

The Prospects for Further Economic Integration in ASEAN

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Abstract

The Association of Southeast Asian Nations (ASEAN), which celebrated its 30th anniversary in 1997, has enjoyed remarkable success as a forum for political cooperation among the states of Southeast Asia. The challenge for ASEAN now is to replicate its political success in the sphere of economic cooperation, where it has had much less success up to now. The main goal of our paper is to investigate the likelihood that ASEAN can, in fact, become an engine of greater economic integration among the countries of Southeast Asia. In particular, we explore the future prospects for AFTA, the regional free trade area.

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I. Introduction

For the past 30 years, the Association of Southeast Asian Nations (ASEAN) has successfully promoted cooperation among its member states.

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ASEAN has promoted regional peace and stability, as best exemplified by its key role in ending the Cambodian civil war in 1991, and there is an extensive amount of mutual consultation and dialogue among the leaders and officials of the member states. Peace and stability have paved the way for rapid economic growth throughout the region although the region's economies have been experiencing difficulties since the second half of 1997. According to Pangestu, Soesastro and Ahmad [1992a], Close political cooperation, discrete diplomacy, consensus-building and non-interference have been the cornerstones of the ASEAN approach. ASEAN also maintains dialogue and good relations with other countries in the Asia Pacific region and beyond. In fact, ASEAN is often held up as a model for effective regional cooperation among developing countries.

The challenge for ASEAN now is to duplicate its political success in the sphere of economic cooperation, where it has been much less successful so far. According to Wong [1992], ASEAN's achievements in the area of regional economic cooperation have been uneven and modest at best. The long-running success of the European Union (EU) and the more recent success of the North American Free Trade Area (NAFTA) suggests that regional economic cooperation may entail significant benefits. The main purpose of our paper is to investigate the likelihood that ASEAN can, in fact, become an engine of mutually beneficial economic cooperation and integration.

This paper is organized in the following order. Section II gives a general overview of ASEAN and the economies of its member countries. Section III provides a brief history of ASEAN economic cooperation. Section IV describes the theory of economic integration. Section V evaluates the prospects for further economic integration in ASEAN by applying the litmus test of the theoretical considerations considered in Section IV. We summarize our findings and conclude in Section VI.

II. Overview of ASEAN

A. ASEAN

The Association of Southeast Asian Nations (ASEAN) was formed on 8 August 1967 following the signing of the Bangkok Declaration. Its founding

members are Indonesia, Malaysia, Philippines, Singapore and Thailand. Brunei joined the grouping on 8 January 1984, followed by Vietnam on 28 July 1995. The association will not be complete without the inclusion of all Southeast Asian countries. In this connection, Myanmar (Burma) and Laos joined the grouping on 23 July 1997. Cambodia was also supposed to join ASEAN at that time - however, its membership was kept on hold following an internal political crisis. Cambodia did, however, join on 30 April 1999, meaning that ASEAN has become a truly pan-regional organization encompassing all of Southeast Asia, as was originally envisioned.

B. ASEAN Economies

1) ASEAN Diversity

The economies of ASEAN countries can be divided into two major categories. The inner core consists of the founding members – Indonesia, Malaysia, Philippines, Singapore and Thailand. The periphery comprises the newer members – Brunei, Vietnam, Laos, Cambodia and Myanmar. The inner core countries are generally richer and more developed than the periphery, with the exception of Brunei, a tiny oil-rich sultanate. Realistically, we can expect integration among the inner core first and only after the periphery has caught up, integration of ASEAN as a whole. Therefore, for the remainder of our study, we will focus almost exclusively on the inner core. We exclude the three Indochina countries as well as Myanmar due to their relative under-development, and Brunei due to its size and special economic structure as an oil-dependent economy.

ASEAN countries show a great deal of diversity in terms of size, population, level of economic development, natural resource endowment and economic structure. Tables 1 and 2 summarize this diversity. Compared to the EU, ASEAN is larger and geographically more disparate. For example, Indonesia, the Philippines and part of Malaysia are insular regions cut off from the continental portion of Southeast Asia. Altogether, the ASEAN countries have a land area of close to 4.5 million square kilometers and a population of around 500 million. The combined GNP of the region amounted to some US\$750 billion in 1996.

