not move far forward unless other East Asian economies will be engaged in the process. (Yang, 2006; Balboa, Medalla and Yap, 2007)

Since the financial crisis of 1997, ASEAN has negotiated, and is negotiating, framework agreements with Asian partners such as China, India, Japan and South Korea, but also with its Asia-Pacific partners Australia and New Zealand. These agreements are intended to cover not only trade in goods but also trade in services, investment and economic cooperation. They are also intended to be WTO compatible, but some go even further than what is on the present WTO agenda (so-called WTO plus agreements). (Vandoren, 2005)

Since the late 1990s, the negotiation processes of Free Trade Agreements (FTAs) at the bilateral, the sub-regional and the regional levels have accelerated considerably,. The number of FTAs, as well as their share of world trade, has been rising. Today, FTAs cover more than half of global trade. However, compared with Europe, Africa and the Americas, East Asia is a latecomer in the move towards FTAs, but responsible for an exceptional increase in the total number of FTAs in the world since the 1990s. (Yunling, 2006; Kawai and Wignaraja, 2007)

ASEAN countries are intensifying the economic integration process, as well as taking part in the regionalism in the East Asian region. Table 2 gives an overview of the intra-regional and inter-regional trading arrangements of East Asian countries.<sup>3</sup>

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<sup>3</sup> This table is an updated version of the table of Cuyvers, De Lombaerde and Verherstraeten (2005).

**Table 2: Economic Cooperation Agreements of ASEAN members**

	<b>Membership</b>	<b>Status (2007)</b>
<b>Intra-regional</b>		
ASEAN: AFTA, AFAS, AIA, AICO, e-ASEAN	ASEAN-10	Implemented
ASEAN-China Comprehensive Economic Cooperation (including FTA)	ASEAN-10, China	Framework Agreement signed in November 2002 which provides an ASEAN-China Free Trade Area (ACFTA), Agreement on Trade in Services signed in January 2007
ASEAN-Japan Comprehensive Economic Partnership (including bilateral FTAs)	ASEAN-10, Japan	Framework Agreement signed in October 2003, Japan-Singapore bilateral implemented, Japan-Indonesia bilateral signed, other bilateral with Japan under discussion, implementation of the CEP will be completed before 2012, free trade pact endorsed in November 2007
ASEAN-South Korea Comprehensive Economic Partnership (including FTA)	ASEAN-10, South Korea	Framework Agreement signed in December 2005, Trade in Goods Agreement signed in August 2006, Agreement on Trade in Services signed in November 2007
China-Japan-South Korea FTA	China, Japan, South Korea	Under consideration, also ongoing negotiations on Japan-Korea and China-Korea bilaterals
ASEAN+3	ASEAN-10, China, Japan, South Korea	Implementation of Economic Cooperation Projects, e.g. IT, SMEs, standards and quality conformance, environment and logistics management
East Asia FTA	ASEAN-10, China, Japan, South Korea, India, Australia, New Zealand	East Asia Study Group's measures for the establishment of an East Asia FTA adopt, further negotiations ongoing
Cambodia bilaterals	North Korea	Trade and investment deal signed in November 2007
China bilaterals	With Hong Kong, South Korea, Thailand	China-Hong Kong bilateral implemented, Partial Trade Agreement signed with Thailand, other bilaterals under negotiation
Hong Kong bilaterals	With China	Implemented
Japan bilaterals	With Malaysia, the Philippines, Singapore, South Korea, Thailand, Indonesia, Brunei Darussalam, Vietnam	Japan-Singapore bilateral implemented, bilaterals with Malaysia, Thailand and the Philippines signed, bilaterals with Indonesia, South Korea, Brunei Darussalam and Vietnam in process
Malaysia bilaterals	With Japan	Signed
Philippines bilaterals	With Japan	Signed
Singapore bilaterals	With Japan, South Korea	Singapore-Japan bilateral implemented, Singapore-South Korea bilateral signed
South Korea bilaterals	With China, Japan, Singapore, Thailand	South Korea-Singapore bilateral signed, other bilaterals under negotiation
Thailand bilaterals	With China, Japan, South Korea	Thailand-Japan bilateral signed, Partial Trade Agreement signed with China, other bilaterals under negotiation
<b>Inter-regional</b>		
AFTA-CER Closer Economic Partnership	ASEAN-10, Australia, New Zealand	Ministerial Declaration signed in September 2002, negotiations on the ASEAN, Australia, New Zealand FTA expected to be completed by mid 2008
Asia Pacific Economic Cooperation (APEC)	ASEAN-6, Australia, Canada, Chile, China, Hong Kong, Japan, Korea, Mexico, New Zealand, Papua New Guinea, Peru, Russia, Taiwan, US, Vietnam	Established in 1989, not a regional FTA as it promotes 'open regionalism', aims to arrive at free trade and investment by 2010 for industrialized members and by 2020 for developing members

