

CAN THE CLV EFFECTIVELY ENGAGE IN THE ASEAN INTEGRATION?

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1. INTRODUCTION

At the 9th ASEAN Summit in October 2003 in Bali, ASEAN leaders agreed to establish an ASEAN Economic Community (AEC) by 2020. The AEC is the next logical step in ASEAN economic integration. The AEC builds upon existing economic programmes such as the ASEAN Free Trade Area (AFTA), the ASEAN Framework Agreement on Services (AFAS), and the ASEAN Investment Area (AIA). In line with the ASEAN Vision 2020, it is envisaged that the AEC will be a single market and production base with free flow of goods, services, investments, capital and skilled labour. The AEC can also be seen as an appropriate response to recent developments in East Asia and greater regional integration in the world. The realization of the AEC is considered very ambitious but not beyond reach. Some may be sceptical about the realization of the AEC given the rather weak ASEAN institutions and the modest success thus far in regional economic cooperation and integration.

Cambodia, Laos, and Vietnam (CLV), three newer members of ASEAN, see deeper regional economic integration as a necessary and unavoidable process, which would bring about benefits as well as challenges to them. In this context, the key question for the CLV is how they can catch up with more advanced economies in the region given their limited resources and our limitations of knowledge and practical experience². Moreover, to a significant extent, the CLV themselves are also different in terms of the pace of reforms and international integration as well as the socio-economic performance³. Therefore, it is not easy to generalise any proposition or conclusion for the CLV as a whole.

To shed light on the issues, this paper attempts to examine the challenges arising from deeper ASEAN economic integration, with the AEC as the ultimate goal, and the possible impact on the CLV countries. In this context, the paper also suggests that key external assistance and

¹ A part of this paper is based on the paper by Vo (2005). The opinions expressed in this report are solely those of the authors and do not necessarily reflect the opinions of the affiliated institution, the Central Institute for Economic Management (CIEM), and should not be attributed to the International Monetary Fund, its Executive Board, or its Management.

² As noted by Schiff and Winters (2003), “regionalism is still a very fertile area for research, with new results and interpretations emerging every day”, and, “there are not many regional integration agreements of sufficient longevity and consistency of application to provide convincing historical evidence, and each case has so many different characteristics and is so confounded by other factors (such as development in politics, economic policy, and the world economy) that disentangling the various effects becomes difficult” (p. 11).

³ See, for example, Leung *et al* (2005).

policy responses may be necessary in order to accelerate regional economic integration and narrow the development gap between the older and newer ASEAN members.

The remainder of the paper is structured as follow: Section 2 analyzes the possible configurations of the AEC and the resulting challenges and impact on the CLV. Section 3 considers the significance of ASEAN’s assistance to the CLV and the appropriate policies needed to respond to the process of regional integration. The final section, Section 4, gives some concluding remarks.

2. THE AEC: POSSIBLE CONFIGURATIONS AND THEIR IMPACT ON THE CLV

Regional economic integration is often defined as the discriminatory removal of all trade impediments between at least two participating nations and with the establishment of certain elements of cooperation and coordination between them (El-Agraa 1999). Regional economic integration has four major forms, namely free trade area (FTA), customs union, common market, and economic union (Table 1).

Table 1: Forms of Regional Economic Integration

	Free intra-scheme trade	Common trade policy	Free factor mobility	Common monetary & fiscal policy
Free trade area (FTA)	Yes	No	No	No
Customs union	Yes	Yes	No	No
Common market	Yes	Yes	Yes	No
Economic union	Yes	Yes	yes	Yes

Source: El-Agraa (1999)

There are already some possible configurations for the AEC. Existing ASEAN economic programmes such as AFTA, AIA, and AFAS suggests that some of the building blocks for the AEC are already in place (ISEAS 2003). The key problem now is to implement or enforce these programmes, especially those related to investment and liberalization of services trade. Also, the AEC needs to take into account factor mobility and financial and macroeconomic policy cooperation and integration. A study by McKinsey & Company (2003) recommended that the AEC should be a kind of “FTA plus” arrangement, including the removal of non-tariff barriers for services, liberalization of regional capital flows with a focus on microeconomic investment policies, and establishment of greater mobility for *skilled* labour in the region. In general, the AEC can be configured as an “FTA plus” arrangement that includes some elements of a common market viz. free movement of factors of production such as capital and skilled labour (ISEAS 2003). The other way is to see the AEC is as a “common market minus” arrangement, which can be more radical approach. Its advantage lies in the explicit formulation of some kind of a “negative list” that can be brought under the umbrella of the integration project (AEF 2003).

The 2003 Declaration of ASEAN Concord II went further with declaration that the AEC shall establish ASEAN as a single market and production base. According Lloyd (2005), however, it is still not clear "what the end objective of an ASEAN single market", if single market is

defined as one in which the Law of One Price must hold in all goods, services and factor markets. It means that the sets of policies involved in the process of integration should include: (i) the elimination of border measures applying to imports into one member country from another member country; (ii) full National Treatment of the behind-the-border measures applying to imports into one member country from another member country; and (iii) harmonization of measures across member countries.