Singapore is a newly industrialized economy, along with Korea, Taiwan

Table 1
ASEAN Basic Indicators (1996)

Country	Size, km ² (‘000)	Population (millions)	PPP (GDP/Capita)	GNP US\$ (billions)	Nominal (GNP/Capita)	Exports (US\$ billions)
Indonesia	1,919.45	200.00	4,140	217.2	1,086	52.8
Malaysia	332.96	21.7	9,835	96.91	4,466	78.2
Philippines	300.00	71.8	3,020	90.83	1,265	23.5
Singapore	0.62	3.1	24,610	94.55	30.5	127.0
Thailand	514.00	61.4	8,165	182.36	2,970	56.9
Inner Core	3,067.03	358.0	5,128	681.85	1,905	338.4
Brunei	5.77	0.3	18,900	6.12	20,400	2.3
Cambodia	181.00	10.3	1,266	2.78	270	0.6
Laos	236.72	5.0	1,670	1.85	370	0.3
Myanmar	678.03	48.3	753	36.95	765	1.0
Vietnam	329.57	76.9	1,310	20.76	270	8.0
Periphery	1,431.09	140.8	1,166	68.46	486	12.2
ASEAN-10	4,498.12	498.8	4,010	750.31	1,504	350.6

Source: Asiaweek (19 December [1997]), The World Economic Factbook [1996]

Table 2
Sectoral Share of GDP of ASEAN Economies (1996)
(unit: %)

Country	Agriculture	Industry	Services
Indonesia	15.2 (35)	42.9 (28)	41.9 (37)
Malaysia	12.2 (n.a.)	46.9 (n.a.)	40.9 (n.a.)
Philippines	21.0 (28.2)	35.7 (33.7)	43.3 (38.1)
Singapore	0.2 (2.2)	36.9 (36.4)	62.9 (61.4)
Thailand	10.4 (30.2)	43.0 (25.7)	46.6 (44.1)
Brunei	n.a.	n.a.	n.a.
Cambodia	42.8 (n.a.)	20.0 (n.a.)	37.2 (n.a.)
Laos	53.6 (n.a.)	20.5 (n.a.)	25.9 (n.a.)
Myanmar	45.8 (49.5)	16.0 (12)	38.2 (38.5)
Vietnam	32.3 (n.a.)	28.6 (n.a.)	39.0 (n.a.)

Note: Numbers inside parentheses are figures for 1970.

Source: Asian Development Bank [1997a]

Table 3A
Inner Core: Structure of Merchandise Exports (1993)
(unit: %)

Country	Fuels, Minerals and Metals	Other Primary Products	Machinery & Transport Equipment	Other Manufactures Clothing	Textile fibers, Textiles and
Indonesia	32 (76)	15 (22)	5 (1)	48 (2)	17 (1)
Malaysia	14 (35)	21 (46)	41 (12)	24 (8)	6 (3)
Philippines	7 (21)	17 (42)	19 (2)	58 (35)	9 (7)
Singapore	14 (31)	6 (18)	55 (27)	25 (24)	4 (4)
Thailand	2 (14)	26 (58)	28 (6)	45 (22)	15 (10)

Note: Numbers inside parentheses are figures for 1980.

Source: World Bank [1997b]

Table 3B
Inner Core: Structure of Merchandise Imports (1993)
(unit: %)

Country	Food	Fuels	Other Primary Products	Machinery & Transport Equipment	Other Manufacture
Indonesia	7 (13)	8 (16)	9 (6)	42 (34)	34 (32)
Malaysia	7 (12)	4 (15)	4 (6)	54 (39)	30 (28)
Philippines	8 (8)	12(28)	5 (5)	32 (24)	43 (35)
Singapore	6 (9)	11(29)	3 (7)	49 (29)	31 (26)
Thailand	5 (5)	8 (30)	7 (7)	45 (25)	36 (32)

Note: Numbers inside parentheses are figures for 1980.

