ASEAN Economic Community (AEC): Why does ASEAN need to go beyond ASEAN Free Trade Area (AFTA)?

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Abstract

With the rise of China and a changing pattern of development, ASEAN is compelled to embark upon an ambitious goal of building an ASEAN Economic Community (AEC) to maintain its investment attraction and international competitiveness. Given a vast diversity within ASEAN, forming a more advanced grouping is expected to a daunting task. However, with China's emergence as the 'factory of the world', ASEAN has no choice but to go ahead with its ambitious goal. The AEC would enhance not only ASEAN's international competitiveness but also its bargaining power.

When ASEAN was founded in 1967, the region was being engulfed by both internal and external security threats. As the threats

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began to subside, especially after the end of Cambodian conflicts, - which had kept ASEAN countries politically united for over a decade - ASEAN countries began to focus their attention on economic cooperation and integration. A major step towards closer economic integration was taken with the launching of ASEAN Free Trade Area (AFTA) in 1993.

AFTA aims to become a free trade area with no tariff and non-tariff barriers on cross-border transactions among ten ASEAN countries. Year 2010 was set as a deadline for six original ASEAN countries: Brunei, Indonesia, Malaysia, the Philippines, Thailand and Singapore, to abolish all import duties in the Inclusion List. For the four new members: Cambodia, Laos, Myanmar, and Vietnam (CLMV), they were given until 2015 to eliminate all tariff barriers.

Though experiencing numerous difficulties along the way towards the final goal of setting up a free trade area, ASEAN is destined to achieve its ultimate goal, either sooner or latter than its initial targeted date. However, setting up a Free Trade Area (FTA) is just a first step towards a more comprehensive economic integration. With China's meteoric rise as "the Factory of the World", allowing a free flow of trade in goods and services is now no longer enough for ASEAN to remain competitive and investment-attractive. In 2002, China received US$ 52 billion in foreign direct investment (FDI), overtaking the U.S. as the world's biggest recipient of FDI. Even with the launching of AFTA, further strengthened by the introduction of ASEAN Investment Area (AIA), ASEAN is still perceived by foreign investors as ten separate largely small markets.

From mid 1980s to mid 1990s, most ASEAN countries managed to attract a huge amount of FDI, propelling their economies to the path of rapid economic growth. At the outset of their industrialisation, they were lucky to be given a major boost from an unexpected source. That was the signing of the Plaza Accord between the US and Japan in 1985, which led to a staggering 100 % appreciation of the Japanese yen in one year. Japanese firms were forced in droves to relocate their production base to countries offering a lower cost of production. ASEAN was at the time a good place to do business.

Sparked by the Japanese's relocation of their production base to South East Asia, a pattern of economic development known as "the geese flying", whereby countries at different levels of industrialisation and development move together (like a flock of flying geese) on the basis of a progressive upgrading of their industries, began to emerge. This pattern of industrialisation and development has recently been shaken by Japan's economic woes and a rise of China as the World's Factory. China with its incredible ability to produce a range of goods that spans the entire value chain poses a daunting competitive challenge to many ASEAN countries.

ASEAN's new member (CLMV countries) are more likely to be affected by the rise of China than the old members whose economies are relatively more matured. Had there been no "China's factor", a significant amount of FDI, especially in labour-intensive industries, would have gone to CLMV countries (as suggested by "the geese flying" pattern of industrial development"). ASEAN-China proposed Free Trade Agreement, though offering huge potential trade benefits for both China and ASEAN, may have some undesirable side effects for ASEAN. Some investors may choose to produce goods in China, where there is a massive pool of low-cost labour, and export to ASEAN under ASEAN-China FTA arrangement.

Apart from the so-called China's factor, there is another important factor that may force ASEAN to re-consider their development strategy. A large proportion of global trade is now conducted between enterprises operating within the same transnational corporation. Large transnational corporations nowadays tend not to manufacture a final industrial product in one particular place. They rather prefer to produce the components of the product in different places in accordance with comparative advantage, and then assemble them in one place.

Firms' decision to invest abroad is generally driven by two factors: "pull factors" and "push factors". Push factors explain why firms decide to invest abroad, while pull factors explain why firms choose particular country as their production base. A sharp appreciation of the Japanese yen after the signing of the Plaza Accord was clearly the push factor for the first wave of FDI from Japan to ASEAN. Today, ASEAN can hardly expect any major push factor like the Plaza Accord. Any major wave of FDI to ASEAN these days will have to come from the pull factors. These pull factors can come from three major sources: market access, efficiency enhancement, and resource attraction.