Table 2: Progress Towards Economic Integration in ASEAN (as of March 2005)

Goods Markets	Services Markets	Capital Market	Labour Market	Multi-Market
Border measures				
Elimination of tariff	* Market access	* MFN treatment	γ Temporary movement of natural persons	X Convergent of competition laws
Elimination of NTBs	* Temporary movement of business persons	X Right of establishment	* Permanent movement of natural persons	X Bilateral cooperation of competition laws
Elimination of Agr. trade distortions	*	repatriation of capital & profits	γ	Intellectual property
Elimination of Government procurement barriers	X			Monetary union
Prohibition of export incentives	X			Unified fiscal system
Prohibition of anti-dumping actions	X			
Beyond – the – border measures				
National Treatment	X National Treatment	* National Treatment	γ	
Prohibition of trade-distorting production subsidies	X	Prohibition of performance requirements	X	
		Prohibition of incentives to foreign investors	X	
		Investor protection	γ	
Across – borders measures				
Convergence of product standards	* Mutual recognition of labour standards	X Harmonization of business laws	X Mutual recognition of labour standards	X
Mutual recognition of product standards	*	Double tax treaty/bilateral investment treaty	γ	
		Harmonization of taxes on business	X	

Note: Symbols γ , *, and X denote scores of all, some, and none respectively

Source: A summary following Lloyd (2005)

Table 2 shows that the progress towards ASEAN economic integration has been limited and far from an AEC/an ASEAN single market which would be imaged. Hew (2005) mentions that given different levels of development within ASEAN, ASEAN economic integration may need

to go through 3 stages, shifting from FTA-plus arrangement by 2020 to a customs union by 2030 and to a common market by 2050. The question of how a far-sighted end-goal of ASEAN can be achieved is beyond this paper. But it is worth noting that this is very much depending on how ASEAN can adopt a new and bold approach in terms of political will, negotiation modality and regional institution setting.

The possible impacts of the AEC on the CLV, thus, need to be examined on the basis of the key elements of the aforementioned four forms of regional economic integration.

Free trade area (FTA) should be a minimum platform for realising the AEC. The expected effects of an FTA (AFTA in the case of ASEAN) are the promotion of regional competitiveness and economic efficiency. In mid-1990s, the ASEAN shares of CLV trade were 35%, 54%, and 21% respectively. For Cambodia and Vietnam, these shares have recently declined as both countries signed bilateral trade agreements with the United States and therefore, their exports to the United States have expanded substantially. The Table 3 indicates that Laos (and to some extent, Myanmar) could gain a rather large welfare benefit from joining AFTA since trade creation would considerably outweigh trade diversion⁴.

Table 3: Total Trade Share (%), 1998-2000 and 2001-2003

	Cambodia		Laos		Myanmar		Vietnam	
	98 - 00	01 - 03	98 - 00	01 - 03	98 - 00	01 - 03	98 - 00	01 - 03
Cambodia	-	-	0.0	0.2	0.0	0.0	1.3	0.6
Laos	0.0	0.0	-	-	0.0	0.0	0.4	0.4
Myanmar	0.0	0.0	0.0	0.0	-	-	0.0	0.0
Vietnam	10.9	5.5	2.7	12.3	0.0	0.2	-	-
ASEAN	33.9	30.1	48.0	62.3	29.8	41.2	22.2	20.2
ASEAN+3	44	42.3	72.4	71.5	59.0	66.3	51.0	51.1

Note: Total Trade = sum of imports and exports. Table read as total trade share of a country in the top row with a partner in the left-hand column.

Source: Sakakibara and Yamakawa (2003; Table 4.1) and Yap (2006; Table 6)

The study by Fukase and Martin (1999) shows that although AFTA implementation is important as a stepping-stone to the wider liberalization, its economic benefits for Vietnam are likely to be small. There are some reasons for that. First, the share of imports from AFTA is relatively small and the liberalization affects these imports marginally. Second, the gains from trade creation are offset by the costs of trade diversion. Third, there may be significant terms of trade losses. The study also points out that the broader the liberalization beyond AFTA, the higher the increase in both exports and imports because the gains from allocative efficiency exceed the deterioration in the terms of trade. At present, this analysis becomes more complicated due to the “spaghetti bowl” effect of the proliferation of regional/bilateral FTAs. For example, the newer members could suffer from effect of trade diversion and bias in foreign direct investment (FDI) attraction created by the FTAs of which they are not members.

⁴ There are two important conditions for strong trade creation effect: (i) members are major trading partners with each other; and (ii) the tariff rates in the intra-region trade prior to the establishment of the FTA were high enough.

The substantial benefits gained by the CLV would largely come from the dynamic effect of trade liberalization through increased competition, economies of scale, and spill-over effects of FDI, especially in terms of technological and management skill transfers. Multinational corporations (MNCs) have been starting to adjust their operation to take into account of AFTA (Fujita 2001). Moreover, at present the production and trade structure between the CLV and other ASEAN members are more complementary than competitive as the ASEAN-6 countries move towards producing more capital and skill-intensive products. This means that the CLV have a chance to become attractive investment locations in international or regional production networks. However, this opportunity depends very much on the reform efforts made by the CLV governments and the capability of domestic business communities in identifying comparative advantages not just in terms of particular industries but also specific areas within those industries.