ASEAN-US Enterprise for ASEAN Initiative (including bilateral FTAs)	ASEAN-10, US	EAI announced in October 2002, Singapore-US bilateral implemented, other bilaterals under negotiation
ASEAN-EU Comprehensive Economic Cooperation (including FTA)	ASEAN-10, EU	EC-ASEAN Cooperation Agreement signed in March 1980
ASEAN-India Comprehensive Economic Cooperation (including FTA)	ASEAN-10, India	Framework Agreement signed in October 2003, negotiations to establish AIFTA have not progressed as envisaged
China bilaterals	With Chile, Australia, New Zealand, Pakistan, GCC <sup>4</sup> , SACU <sup>5</sup>	Ongoing negotiations
Hong Kong bilaterals	With New Zealand	Ongoing negotiations
Japan bilaterals	With Canada, Chile, Mexico	Japan-Mexico and Japan-Chile bilateral signed, Japan-Canada Economic Framework Agreement signed
Malaysia bilaterals	With US, Australia, New Zealand, Pakistan	Malaysia-US bilateral signed, other bilaterals under negotiation
Philippines bilaterals	With US, India	Philippines-India bilaterals signed, other bilaterals under negotiation
Singapore bilaterals	With Australia, Bahrain, Canada, Chile/New Zealand ("Pacific Three"), EFTA <sup>6</sup> , Egypt, India, Jordan, Kuwait, Mexico, Pakistan, Panama, Peru, Qatar, Sri Lanka, United Arab Emirates, Ukraine, US	Bilaterals with Australia, EFTA, New Zealand and US implemented, bilaterals with Chile, India, Jordan, Panama and Qatar signed, other bilaterals under negotiation
South Korea bilaterals	With Australia, Chile, Mexico, New Zealand, US, EFTA, Canada, EU	South Korea-Chile bilateral implemented, bilaterals with New Zealand, US and EFTA signed, other bilaterals under negotiation
Thailand bilaterals	With Australia, Bahrain, India, New Zealand, Peru, US	Thailand-Australia bilateral implemented, bilaterals with New Zealand and Bahrain signed, other bilaterals under negotiation

The Asia Pacific Economic Cooperation (APEC) was established in 1989 to enhance economic activity and create a sense of community in the region. APEC consists of 21 member countries<sup>7</sup>, accounting for approximately 41 % of the world's population and about 49 % of world trade, and operates on the basis of non-binding commitments, open dialogue and equal respect for the views of all participants. Decisions are reached by consensus and commitments are undertaken on a voluntary basis. Since its foundation, APEC worked to reduce tariffs and other trade barriers across the Asia-Pacific region. In 1994, the leaders adopted the Bogor Goals, the attention to achieve free trade and investment in the Asia-Pacific by 2010 for industrialized economies and 2020 for developing economies. The APEC leaders endorsed in 2005 the Busan Roadmap, which draws attention to the areas where progress has to be made in response to the world's changing environment. The Hanoi Action Plan, approved in 2006, is intended to work out specific actions to implement the Busan Roadmap. The main problem is, however, that there is no enforcement mechanism and the members cannot be forced to take action.

<sup>4</sup> Gulf Cooperation Council: Kuwait, Qatar, Oman, Saudi Arabia, Bahrain and United Arab Emirates

<sup>5</sup> Southern African Customs Union: South Africa, Botswana, Lesotho, Namibia and Swaziland

<sup>6</sup> European Free Trade Association: Iceland, Liechtenstein, Norway and Switzerland

Today, the organization is now more an informal club, rather than a serious regional reformer. Nevertheless, the attendance of leaders at the meetings illustrates that it remains an important forum. (MOFA, 2006; APEC, 2007; EIU, 2007)

ASEAN+3 cooperation started in December 1997 with the informal summit between ASEAN member countries and China, South Korea and Japan. At the 3<sup>rd</sup> ASEAN+3 Summit in 1999 the process became institutionalized. The desire was expressed to strengthen and deepen East Asian cooperation, in particularly the economic, social and political area. Since then, a number of documents have been adopted to give direction to the ASEAN+3 cooperation. An important document is the Report of the East Asia Study Group (EASG) which was adopted in 2002. The report contains a list of 17 short-term, and 9 medium and long-term measures. The countries agreed to implement all the short-term measures by 2007. (ASEAN Secretariat, 2007f) ASEAN+3 booked significant results in the monetary field, especially the Chiang Mai initiative (CMI) and the Asian Monetary Fund (AMF), which are discussed in section 5.