Source: World Bank [1997b]

and Hong Kong. Malaysia and Thailand have experienced buoyant rapid in the past two decades and are following the early growth pattern of the four NIEs. The Philippines, long the laggard among the inner core, has recently rebounded under the administration of President Ramos. Indonesia has recorded sustained growth largely on the strength of labor-intensive export industries. The three Indochina states of Cambodia, Laos and Vietnam are the economic lightweights of the association, along with Myanmar. The World Bank [1997a] classifies Singapore as high income, Malaysia as upper

Table 3C
Inner Core: Composition of Manufactures Exports, 1994
(unit: percent)

Country	Textiles and Other Labor-intensive Items	Electronics, Machinery and Other Human Capital- intensive Items	Other Manufactures
Indonesia	58.01	38.4	3.56
Malaysia	11.76	84.56	3.68
Philippines	18.73	32.17	49.10
Singapore	5.91	88.06	6.03
Thailand	34.54	60.24	5.22

Source: Asian Development Bank [1997b]

middle income, Indonesia, Thailand and the Philippines as lower middle income, and all the periphery countries other than Brunei as low income. Currently, the entire region is suffering from the effects of a currency crisis that began with the forced devaluation of the Thai baht in July 1997.

2) Trade Patterns

All inner core countries experienced sharp growth in manufactured exports in the past two decades as their economies shifted from agriculture to manufacturing and from import substitution to export promotion. Table 3A shows that manufactured products form the largest share of the exports of the inner core countries and their importance has been steadily increasing over the years. Table 3B shows that manufactures make up the bulk of the inner core's imports. Machinery, transport equipment and other sophisticated manufactures dominate the imports of the inner core. The imports are usually capital-intensive, skill-intensive and technology-intensive. These are mostly capital goods and immediate goods used as inputs in the industrial expansion and infrastructure development of the region.

In terms of the specific composition of their manufactured exports, however, the inner core economies are quite diverse. Singapore exports mainly high quality manufactures and services. These are capital- and skill-oriented products such as semiconductors, microchips, computer software and elec-

Table 4
Share of Intra-ASEAN Trade in Total Trade (1993 - 95)
(unit: US\$ millions)

	1993	1994	1995
Intra-ASEAN	80,855.99	104,118.64	122,565.17
Total	428,666.91	514,006.33	620,202.16
Share of Intra-ASEAN	18.86%	20.26%	19.76%

Source: ASEAN Secretariat [1996]

Table 5
Share of Exports to ASEAN in Total Exports and
Share of Imports from ASEAN in Total Imports (1995)

Country	ASEAN's Share of Total Exports (%)	ASEAN's Share of Total Imports (%)
Indonesia	10.9	8.8
Malaysia	26.3	17.1
Philippines	12.8	10.4
Singapore	28.1	23.7
Thailand	18.9	12.2

Source: IMF [1997]

Table 6
Country Share of Intra-ASEAN Trade (1994)

Country	Share of Exports (%)	Share of Imports (%)
Indonesia	10.2	5.8
Malaysia	26.2	21.2
Philippines	2.3	3.4
Singapore	54.7	61.8
Thailand	6.7	7.8

Source: ASEAN Secretariat [1995]

tronic equipment. Malaysia and Thailand specialize in electrical components, footwear and textiles. Textiles, footwear and toys dominate Indonesia's exports although electronic goods are growing in importance. The Philippines continues to depend on textiles and other low-end manufacturing exports. Table 3C shows that Singapore is furthest up the technological ladder, followed by Malaysia and Thailand in the middle and Indonesia and the Philippines at the bottom.

Trade among the inner core countries remains limited at most, as we can see from Table 4 and 5. Intra-ASEAN trade averaged 19.6% of total ASEAN trade during 1993-1995. Table 6 shows that Singapore accounts for over half of both intra-ASEAN exports and imports. According to Tan [1996], excluding Singapore reduces intra-ASEAN trade to less than 5 percent of ASEAN's total trade. Singapore's dominance of intra-ASEAN is largely due to its entrepot role in the region. According to the Department of Statistics Singapore [1996], re-exports of imported goods accounted for 38% of Singapore's total exports. Since entrepot trade involving Singapore reflects the use of Singapore's port by its ASEAN neighbors for transit purposes rather than international trade in a more meaningful sense, we can infer that intra-ASEAN trade is still relatively small.