The increasing openness to international markets can have a contribution to poverty reduction (e.g. through the effect on growth), but it can also result in higher income inequality and this will further marginalize the poorest groups, especially those in isolated areas. There is also a short-run social cost due to the restructuring of uncompetitive industries and the state sector. Another question is about the loss of customs revenues as AFTA and other international commitments are being implemented. The fact is that the shares of trade taxes (mostly import duties) in total tax revenue in CLV declined, from 55%, 17%, and 27% in 1998 to 35%, 11%, and 23% in 2001, respectively. According Tongzou and Khan (2005), the CLV stand to lose significant amounts of customs revenues from ASEAN imports due to AFTA scheme. However, the overall revenue (tax as well as non-tax) is likely to rise substantially in all CLV countries.

Without competitive services sectors - especially those which are knowledge-intensive and have high value-added - an FTA framework such as AFTA will not be sufficient to develop a dynamic economic region. The welfare gains from preferential *liberalization in services trade* could be substantial since the costs of trade diversion are likely to be small (many restrictions increase the costs of foreign providers without generating any benefits from importing country). As in the case of goods trade, the scope for dynamic gains is very broad due to increased competition, exploitation of scale economies, and knowledge spill-over. Also, non-preferential liberalization based on MFN principle is likely to produce larger gains than preferential liberalization.

Service trade liberalisation via AFAS is a replication of the WTO General Agreement on Trade in Services (GATS) but with a less formal framework given the absence of a dispute settlement mechanism (Stephenson and Nikomborirak 2002). So far, the content of services trade liberalization in most of the ASEAN countries, “can at best be termed as weak” (ISEAS 2003). The study by Bartlett and Vo (2006) reveals that the AFAS’s performance over the last 10 years has not been impressive, and among 9 performance criteria one, three, and five were rated as good, adequate, and poor respectively⁵. This can be understandable since services

⁵ They are: 1. Coverage/width of liberalization (adequate); 2. Depth/extent to which the agreement is binding

trade liberalization is much more complicated than conventional trade agreements. Firstly, preferential treatment is granted mostly through discriminatory restrictions on the movement of labour (temporary or permanent) and capital and a variety of domestic regulations and national laws (the behind-the-border restrictions). Secondly, it may touch on strategic or politically sensitive sectors such as telecommunication, transportation and utilities - which are either dominated or monopolised by inefficient state-owned enterprises (SOEs). The governments therefore are under tremendous pressure to protect these industries.

For the CLV, institutional weaknesses, the lack of human resource, the ineffectiveness of administrative machinery and authorities' coordination, and state monopoly in some key services sub-sectors have posed huge constraints on the scope and the depth of commitments to services trade liberalization. As comparative advantages in services sector are largely in favour of skilled labour, there is also the fear that services trade liberalization would further magnify the income gap between the old and newer ASEAN members and within the CLV countries.

It is worth noting that the sequencing of liberalization matters more in services trade than in the case of goods trade. This is because the location-specific sunk costs of production (in a large number of sectors ranging from professional to telecommunications and financial services) can make temporary privileged access for an inferior supplier translate into long-term advantage in the market. Thus, the entry of more efficient service providers could be permanently prevented if their competitive advantage does not offset the advantages conferred by incumbency (Mattoo and Fink 2002). In that sense, the case of Cambodia's and Vietnam's, to some extent, accession to WTO with a relatively wide coverage of deep commitments to services trade liberalization is interesting and should be considered by other countries⁶.

As tariff regimes with non-members are different, FTA can create trade deflection (i.e. importation of products originating outside the region from the lowest external tariffs), which undesirably redirects production and investments. The usual solution for the deflection effect is the "rules of origin". But they can lead to trade diversion. Moreover, they also pose governance and administration problems. In general, *a customs union* is more efficient than an FTA and allows greater market integration. For ASEAN, although the harmonization of product standards and customs procedures is recognized as being very important, the establishment of the ASEAN common trade policy is now not under consideration for the AEC. A customs union requires more coordination between members and creates tighter constraints on individual member policies. These requirements are very challenging for all ASEAN countries (not just the CLV) especially when they already have different trade commitments through GATT and bilateral agreements⁷. In that sense, obviously, the "spaghetti-bowl" syndrome has already created problems for advancing ASEAN economic integration.

(poor); 3. Level of restrictiveness (adequate/good); 4. Scope of "policed decentralization" (adequate); 5. Scope of MRAs (poor); 6. Extent of harmonization (poor); 7. Quality of regulations and governance (poor); 8. Agreement wide transparency and predictability (poor); 9. Sectoral/Modal transparency and predictability (adequate).

⁶ There is a high probability that Vietnam can become a WTO member by the end of 2006.

⁷ To implement a customs union all members would be required to lower their tariff for each product to the lowest level committed by any one ASEAN country for that product (ISEAS 2003)

A common market with free factor mobility is believed to enhance efficiency through a more rational resource allocation. Net benefits gained, however, depend on the changes in total output and factor returns from abroad. Also, pecuniary rewards are not the only consideration: other factors such as income tax, health and education benefits, housing allowances, and social-political environment are also essential (El-Agraa 1999). Once again, it is necessary for all ASEAN countries to undertake comprehensive domestic reforms and to have better regional coordination.