Since July 1996, the moment that ASEAN accorded China full dialogue partner status, the cooperation between ASEAN and China has broadened and deepened substantially. In November 2002, the Framework Agreement on Comprehensive Economic Cooperation was signed. This agreement envisages an ASEAN-China Free Trade Area (ACFTA) by 2010 for ASEAN-6 and China, and by 2015 for ASEAN-CLMV. Afterwards, two agreements were signed under the Framework Agreement on Comprehensive Economic Cooperation: the Trade in Goods Agreement in November 2004 and the Trade in Services Agreement in January 2007. The latter entered into force in July 2007 and aims to expand trade in services in the region. Today, talks have moved on to investments. (ASEAN Secretariat, 2007g and 2007h)

ASEAN and Japan established informal relations in 1973, which were formalized in March 1977 with the establishment of the ASEAN-Japan Forum. Since then, cooperation has made significant progress covering political, security, financial, economic, social and cultural areas. On 8 October 2003, ASEAN and Japan signed the Framework Agreement for Comprehensive Economic Partnership (CEP). Japan has signed a number of bilateral FTAs with ASEAN countries. However, ASEAN is waiting for Japan to clear up its bilateral issues with the four ASEAN-CLMV countries before proceeding to sign the ASEAN-Japan CEP (AJCEP). The implementation of AJCEP, including elements of a possible free trade area, will be completed by 2012. The intention of Japan to sign a plurilateral agreement with ASEAN as a whole probably reflects Japan's aim to counterbalance China's growing economic importance in the region. However, Japan remains ASEAN's major trading partner and in 2005 trade increased to 155 billion US dollar, representing 12.6 % of ASEAN's global trade. Today, both parties agreed to a free trade pact which will be formally signed in 2008. Once approved, Japan will remove tariffs on 90 % of its imports while ASEAN-6 will reciprocate in 10 years and ASEAN-CLMV has 15 to

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<sup>7</sup> Australia, Brunei Darussalem, Canada, Chile, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, Russia, Singapore, Taiwan, Thailand, the Philippines, US and Vietnam

18 years to eliminate their tariffs on Japanese imports. Sensitive items such as rice and beef remain protected. (ASEAN Secretariat, 2004a; Sharani, 2007)

Approximately 30 years after the establishment of ASEAN, their leaders adopted on 15 December 1997 the ASEAN Vision 2020, a long term road map to lead the member states to the year 2020. They envisaged the Southeast Asian region to be an ASEAN Community by 2020 with the causes of conflict eliminated and all disputes solved by peaceful means. In the Bali Concord II, adopted on 7 October 2003, ASEAN leaders formally expressed their intention to establish an ASEAN Community made up of three pillars, namely an ASEAN Economic Community (AEC), an ASEAN Security Community (ASC) and an ASEAN Socio-Cultural Community (ASCC). The Hanoi Plan of Action (HPA), which ended in 2004, was the first action plan to achieve the ASEAN Vision 2020. Therefore, at the 10<sup>th</sup> ASEAN Summit in Vientiane in November 2004 the Vientiane Action Program (VAP), a six year plan (2004-2010), was adopted to serve as guideline for realizing the ASEAN Community. (ASEAN Secretariat, 1997, 2003b and 2004b) Nowadays, the target date of the establishment of the ASEAN Community is advanced to 2015. (ASEAN Secretariat, 2007i)

On 12 December 2005 in Kuala Lumpur, the ASEAN leaders committed themselves to establish the ASEAN Charter, to serve as a legal and institutional framework of ASEAN to support the realization of its goals and objectives. Moreover, it will give a legal statute to ASEAN and aims also to protect the region's environment and human rights. Therefore, they established an Eminent Persons Group (EPG) to examine and provide recommendations on the directions and nature of the ASEAN Charter relevant to the ASEAN Community. The Cebu Declaration on the Blueprint of the ASEAN Charter was signed on 13 January 2007 during the 12<sup>th</sup> ASEAN Summit. By doing so, the ASEAN leaders endorsed the Report of the EPG on the ASEAN Charter as one of the basis of the drafting of the ASEAN Charter. The ASEAN member states signed the Charter on 20 November 2007 at the 13<sup>th</sup> ASEAN Summit in Singapore. It will come into force after ratification by all the member states. (ASEAN Secretariat, 2005b and 2007i; Xinhua, 2007)

#### 4.1 ASEAN Economic Community (AEC)

The establishment of the ASEAN Economic Community is the ultimate goal of economic integration as outlined in the ASEAN Vision 2020. The AEC is meant to be a single market and production base with a free flow of goods, services, investments and a freer flow of financial capital. The AEC should also promote equitable economic development, reduce poverty and socio-economic disparities, and strengthen the ASEAN institutional mechanisms, including the improvement of the Dispute Settlement Mechanism. (ASEAN Secretariat, 2003b)