ASEAN consists of ten diverse countries from a small but technologically advanced country like Singapore to a large and resource-rich country like Indonesia. ASEAN's vast diversity is its asset that can be used as "pull factors" to attract FDI. However, to fully exploit ASEAN's unique and diverse advantage, ASEAN countries must turn their region into an integrated production network. This can only be achieved by a higher level of economic integration, which involves not just a free flow of goods and services, but also a free flow of production inputs (capital and labour) together with a common external trade policy.

Without a free flow of goods, services, and production factors, it would be difficult for ASEAN to create an effective integrated production network needed to counter a rise of China as the World's Factory. Without a common external trade policy, ASEAN would never be able to go beyond what it has been (a very loose institutional structure). To maximise its true economic potentials, ASEAN will have to move to a higher level of economic integration.

Generally, the process of regional integration follows a fairly set pattern, which can be classified into five levels:

(1) Free Trade Area (FTA) involves an elimination of all tariffs and non-tariff barriers among the member countries, while allowing member countries to maintain their own trade policy towards non-FTA members.

(2) Customs Union is basically FTA plus a common external trade policy.

(3) Common market goes beyond a customs union by allowing not only a free flow of trade in goods but also a free movement of production inputs (capital and labour).

(4) Economic Union is the most advanced type of economic integration. It involves not only a free flow

of trade in goods and production inputs but also the harmonisation of monetary and fiscal policies of member states.

(5) Monetary Union is usually considered to be the ultimate stage of economic integration, which involves a comprehensive integration of virtually everything from the real sector to financial sector. Monetary policy is run by a single central bank. Member countries' currencies are replaced by a single currency. European Union (EU) is a good example of this kind of integration.

Given ASEAN countries' vast political and economic differences, what ASEAN can hope for in the medium term would be an ASEAN Single Market, which may be called ASEAN Economic Community (AEC), although not quite theoretically corrected. When the European Economic Community (EEC) was formed in 1958, it was not really a common market until the Maastricht Treaty was signed in 1992, when capital and labour were allowed to move freely within the newly founded European Community (EC).

Moving from Free Trade Area to Customs Union and then to Common market is not an easy task. AFTA was launched a decade ago, but the member countries are still struggling to meet their targeted date. To achieve an even more ambitious goal, ASEAN leaders will have to have a strong political will and determination. It took 34 years for the EEC to become a single market (the EC). During these 34 years, the EEC members had to overcome numerous political and economic setbacks, some were so serious that even staunch integration supporters began to doubt Europe's most ambitious plan. However, with the strong political will and determination of key founding members like France and Germany, the European dream eventually became a reality.

With an emergence of the so-called China's factor, ASEAN countries have no other choices but to elevate their integration, which will inevitably require the varying degree of shared sovereignty. Will ASEAN countries be willing to share their sovereignty? The concept of European integration was born out of the despair shared by many European leaders that their countries deserved something better than centuries-old rivalries, which had led them to two World Wars. European integration was, therefore, deemed as the only hope for peace and democracy through pooled sovereignty. In case of ASEAN integration, a push factor towards closer integration appeared to come mainly from the emergence of China.

At the ASEAN Summit on 4 November 2002 in Phnom Pehn, Cambodia, Singapore Prime Minister Goh Chok Tong proposed the formation of ASEAN Economic Community (AEC) by 2020. Given ASEAN' s diverse economic, political and cultural differences, forming a more advanced grouping is understandably a daunting task, especially when taking into account of what ASEAN has gone through with their Free Trade Area.

Thailand and Singapore are perhaps the most obvious supports of the AEC, while Malaysia is probably the most obvious sceptic. CLMV is likely to be cautious in embracing the idea of a more advanced integration due to their economic conditions. Unlike the European integration whereby the new members could expect huge market access and massive structural development aid from becoming the member, the AEC cannot offer what the EU does. However, ASEAN countries have to be reminded that with the rise of China, ASEAN would become increasingly marginalised if they choose to remain, as they are now, the association of ten independently minded countries.

For the new ASEAN members (CLMV), their economic future looks bleak. They are unlikely to be able to follow their older ASEAN fellows' path of development, based on the so-called geese-flying pattern of industrial development. For the old ASEAN members, they are now finding themselves competing head-on with China. Around 83% of Indonesia's exports, 65% of Thailand's and 48% of Malaysia's are similar with China's. The establishment of the AEC will give all ASEAN members (old and new) a chance to be part of a fully integrated regional production network where there will be a free flow of trade in goods and services and a free flow of production inputs. The proposed AEC would greatly enhance not only ASEAN's international competitiveness but also its bargaining power, especially when negotiating with larger trading partners.