For ASEAN, the objective of the AIA is to make the region a competitive, open and liberal investment area. The AIA binds member countries to gradually eliminate investment barriers, liberalize investment rules and policies, grant national treatment and open industries to ASEAN investors by 2010 and to all investors by 2020. However, the granting of national treatment and opening of industries has exemptions as embodied in the temporary exclusion list and sensitivity list. The investment measures seem to apply initially only to the manufacturing sector as the timetable has yet to be defined for other sectors (Austria and Avila 2001). In the meantime, ASEAN is facing several competitive challenges (Fujita 2001). First, China has emerged as a global/regional manufacturing “hub”, a major competitor in attracting FDI and is a major exporter to world markets. Second, many regional arrangements in the world could also be good production sites for industries like electronics, textiles and garments, footwear. Third, the MNCs increasingly look at ASEAN in the context of their wider regional and global strategies and are becoming increasingly selective in where they want to invest. Measures to implement the AIA are therefore not far reaching enough. Moreover, it would be difficult for ASEAN to undertake deeper economic integration if the pace and the extent of services trade liberalization within ASEAN are not accelerated⁸.

As net “capital importers”, the CLV would gain more benefits from an ASEAN common market, but only if they can accelerate domestic economic and institutional reforms. The idea of establishing greater mobility for skilled labour in the region is a good one. The meaning of “skills” (viz. the harmonization of the labour skill standards), however, may not be in the CLV’s favour. A formal framework for the export and import of less skilled labour should also be considered. The main concern is that if capital and skilled labour move predominantly in only one direction, then some areas may be adversely affected and regional imbalance would be aggravated.

There is also the idea of consolidating stock markets in Southeast Asia into a single trading platform for equity securities in the region. The aim of such a proposal is to enlarge investor base, enhance the liquidity for individual stocks, and create critical mass compared with major stock markets in the world (Freeman 2003). It is hoped that a greater integration of the financial markets would help prevent the marginalization of some of the financial markets in the region. In fact, the ASEAN stock market inter-link was established in 2005. This project, however, relates only to the stock markets in the ASEAN-5; in the CLV, stock markets are either absent

⁸ This is because commercial presence (or right of establishment) regarding foreign investment is a major mode of service provision.

or still at early stage of development⁹.

Economic union as the highest level of regional economic integration also involves fiscal harmonization and monetary integration. Fiscal harmonization may improve efficiency by eliminating non-tariff measures and market distortions. Coordination of fiscal and monetary policies, which is implied by monetary integration may result in greater cost-effectiveness through transaction costs reduction and economies of scale. Moreover, they promote macroeconomic stability and possibly income equality (El-Agraa 1999). As surveyed by Rana (2002), the benefits from monetary and financial cooperation increase with the level of trade integration.

Fiscal harmonization and monetary integration are very complicated – even more so when they interact with trade integration and factor mobility. (Even the European Union is not considered strong in fiscal harmonization.). Exchange rate policy can hardly be used for macroeconomic stabilization if the labour market is not flexible and fiscal policies still lack the necessary coordination. Moreover, member countries have to sacrifice some degree of sovereignty and monetary policy control.

Monetary and financial cooperation in East Asia could include: (i) a self-help regional financial facility; (ii) a regional monitoring and surveillance process; (iii) a better exchange rate and monetary policy coordination mechanism; and (iv) development of a regional bond market. Regarding the first area, some rather significant progresses - for example, the Chiang Mai Initiative (CMI) with the expansion of ASEAN Swap Arrangement (ASA) and the network of Bilateral Swaps and Repurchase Agreements (BSA) - have been made¹⁰. The surveillance mechanism has been developed but it is not likely to be effective soon. Another pillar yet to be developed is exchange rate and monetary policy coordination, without which incentives for mutual surveillance will be limited. This is a sensitive issues and therefore leadership is critical. But the strong underlying competition between China and Japan may be the most serious roadblock to the further development of the CMI as well as the ASEAN Plus Three process in general. Up to now, there is not yet any significant concrete measure to be implemented, but feasibility-study of a exchange rate and monetary system which could be applied in East Asia. The ASEAN+3 countries have reached a very high consensus on the necessity of developing a regional bond market. The Working Groups have considered all related problems such as underwriting, credit ratings, information exchange mechanism, settlement system, and institutional and legal infrastructure. Development of regional bond market, however, has been rather slow.

⁹ Cambodia and Laos do not yet have a stock market. Myanmar piloted a single stock market in the mid-1990s but this project was not subsequently developed (Freeman 2003). In Vietnam, the stock market was opened in July 2000, and as of May 2006 it has 35 and 11 listed companies in two trading floors in Ho Chi Minh City and Hanoi, respectively. The market is still very thin with capitalization of slightly over 3% of GDP (by the end of 2005). Recently, however, there has been a high expectation of its enormous unexploited growth potential.

¹⁰ The ASA expanded in November 2000 covers all ASEAN members with the total amount of US\$ 1 billion. The contribution of ASEAN-6 amounts to US\$ 150 million each, Vietnam US\$ 60 million, Myanmar US\$ 20 million, Cambodia US\$ 15 million, and Laos US\$ 5 million. As of December 2003, 16 BSA between individual ASEAN countries and Japan, China, and Korea, have been concluded with a total amount of US\$ 35 billion. So

In the process of monetary and financial cooperation and integration, the CLV can hardly be expected to take the lead given their very weak financial strength and position. The major task for the CLV now and in the near future is to improve the effectiveness of monetary policy and to restructure the fragile banking system.