The need for a trade dispute settlement mechanism became apparent after the establishment of AFTA. The AFTA agreement provides only for consultations in case of differences in the interpretation or application of the agreement. With the adoption of the Protocol on Dispute Settlement Mechanism on 20 November 1996 ASEAN moved towards a legal system that relies on panels and a simple majority to take decisions. Over the years, the Dispute Settlement Mechanism (DSM) has evolved

from a non-formal into a formal system. Notwithstanding this progress, the system contained a number of shortcomings. One example is the use of the AEM as the appellate body. As the AEM consists of political representatives rather than experts, it is likely to represent national interests and, therefore, decisions can be politically biased. The signing of the ASEAN Protocol on Enhanced Dispute Settlement Mechanism on 29 November 2004 was an important step forward since trade disputes are brought before panels. The mechanism focuses on objective procedures and the consistency of the decisions. Moreover, the Protocol is also relevant for the AEC as it improves the DSM. Nevertheless, the ASEAN Dispute Settlement Mechanism is still in an early stage. Besides, a code of conduct for panels should be adopted as corruption is still a serious problem in some ASEAN member states. (ASEAN Secretariat 1996 and 2004c; Koesrianti, 2005)

A great challenge for the AEC is competition from India and China, two fast growing emerging economic powers. China is in many ways unbeatable as a manufacturer and attracts a lot of foreign investments, which is also partially caused by still prevalent discrimination of foreign investors by national laws in some ASEAN countries in favor of domestic investors. To tackle these emerging competitors, the ASEAN countries have to deepen their economic integration and to increase efficiency of all economic transactions in the region. The dramatic increase of foreign investment in China can also be an opportunity for the ASEAN countries, since investors aim at diversifying their investments in order to reduce risks, and ASEAN, as a regional grouping, can be very attractive. Therefore, national treatment of foreign investors in the ASEAN countries is needed. (Yudhoyono, 2004)

The Vientiane Action Plan recognizes that the deepening and broadening of ASEAN should be accompanied by technical and development cooperation to narrow the development gap within ASEAN. One component of the VAP is the establishment of the ASEAN Development Fund which could advance the development of ASEAN-CLMV countries. The Agreement on the Establishment of the ASEAN Development Fund was signed on 26 July 2005. Currently, Singapore contributed voluntary 500,000 US dollar to the fund to support the implementation of the VAP. (ASEAN Secretariat, 2004b and 2007k) Besides, the goal to reduce the development divide is being pursued through the Initiative for ASEAN Integration (IAI) and the Roadmap for the Integration of ASEAN (RIA). In the IAI, signed on 23 July 2001, the member countries declared to take special efforts to help the development of ASEAN-CLMV with priority given to infrastructure, human resource development and ICT. Notwithstanding the implementation of IAI has brought a number of results (there were 134 projects in August 2007), this initiative requires more resources to meet their urgent needs. An integrated approach should be developed to widen transport linkages to narrow the development gaps. The RIA specifies milestones including specific steps and timetables. (Ha Thi Ngoc Ha, 2007; ASEAN Secretariat, 2001 and 2007i) In 2003, the AEM identified 11 priority sectors, chosen for their comparative advantage, for accelerated economic integration. A twelfth sector, logistics, was added in 2006. As table 3 shows, member states took on the coordination role for each of the 12 sectors. (ASEAN Secretariat, 2007j)

**Table 3: Priority sectors and their coordinator**

<b>Priority sectors</b>	<b>Coordinator</b>
Agro based products	Myanmar
Air travel	Thailand
Automotives	Indonesia
e-ASEAN	Singapore
Electronics	Philippines
Fisheries	Myanmar
Healthcare	Singapore
Logistics	Vietnam
Rubber based products	Malaysia
Textiles and apparels	Malaysia
Tourism	Thailand
Wood based products	Indonesia

Source: ASEAN Secretariat, 2007j

For all priority sectors, except logistics, roadmaps have been developed in conjunction with the private sector. These were adopted in 2004 and chart the path to full integration by 2010. The logistics sector roadmap is being developed. With the signing of the ASEAN Framework Agreement for the Integration of the Priority Sectors and the ASEAN Sectoral Integration Protocol for the Integration of the Priority Sectors on 8 December 2006 in Cebu, AEM launched phase 2 of the integration of the priority sectors. In essence, the existing roadmaps were fine-tuned. The roadmaps include for instance measures to harmonize product standards and the elimination of tariffs on about 4,000 products. Currently, several results have already been achieved in some sectors, including the establishment of a single regulatory regime for electrical and electronic equipment, and a Visit ASEAN Pass that will enable cost-effective travel in the region. (ASEAN Secretariat, 2007j)

The ASEAN leaders argue that the economic liberalization in these 12 priority sectors will serve as example for the other sectors. Cuyvers, De Lombaerde and Verherstraeten (2005) have pointed out some weaknesses in this reasoning. When e.g., trade in a particular sector is liberalized, the tariffs on the intermediate goods used should also be eliminated. As these intermediate goods are possibly produced in other sectors that are not speeding up liberalization, tariffs on essential intermediate goods will remain an important stumbling block in the creation of a single market for the priority sectors.

In comparing the intended ASEAN Economic Community with the European Union, one should also not forget the inherent structural differences between the two. ASEAN is not a customs union with a common external trade policy, including common external tariffs. It is certainly not a single market like the European Union. Within ASEAN major barriers to the free movement of resources still exist, including large discrepancies in tax rates on investments and businesses, both intra- and trans-regional.