In the CLV, the effectiveness of monetary policy is still limited due to the lack of indirect monetary instruments and/or an effective money market, and the existence of a high degree of dollarization. The central banks are still forced to create money to finance budget deficit (as in the case of Laos, Cambodia recently). In general, the banking systems are characterized by weaknesses in prudential supervision, inefficiency in financial intermediation, the dominant role of state-owned commercial banks, and heavy government intervention in bank lending. In Cambodia, public confidence in the banking system is low. Recent monetary survey has revealed that net domestic credit is largely negative and the Cambodian savings placed outside the country (about US\$ 800 million) is almost twice the amount of loans, which multilateral institutions provided to Cambodia between 1994 and 2000 (Sok Hach 2001). In Laos and Vietnam, the non-performing loans (NPLs) are still at a rather high level¹¹. Bad debts have also been associated with the inefficient SOE sector. State-owned commercial bank restructuring will be a key component of banking reforms and should be undertaken simultaneously with SOE reforms.

The CLV could also face difficulties in having a consistency between monetary policy (including interest rate policy) and exchange rate policy while liberalizing the financial sector and gradually opening the capital account in balance of payments. Therefore, the roadmap of financial liberalization followed by the CLV is very different from that of the older ASEAN members.

3. DEALING WITH CHALLENGES

Even in an integrated ASEAN, there will be a high possibility of widening development gap between the newer and older member countries. Having the appropriate responses to address the challenges and possible unfavourable effects of integration on the CLV (and Myanmar) will be critical. There are three inter-related angles in which these responses could be examined: ASEAN assistance, cooperation among the CLV (including Myanmar), and the policy pursued by each individual newer member.

Like other external assistance for the CLV, *assistance from the older members of ASEAN* has two major components. The first is the special and differential treatment (SDT) notified in ASEAN agreements, e.g. by allowing a longer period of implementation of liberalization or easier access to other members' markets. The second is technical assistance.

The idea behind the SDT is the recognition of the different capacities of adjustment and

far the CLV are not involved in any BSA (UNESCAP 2004).

¹¹ For Vietnam, NPLs as percentage of total loans declined from about 13% in 2000 to about 3% by the end of 2005. These official figures seem to be underestimated. Using international accounting standards, the ratio of NPLs could be three times higher than official figures. For Laos, with an NPL ratio of 60%, the provisioning and recapitalization of state-owned commercial banks would cost 4% of GDP (ADB 2001).

adaptation during the liberalization process. However, it is widely recognized that the SDT makes it easier for governments in developing countries to surrender to pressure-group demands for import restrictions, and as a result, encourage rent seeking activities. That is why such special treatments should be temporary and firmly implemented. In some cases, it would be better for the CLV to have easier access to the markets, which offer special treatment to goods imported from the CLV.

At the 4th ASEAN Informal Summit in Singapore in November 2000, ASEAN leaders agreed to launch the Initiative for ASEAN Integration (IAI) with the aim of narrowing the development gap within ASEAN and assist the newer members in the process of regional integration. The IAI Action Plan for 2002-08 focuses on 4 priority areas, namely infrastructure, human resource development, information and telecommunication technology, and capacity building for regional economic integration.

The areas the IAI focuses on are undoubtedly essential for the CLV (and Myanmar as well) but the problem lies in the effectiveness of the programs. The financial resources committed to the IAI programmes are relatively small compared with other Overseas Development Assistance (ODA) received by the newer members. There is also the problem of coordination between the IAI programmes. ASEAN's support for the CLV, therefore, should be incorporated with other external assistance (for example, with multinational donors' and Japan's ODA). Throughout the 1990s, Japan increased ODA to the CLV with a shift in emphasis from infrastructure building to technical assistance. Japan International Cooperation Agency (JICA) has implemented new policy assistance programs to Vietnam and Laos, and will be extended to Cambodia and Myanmar in the near future. They could be incorporated in various support activities under ASEAN and ASEAN – Japan Comprehensive Economic Partnership framework (Yamazawa 2003). It could be also possible to enlarge technical assistance to involve greater ASEAN participation. This would not only improve the integration capacity of the newer members, but also strengthen the solidarity of ASEAN.

Moreover, ASEAN's assistance for the newer members needs to cover the area of institutional building (which again needs to be incorporated with other donors' assistance). Institutions do matter for economic growth and sustainable development. Trade liberalization and integration can be viewed as institutional changes and reform. ASEAN could develop an exchange programme on building market institutions in the context of globalization and regional integration. The exchange programme can play a role in building more appropriate institutions for individual economies, especially those in transition as well as ASEAN as a whole. Moreover, this would make a positive contribution to the process of building political convergence in East Asia (perhaps the most important factor in guaranteeing the success of East Asian integration).

It would be useful for the newer ASEAN members to exchange views and share information on various issues relating to economic development and reforms. Also, forging closer business linkages in these countries needs to be encouraged.