Notwithstanding the initiatives taken, the development gap between ASEAN-6 and ASEAN-CLMV is still very large. Therefore, a forced convergence of external tariffs in the short run should not be wise. In the long run, convergence seems desirable, but is impeded by the lack of supranational institutions

and structural mechanisms. This is not really surprising as ASEAN countries always have been unwilling to delegate power to some supranational body. One should not forget that ASEAN was established by a declaration and not by a treaty, thus missing legal personality, a situation which will change by the ratification and implementation of the ASEAN Charter by the ten member states in the near future. (Cuyvers, De Lombaerde and Verherstraeten, 2005; ASEAN Secretariat, 2006f) But even then, only some of the major institutional impediments to deeper economic integration and to the creation of an economic community will be removed.

ASEAN countries are concluding bilateral and plurilateral trading arrangements at a high speed, and one can legitimately ask if these initiatives are not undermining ASEAN's relevance. Bilateral FTAs might well jeopardize ASEAN integration as all member countries are free to pursue their own commercial policy agenda. Moreover, it is clear that the negotiating power of an individual member state is smaller than that of ASEAN as a whole. Cordenillo (2005), however, has stated that ASEAN is very careful in ensuring that the many FTAs do not undermine ASEAN's internal integration efforts. Still, the bilateral trading arrangements could become an important hurdle on the way towards a single market due to the so-called "spaghetti bowl" effect (in the Asian context also coined as "Asian noodle bowl" effect), which refers to the harmful consequences of the use of diverging rules of origin, product standards and conformance requirements in the individual bilateral agreements with non-ASEAN members. Such diverging requirements become technical barriers and confuse the private sector agents as they have to pay attention to different regulations in every country. The cost of the "spaghetti bowl" is estimated at about 5 % of the value of exports. (Cuyvers, De Lombaerde and Verherstraeten, 2005; Lee and Park, 2005; Plummer, 2006b)

Bilateral agreements with external partners can be building blocks for East Asian regional integration if they are designed to fit into a common ASEAN framework. Since the 1990s there is a growing interest among East Asian countries to establish a region-wide FTA, which led to the establishment of the East Asian Vision Group (EAVG) at the Hanoi ASEAN+3 Summit in December 1998. The EAVG submitted a report to the leaders of the ASEAN+3 in 2001 proclaiming their vision of an East Asian Community and suggesting the formation of an East Asia Free Trade Area (EAFTA). To reach this goal, the ASEAN+3 Summit was transformed into an East Asian Summit and a Joint Expert Group (JEG) for Feasibility Study on EAFTA was established. At the first East Asia Summit in December 2005 in Kuala Lumpur, 16 countries were represented: ASEAN+3, Australia, New Zealand and India. During this short meeting the emphasis was on building confidence between the members. In spite of the apparent economic advantages, the road to an EAFTA is paved with numerous problems that should be resolved first, including the diversity among East Asian countries and the low level of regional awareness. The JEG presented its report in July 2006 and foresees to start the EAFTA negotiations in 2009, to be ended in 2011. Furthermore, EAFTA should be completed in 2016 and no later than 2020 for ASEAN-CLMV. (Pasadilla, 2004; Frost and Rann, 2006; Lee et al, 2006; Soesastro, 2007)

## 4.2 ASEAN Security Community (ASC)

With the adoption of the Bali Concord II in October 2003, the ASEAN leaders formally expressed their intention to establish an ASEAN Security Community, the second pillar of the ASEAN Community. The idea of establishing an ASC was largely of Indonesian origin. The ASC envisaged bringing political and security cooperation in the region to ensure that countries live in peace with each other. Therefore, the members would rely exclusively on peaceful means to settle intra-regional differences. The ASEAN Security Community Plan of Action (ASCPA) was adopted at the 10<sup>th</sup> ASEAN Summit in November 2004 to coordinate the process of cooperation towards an ASC. The plan encompasses six components, including political development, shaping and sharing of norms, conflict prevention, conflict resolution, post-conflict peace building and implementing mechanisms. The implementation of the specific provisions under the ASCPA has to be completed by 2010. (ASEAN Secretariat, 2004d; Haacke, 2005; Kesavapany and Hew, 2007)

The ASCPA struggles with several problems and remains rather a concept than a real and effective plan of action. The measures that are suggested are generally not specific enough and have no expected outcomes. Besides, a lot more work needs to be done to implement the ASCPA in a comprehensive manner. Above all, there is a need to build capacity for conflict resolution and peace-building, where very little progress has been made. Hence, there are also some issues that should be prioritized such as anti-corruption measures and counter terrorism initiatives. ASEAN member states, many of which show a low level of democratic freedoms and a bad human rights record, are also facing difficulties in modifying their current narrow interpretations of non-intervention and non-interference, which suits them well. In addition, the ASC must also seek to expedite territorial disputes and a regional court of justice should be established. (Liu, 2006; Kesavapany and Hew, 2007)