However, there are many constraints in developing effective and efficient *cooperation among the CLV countries*. This would include limitations in both human and financial resources as well as small domestic market size. Moreover, the CLV have similar comparative advantages and their trade structure is more competitive than complementary. This would provide limited business opportunities. (Note that Vietnam has a stronger comparative advantage in manufacturing exports since it has a higher skill-land ratio.) In fact, the volume of trade between Vietnam and the other three newer members is very small and the trade value among these three members is nearly zero (Table 3).

With the vision of freeing people from poverty and providing sustainable development opportunities for all citizens in the Greater Mekong Sub-region (GMS), which includes all CLV, Myanmar, Thailand and China's Yunnan province, a development strategy has been implemented for the period of 2004-08. The strategy consists of 11 flagship programs (3 economic corridors and 8 others), focusing on four key issues: (i) connectivity and cross-border movement and tourism; (ii) integration of national markets and private sector development; (iii) human development and capacity building; and (iv) environmental and natural resource management. The potential risks associated with the strategy implementation include: resource and capacity constraints, unexpected environmental impacts, increasing hardship for woman and children as a result of illegal trafficking and of vulnerability to diseases, and the bypass of poverty reduction for some communities (ADB 2004). This shows once again that an effective cooperation within the newer members should include both other countries and international donors.

The external assistance will not be fruitful unless the *CLV continue their institutional and economic reforms* to meet the requirements for further integration into the world economy and regional markets. This is very much dependent on how the CLV can overcome the following challenges:

- *Can the CLV coordinate integration with structural reforms?* Trade liberalization and economic integration would achieve more if they are supported by reforms in the inefficient SOE sector and banking system. The key point for the CLV is to promote a fair and competitive business environment that would facilitate the development of the private sector (which is considered a dynamic force for economic development and a main source of employment). Note that the time frame for reforms is limited given China's accession to the WTO, the establishment of an ASEAN + 1 FTAs, and the need for the CLV to meet their international obligations.

The question of structural reforms in the CLV is very much dependent on how these countries can overcome the legacy of a command economy. An appropriate strategy for the CLV is to take advantage of the pressure brought about by international integration to accelerate structural reforms domestically.

- *Can the CLV build up a social consensus for further reforms and economic integration?* The short-term social costs (in terms of unemployment) due to the structural adjustment under economic integration are unavoidable. Although trade liberalization and integration

can have a considerably positive impact on employment creation (especially for lower skilled labour) and poverty reduction, it may widen the income gap in the CLV. There is also an asymmetry in incentives for different social groups, depending on whether they become “winners” or “losers” during the economic integration process. The potential benefits of trade liberalization and economic integration can be somewhat uncertain. However, interest groups that stand to lose out in such reforms are often in influential positions. Therefore, it may be difficult to find interest groups that would strongly support these reforms.

These social costs can be reduced if the appropriate policies and reforms, such as the encouragement of private sector development, reform of the labour market, delivery of training services, and the establishment of social safety nets, are adopted¹². International commitment to assist the CLV is essential for mitigating the social costs. The political will of leaders is also a decisive factor for overcoming any opposition to reforms.

- *Can the CLV overcome the institutional constraints to having a more pro-active integration strategy?* In general, the legal frameworks in the CLV are still weak to support a competitive market economy and further economic integration. Therefore, reforming economic institutions would first of all call for further improvement in the legal framework, particularly clarifying the ‘rules of the game’ in an open, market-oriented economy. This would involve a comprehensive review and amendment of the existing system of regulations pertaining to international trade and investment.

Legal requirements and commercial contracts need to be enforced effectively and this would very much depend on public administration reforms. In the context of the business sector and FDI, major concerns have been related to policy uncertainty and unpredictability, the multiplication of rules and the effective application of rules, and the administrative procedures (viz. red-tape, complicated forms and corruption). Transaction costs and business risk are still high, which in turn, induces rent-seeking behaviour that ultimately undermines the dynamic development of the business sector and the economy’s overall competitiveness.

At the same time, wider participation of the public in social, economic and political activities needs to be promoted. This is important not only for empowering the public, but also for putting pressure on improving the capacity and quality of public services. Furthermore, the effectiveness of the public’s participation not only depends on opportunities, but also on their capabilities. Raising awareness and public education is essential in ensuring that the public have a better understanding of their rights and obligations.

- *Can the CLV have a more appropriate road map for international economic integration?* At present, in the context of the “spaghetti-bowl” syndrome of recent rapid proliferation of regional/bilateral FTAs, this question is not easily answered. But the first thing that policy makers in the CLV should think about, is whether it is better to multilateralize their commitments - especially those for trade in some services sectors - within the ASEAN

¹² It is, of course, not easy to search for a low cost social safety net. Nevertheless, family and kinship ties are strong in the CLV. The state could perhaps combine some elements of the social safety net not only with private participation, but also with family and kinship support.

framework as part of a more enlarged trade block accession. For example, CLV would greatly benefit from becoming members of the WTO. Moreover, the WTO membership can reduce significantly the negative impacts of trade and investment diversions brought about by the FTAs, especially those CLV are not involved in.

Another problem is about the road map for financial liberalization and capital account opening. International experiences show that the right agenda for opening an economy to outside world follows the sequence of restructuring the domestic economy in the first place, then reform of domestic financial system, trade liberalization, and finally capital account liberalization. During this process, the improvement of macroeconomic policies (monetary policy, fiscal policy and exchange rate arrangement) is also essential for keeping economic stability and having successful financial integration.