No doubt, one of the greatest failures of the ASEAN Security Community and ASEAN as a whole is Myanmar. Amnesty International has stated that during the last two decades, Myanmar has not made any significant improvement in human rights, democracy and national reconciliation. Many people have been prosecuted for talking about human rights to journalists and torture is frequently used. It can be safely argued that ASC has not contributed in any way to help resolve the stalemate in that member country, which definitely demonstrates that still a lot of work needs to be done before we really can talk about an ASEAN Security Community. It is hoped that the signing of the ASEAN Charter by Myanmar on 20 November 2007 will improve the situation in the not too distant future. (Liu, 2006)

## 4.3 ASEAN Socio-Cultural Community (ASCC)

The ASEAN Socio-Cultural Community aims at raising the quality of life of the ASEAN citizens, to strengthen their cultural identity and to achieve a more sustainable use of natural resources. The ASCC Plan of Action, declared at the 10<sup>th</sup> ASEAN Summit in Vientiane consists of four core elements: to build a community of caring societies, to manage the social impact of economic integration, to enhance environmental sustainability and to strengthen the foundations of regional social cohesion. (Hj Saim, 2007) In spite of these intentions, the ASCC is the weakest pillar of the ASEAN Community

and is more an aspiration than an objective. Therefore, extra attention should be devoted to make progress in this field as it underpins the establishment of an ASEAN Community. After all, economic and security cooperation is very difficult without any ASEAN socio-cultural awareness. Unlike the AEC and the ASC, which are directed by Economic and Foreign Ministers, the leadership of the ASCC stays ambiguous. A lot of the ASCC objectives are addressed by other ASEAN sectors or overlap with plans of the ASC. Consequently, the challenge in realizing the ASCC lies in formulating more specific targets and in improving inter-sectoral coordination. (Kesavapany and Hew, 2007)

AIDS/HIV has become one of the most important global problems, affecting every region and every country in the world. The predominance of the AIDS/HIV problem undermines all initiatives to reduce poverty and to promote development. The highest national infection levels in Asia are found in South East Asia. In 2006, there were about 1.6 million people living with HIV in the ASEAN region, an astonishing figure taking into account that the majority of these infections could have been prevented. At the 12<sup>th</sup> ASEAN Summit in January 2007, the member states agreed to stop and reverse the spread of HIV and AIDS, and to strengthen the national AIDS policies and programs to protect infected persons. Another key achievement of that Summit was the agreement to remove the current obstacles in access to quality products and medicines for HIV and AIDS prevention and treatment. These engagements are, no doubt, necessary and positive, but the question is if they are sufficient to stem the epidemic. (UNAIDS, 2006; ASEAN Secretariat 2007i)

## 5. Towards a common currency

The Asian financial crisis of 1997-1998 increased the interest in regional financial and monetary cooperation. During the crisis it became obvious that a number of factors contributed to the outbreak and the spread of the financial crisis, among which the spillovers from exchange rate policies, the inadequate supply of international liquidity and the structural weaknesses in the financial sector. Faced with these contributing factors, monetary authorities and academics started looking at the European experience in the field of monetary cooperation and integration. (Balboa, Medalla and Yap, 2007)

The Chiang Mai Initiative (CMI), signed in May 2000, was an important step towards more financial stability in the region and extends the existing ASEAN Swap Arrangement (ASA) to all ASEAN member states and to China, Korea and Japan. ASA, established in August 1977, was intended to alleviate temporary liquidity shortages among central banks in the member countries. The ASA was originally designed for a period of one year, but was several times extended. CMI consists of a network of Bilateral Swap Agreements (BSA) between ASEAN+3 countries and aims to provide supplementary short-term currency to countries with possible liquidity shortfalls. Japan and China play key roles in this system as only they can take the role of lender to central banks in the region. The leaders also agreed to increase the initial amount of 200 million US dollar up to 1 billion US dollar. Furthermore, the CMI is more complex than the ASA due to the multitude of occasionally diverging

provisions in the bilateral agreements. (Wang, 2002; Cuyvers, De Lombaerde and Verherstraeten, 2005; Balboa, Medalla and Yap, 2007)

On 2 June 2003, the Executives' Meeting of East Asia and Pacific Central Banks initiated the Asian Bond Fund (ABF). This group consists of the central banks of Thailand, Singapore, the Philippines, Malaysia, Indonesia, Japan, South Korea, China, Hong Kong, Australia and New Zealand. Thus ASEAN-6 is represented with exception of Brunei Darussalam. The ABF intends to run a 1 billion US dollar fund, coming from Asian and Pacific countries, to purchase a basket of US dollar dominated Asian government bonds. Through this initiative, the 11 central banks will promote greater regional financial integration in the bond market. (TISC, 2004)

The Asian Bond Market Initiative (ABMI), which was endorsed at the ASEAN+3 Finance Ministers Meeting in August 2003, aims to develop efficient and liquid bond markets which would enable a better use of Asian savings for Asian investments. The activities of the initiative focus on facilitating access to the market through a wider variety of issuers and types of bonds, and enhancing the market infrastructure to foster bond markets in Asia. ABMI will also address the double mismatch in the financial markets, i.e. the mismatch between on the one hand debt maturities, the use of short term borrowings for long term investments, and on the other hand the denomination of this debt, rather in foreign than in local currencies, which can create a currency crisis. (ADB, 2007; Balboa, Medalla and Yap, 2007)

At the 10<sup>th</sup> ASEAN+3 Finance Ministers Summit on 5 May 2007, the member states agreed to create an Asian Monetary Fund (AMF) of 80 billion US dollar for common responses to financial crises in the region. However, many obstacles have to be removed before an independent AMF can be established, such as e.g., a solution for the conflicts between Japan and China, who both aims at a dominant role in the region. Another problem is the opposition of the United States against the initiative, that can only be tackled by a strong unified voice from the region, which at present is absent with China and Japan wrestling over every issue and South Korea actually trying to have a voice in the choir as well. (The Hankyoreh, 2007)

Already during the Asian crisis, the idea of creating a monetary union spread among the politicians in South East and East Asia. It was increasingly felt that intra-regional exchange rate stability is desirable for East Asia and a monetary union is the best way to ensure it. Among academics in the region, this issue became obviously linked to the discussion on the region being, in whole or in part, an Optimal Currency Area (OCA).

The decision on monetary unification depends on the effect, positive or negative, of establishing a currency area. A currency area increases the monetary efficiency gain, which are profits from avoiding the uncertainty and transaction costs due to floating exchange rates. Against this monetary efficiency gain stays the national loss of monetary policy as macroeconomic policy instrument, which is larger for an economy with a low degree of economic integration than for a regionally more integrated economy.

In deciding on joining or not a currency area, each national government has to look at benefits and losses involved. (Kawai and Motonishi, 2004)

By looking at the EU experience, Plummer (2002) distinguishes four significant benefits for ASEAN countries when they opt for closer financial and monetary cooperation. First, such cooperation will go along with a Maastricht Treaty type of agreement, which will create a converging and, therefore, more stable macroeconomic environment in the region. Second, the less credible countries will be able to import credibility as the common monetary policy will be driven by the most credible countries (Cf. Italy importing German monetary credibility). Third, interest rate spreads will converge which in turn, will lower the cost of capital. Finally, the harmonization of rules and the regulatory framework that could accompany regional integration will render the region more attractive to foreign investors.

In the light of these potential benefits, it is interesting to refer to a statement by Mahendra Siregar, Indonesia's Deputy Coordinating Minister for Economic Affairs, at the 38<sup>th</sup> AEM Meeting in August 2006, that with reference to criteria such as the intensity of intra-regional trade and the convergence of macroeconomic conditions, the ASEAN countries are not looking to create a monetary union. It can be rightly stressed that ASEAN trades a lot more with other countries (75.1 %) than among its members (24.9 %) and that the region is facing a high degree of divergence in economic development. The region is also confronted with a discrepancy in exchange rate regimes, ranging from a hard peg (Brunei Darussalam) to a free float (Indonesia). These factors make it very difficult indeed for the ASEAN countries to agree on a common exchange rate, not to mention a currency union. (Rajoo, 2006; Xu, Ward and Gan, 2006)

According to Kawai and Motonishi (2004), especially the middle- and low-income countries of ASEAN have to pursue further structural reforms. The middle-income ASEAN economies (Malaysia, Thailand, Indonesia and the Philippines) have to reform their economies to deal with greater international competition. The low-income ASEAN states (Cambodia, Laos, Myanmar and Vietnam), however, have to develop their institutions and policy frameworks before embarking on regional monetary policy coordination.

Empirical studies such as Zhang, Sato and McAleer (2002), Kawai and Motonishi (2004) and Nguyen (2007) are not supporting strongly the case for an OCA in East Asia. Nevertheless, some imply that several economies are better candidates for a currency area, such as Japan, South Korea, Taiwan, Singapore, Hong Kong, Malaysia and Thailand, as these countries are reasonably well integrated with each other in terms of finance, trade and macroeconomic activity. Indonesia and the Philippines are close to this group.

However, these empirical studies do not take into account that OCA conditions can also be endogenous. A currency area will promote OCA conditions by promoting trade in goods and services, capital flows and labor mobility, and by linking the economies. Thus, once a group of economies forms a currency area the degree of economic integration among these economies will become higher.

(Kawai and Motonishi, 2004) According to Nguyen (2007), a currency union of Singapore and Malaysia is possible and could serve as a trendsetter for a currency union in East Asia in the near future. Xu, Ward and Gan (2006) see these two countries plus Thailand as candidates to form a currency area as a start in the region, but do not find evidence for these countries to adopt a single currency, the Japanese yen or the US dollar, and rather propose to peg to a basket of currencies, including the Japanese yen, the US dollar and the euro.