- *Can the CLMV respond appropriately to the “China factor”?* China’s WTO accession and the establishment of an ASEAN – China FTA can have a positive impact on ASEAN and the CLV, particularly in terms of trade expansion, GDP growth, and welfare improvement. More importantly, rising competition from China has put more pressure on the CLV to accelerate structural and institutional reforms as well as the integration process.

Meanwhile, the China challenge has also raised some concern for the CLV. The first is associated with the possible negative impact on their exports in third markets and even on their domestic markets due to more intense competition from China. The second is the possibility that the CLV would become less attractive to FDI in comparison to China. Moreover, the CLV may fall into the so-called “low cost labour trap”¹³ and this will not be in their best long-term interest.

Without the domestic reforms, further economic integration will lead to the intensification of the CLV’s traditional comparative advantage (labour cost and natural resources). The CLV need also to take a broader approach to economic integration in order to enhance their attraction as a destination for FDI (This will also depend on ASEAN’s common efforts in strengthening and deepening the process of regional integration.). Last but not least, avoiding this trap will depend increasingly on the quality of human resources in the CLV, which can not be improved if these countries do not fundamentally change their education and training systems in order to meet technological and industrial needs.

4. CONCLUDING REMARKS

At present, both centrifugal and centripetal tendencies of economic integration can be observed in ASEAN. A commitment to establishing the AEC can be seen as a very positive step in deepening ASEAN economic integration in all aspects, namely strengthening ASEAN’s bargaining power in the world economy and making ASEAN a “hub” for the whole of East Asia. But, ASEAN’s weak institutions are a major obstacle to accelerate regional economic integration. There is also a tendency for some ASEAN countries to move

¹³ This means that the *only* low labour cost comparative advantages will be intensified during the integration process and therefore, the economy would become marginalized at the lower end of the supply chain of value added.

forward and escape the “status quo” through bilateral trade agreements. The risk associated with this tendency is the possibility of weakening the position of ASEAN as a group and credibility in ASEAN integration. The question is how can ASEAN have a more rule-based institutional infrastructure while maintaining some of the positive elements of the traditional “ASEAN Way”? Clearly, political will and strong leadership are essential for this change. It is also very important for ASEAN countries to effectively implement agreements that are already or will be in place. The benefits gained from this action would surely support further regional integration.

In general, ASEAN’s efforts to integrate can play an important role in promoting economic growth in the CLV (and Myanmar) and narrowing the development gap between the CLV and other ASEAN countries. This provides an opportunity for the CLV to benefit from static and especially dynamic gains, and to learn from past international experiences in socio-economic development. ASEAN can be seen as a “fitness gym”, which allows the CLV to conduct a training “work out” in preparation for the serious exercise of competing in the global economy (Freeman 2001). ASEAN integration is also a means for the CLV (and other members as well) to explore stronger relationships with external economic partners and improve their international position.

ASEAN integration - and particularly the establishment of the AEC - could pose economic challenges and possible unfavourable effects on the CLV. Given resource limitations and the weaknesses of its institutions, the CLV are concerned about being marginalised during the process of regional integration. Other concerns include the widening of the development gap between the older and newer ASEAN members, the high social costs due to structural adjustment, and the possibility of falling into a “low cost labour trap”. These challenges become amplified in the context of globalization and rapid technological development. The CLV would therefore need to accelerate the reform process, which includes institutional development, macroeconomic policy improvement, structural reforms, poverty reduction, and human resource development. And as mentioned in Leung *et al* (2005), with appropriate assistance from international and regional community, the risks of the continued integration and transition could be managed. There is, therefore, a room for optimism that CLV countries will, in time, be able to develop their own market institutions and participate fully in world economic growth and prosperity.

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CAN THE CLV EFFECTIVELY ENGAGE IN THE ASEAN INTEGRATION?

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Presentation prepared for the seminar “Accelerating Development in the Mekong Region—the Role of Economic Integration”, Siem Reap, Cambodia, June 26–27, 2006. The views expressed in this presentation are those of the author and should not be attributed to the International Monetary Fund, its Executive Board, or its Management.

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- Realization of the AEC by 2020 → A logical step of ASEAN integration, but with some concerns:
 - ✓ Modest success so far in ASEAN integration
 - ✓ Weak ASEAN institutions
 - ✓ “Development gap” between older and newer members

 - Outline of presentation:
 - ✓ Possible configurations of the AEC
 - ✓ Impacts on the CLV
 - ✓ Dealing with challenges

Note: The CLV are different in pace of reforms, integration as well as socio-economic perform → Hard to generalise any proposition/conclusion for the CLV as a whole

The possible configurations of the AEC?

- Forms of regional integration: 1. FTA; 2. Custom union; 3. Common market; 4. Economic union; and 5. Political union
- Ideas of configuration of the AEC?
 - ✓ Some building blocks are in place: AFTA, AIA, AFAS
 - ✓ “FTA plus” (McKinsey & Company 2003)
 - ✓ A “common market minus” (AEF 2003)
 - ✓ A “single market” (2003 Declaration of ASEAN Concord II)

The possible configurations of the AEC?