Jeon and Zhang (2007) are referring to diverging political environments, economic standards and cultural background to voice serious doubts about the East Asian countries forming a common currency area and adopting an uniform monetary policy in the near future. It looks more realistic for Japan, Taiwan and Korea to form a currency area in the long run than any other country in the region. China does not belong to this group as its economic structure and shock adjustment mechanism are reasonably different from those in the other three countries.

Karras (2005) performed a cost-benefit analysis of membership for 18 Asian and Pacific economies in a yen-based monetary union, Japan being an important economy in East Asia which could play a leading role in promoting regional monetary integration. His empirical results show that the costs and benefits vary considerably across the 18 countries, although they are often positively correlated. In other words, the countries that have a lot to gain by adopting the yen have also a lot to lose from it. Nevertheless, Indonesia for example appears to be a good candidate as it combines a high inflation bias and a high cyclical correlation with Japan. Moreover, based on the above mentioned endogeneity argument one can argue that the adoption of the yen can enhance the structural similarities of the economies involved. However, the choice to adopt the yen is evidently also an element of a political process and thus more than a pure economic decision.

The idea of a common Asian currency throughout the region was first launched by Malaysia in 1997 at the ASEAN Summit, probably influenced by the decision of the European Union in 1992 to introduce the euro, which actually happened in 1999. The Asian Development Bank (ADB) announced in 2006 that they were working on a plan to issue the Asian Currency Unit (ACU) as a first step towards a single currency in the region. The ACU will be a statistical index based on a basket of the currencies of the ASEAN+3 countries. The weight of each currency will be determined by the trade volume and GDP of each country. In May 2006, the Ministers of Finance of ASEAN+3 agreed to have a study carried out on the creation of an ACU. Recently, on 15 October 2007, a one day workshop about the challenges and opportunities of an ACU was held in New Delhi, India, in order to draft a plan of forward looking measures that could serve as an input for future policy actions. However, many politicians and researchers are convinced that there will be a long way to go from an ACU to a single common currency. Moreover, Asia is different from the Eurozone with respect to imbalances. (Dongsheng, 2006; Jeon and Zhang, 2007; ICRIER, 2007)

## 6. Conclusion

ASEAN has made significant progress since its establishment in 1967. At the beginning, the five ASEAN pioneer countries were particularly pursuing political goals. Today, the ten member countries are working closely together in the economic, security and cultural field. Moreover, the political leaders agreed to give legal personality to ASEAN at the 13<sup>th</sup> ASEAN Summit on 20 November 2007.

AFTA is considered as the cornerstone of ASEAN economic integration. AFTA aims at liberalizing trade and to eliminate quantitative restrictions and other non-tariff barriers among the ASEAN countries. However, there are still several sensitive products that are excluded from the CEPT Scheme, and intra-ASEAN trade is liberalized at different speeds as ASEAN-CLMV countries are allowed to apply a later deadline. The ASEAN political leaders also agreed to liberalize intra-ASEAN trade in services by 2015.

In addition to the intensification of the economic integration process, the ASEAN countries are also taking part in East Asian regionalism as evidenced by the many intra-regional and inter-regional trading arrangements in the region. The bilateral agreements with external partners could, however, be an obstacle towards a deeper and wider economic integration because of the so-called “spaghetti bowl” effect. The costs associated with this effect are estimated at about 5 % of the value of exports. Therefore, the bilateral agreements should be designed to fit into a common ASEAN framework.

In the Bali Concord II, the ASEAN leaders expressed their intention to establish an ASEAN Community made up of three pillars.

- The ASEAN Economic Community is meant to be a single market and production base, but its implementation is hampered by several problems, among which the development gap between ASEAN-6 and ASEAN-CLMV, the discriminatory treatment of foreign investors by national laws and the large discrepancies in tax rates on investments.
- The ASEAN Security Community envisages bringing political and security cooperation in the region, but the critical situation in the military-run Myanmar and the lukewarm response from other ASEAN countries to this, demonstrates that the achievement of these goals will not be an easy job.
- The last and also the weakest pillar is the ASEAN Socio-Cultural Community. Extra attention should be devoted to make progress in this field as it underpins the establishment of an ASEAN Community. After all, forming a community is very difficult without any ASEAN socio-cultural awareness.

In 1997, the interest in regional financial and monetary cooperation increased due to the Asian financial crisis. Exactly ten years later, in May 2007, the ASEAN+3 Finance Ministers agreed to establish an Asian Monetary Fund of 80 billion US dollar, which will be used to respond to new crises in the region. No doubt, given the many internal and regional problems, it will take a long time before the ASEAN countries will be able to form a currency area. Other countries in the region are more suited to form such area. The Asian Development Bank announced in 2006 that they were working on

a plan to issue the Asian Currency Unit. Although the ACU could be introduced in the near future, there will be a long way to go from an ACU to a single common currency.

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