- Lloyd (2005): Progress in ASEAN integration is far from ASEAN single market, which can be imaged
- Hew (2005): FTA plus by 2020 → custom union by 2030
→ common market by 2050?
- The possible impacts of the AEC on the CLV need to be examined on the basis of key elements of the major integration forms



Impacts on the CLV?

➤ Benefits:

- ✓ Static and especially dynamic efficiency gains, which promote economic growth and narrow development gap
- ✓ A place for “learning by doing” and strengthening competitiveness of the CLV as locations in regional production networks
- ✓ Training works for the more serious exercise of competing in the global economy
- ✓ Opportunities to exchange and to learn the experiences in development process
- ✓ A means to explore stronger relationships with external economic partners and improve their international position



Impacts on the CLV?

➤ Challenges/unfavourable effects:

- ✓ Marginalization in the process of regional integration
- ✓ Social costs due to structural adjustment,
- ✓ Possibility of falling into “low cost labour trap”
- ✓ Widening of the development gap between the older and newer ASEAN members and within the each CLV country (eg. downward pressure on the costs of less-skilled workers, while a tendency for increasing wages in high VA services sectors)



Impacts on the CLV?

➤ Some other issues:

- ✓ The sequence of liberalization in services trade? (A reason: sunk costs of production). Cambodia's and VN's accession to WTO?
- ✓ Can the CLV as “capital importers” gain greater benefits from the ASEAN common market?
- ✓ The idea of greater mobility for skilled labour: The harmonization/MRAs of the labour skill standards? Framework for movement of less skilled labour?
- ✓ CLV's participation in the process of monetary and financial integration?



Dealing with challenges?

How the ASEAN and CLV can have right and appropriate responses?

➤ Assistance of the older members?

- ✓ S&DT should be temporary and firmly implemented.
- ✓ Technical and support activities by the IAI: Effectiveness has been not good as expected. The ASEAN's support for the CLV should be incorporated with the other external assistance
- ✓ The ASEAN's support needs to cover the area of institutional building

Dealing with challenges?

➤ Cooperation among the newer ASEAN members

- ✓ It can be useful, but with many constraints and limitations
- ✓ Focus should be on GMS. Strategy 2004-08 consists of 11 flagship programs on 4 areas. Potential risks?

Total Trade Share (%), 1998-2000 and 2001-2003

	Cambodia		Laos		Myanmar		Vietnam	
	98 - 00	01 - 03	98 - 00	01 - 03	98 - 00	01 - 03	98 - 00	01 - 03
Cambodia	-	-	0.0	0.2	0.0	0.0	1.3	0.6
Laos	0.0	0.0	-	-	0.0	0.0	0.4	0.4
Myanmar	0.0	0.0	0.0	0.0	-	-	0.0	0.0
Vietnam	10.9	5.5	2.7	12.3	0.0	0.2	-	-
ASEAN	33.9	30.1	48.0	62.3	29.8	41.2	22.2	20.2
ASEAN+3	44	42.3	72.4	71.5	59.0	66.3	51.0	51.1



Dealing with challenges?

- CLV's institutional and economic reforms:
 - ✓ Coordinating trade liberalization and economic integration with structural reforms
 - ✓ Searching for a social consensus and overcoming interest/vested groups
 - ✓ Overcoming institutional constraints to having a more proactive integration strategy
 - ✓ Searching for an appropriate road map for economic integration
 - ✓ Responding appropriately with “China economic factor”

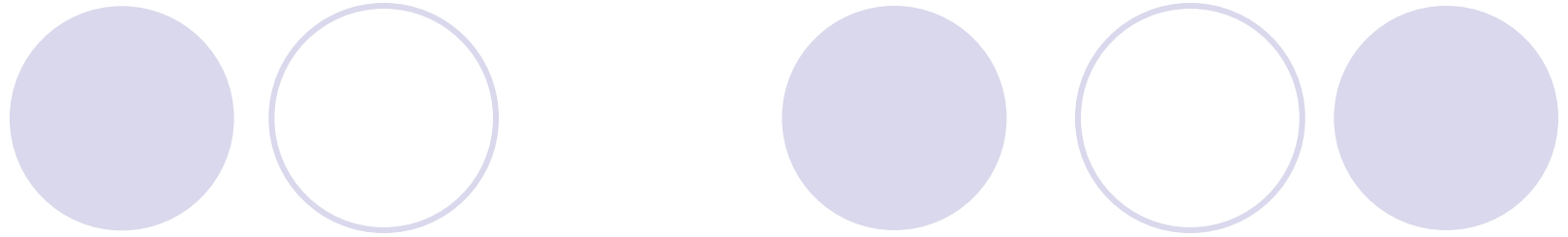


Conclusion

- ASEAN integration:
 - ✓ Centrifugal vs. centripetal tendency and credibility?
 - ✓ New regional institution (Political will and leadership?)
 - ✓ Implementation of agreements already in place?

- Effectiveness of external assistance

- Domestic reforms to overcome the following obstacles
 - ✓ A legacy of a command economy
 - ✓ Social unfavourable impacts of integration and the “benefit distribution” system in favour of vested groups
 - ✓ The “low cost labour trap”



THANK YOU!