The low intra-ASEAN trade suggests that the ASEAN economies are more mutually competitive than complementary. This is because the ASEAN countries, with the exception of Singapore, export broadly similar products (labor-intensive manufactures) to similar extra-regional markets and import broadly similar products (capital-intensive manufactures) from similar extra-regional sources. The main export markets and import sources of all the inner core countries are the US, Japan, the EU and NICs other than Singapore - Korea, Taiwan and Hong Kong. In 1993, according to the ASEAN Secretariat [1997a], the four markets jointly accounted for 70%, 58%, 81%, 56% and 65% of the exports of Indonesia, Malaysia, Philippines, Singapore and Thailand, respectively, and 67%, 67%, 68%, 60% and 67% of their respective imports.

3) Capital Flows

Foreign direct investment (FDI) has been crucial to the dynamic growth of Southeast Asia. The FDI has played a major role in the success of export

promotion policies, especially in the manufacturing sector. Foreign affiliated companies have been a major driving force behind the rapid growth of export manufactures in ASEAN countries. FDI inflows into ASEAN grew rapidly during the 1980s and 1990s. In 1995, according to the World Investment Report [1997], the region as a whole received around US\$19 billion of FDI - US\$6.9 billion in Singapore, US\$4.3 billion in Indonesia, US\$4.1 billion in Malaysia, US\$2.0 billion in Thailand and US\$1.5 billion in the Philippines. The biggest sources of FDI are the United States, Western Europe and Japan. The appreciation of the yen and rising wage costs in Japan has accelerated capital inflows from Japan since the early 1980s.

Singapore and Malaysia are the only major overseas investor in the region. The other three countries have also made some direct investments abroad recently. In 1995, again according to the World Investment Report [1997], the FDI outflow of Singapore and Malaysia approached US\$4 billion US\$2.6 billion respectively while that of Thailand, Indonesia and the Philippines amounted to US\$900 million, US\$600 million and US\$400 million respectively. ASEAN as a whole runs a current account deficit vis-a-vis the rest of the world and depends heavily on external financing. All inner core countries except Singapore are debtors rather than creditors. In 1996, according to the Asian Development Bank [1997], Singapore recorded a current account surplus of US\$14.2 billion while the rest had deficits of varying magnitudes - US\$8.9 billion in Indonesia, US\$5.9 billion in Malaysia, US\$3.5 billion in the Philippines and US\$14.5 billion in Thailand. All of this implies that there is only limited scope for intra-regional investment to act as an engine of economic integration.

III. A Brief History of ASEAN Economic Cooperation

A. An Overview

Although ASEAN was formed in 1967, progress in economic cooperation has been halting and slow. Bloomquist [1993] notes that as early as the late 1960s, a number of studies, most notably United Nations-sponsored investigation - the Robinson Report - called for regional import substitution and recommended limited trade liberalization along with coordinated industrializa-

tion policies. As Naya and Imada [1992] point out, there have been three major phases of ASEAN economic cooperation. In the first phase [1967-1976], member countries tried to become familiar with each other and lay the general foundations for future cooperation. In the second phase [1976-1992], there was some cooperation and formal agreements among the member states, focusing mostly on building specific institutions for cooperation. The third stage [1992-2003], which involves significantly more active economic cooperation than the first two phases, aims to establish a free trade area among the ASEAN economies.

The ASEAN economies have attempted cooperation in a wide range of economic fields, including agriculture, banking and finance, tourism, transportation, human resources development, energy and environmental activities. Furthermore, as Goyer [1996] points out, those economies have engaged in a number of initiatives to promote regional industrial coordination with the ultimate aim of achieving greater economies of scale and specialization in industrial production. One of those initiatives involved allocating large-scale government projects among different member states while another one sought to allocate different stages of production in an industry to different member states. Yet another scheme was aimed at promoting intra-ASEAN investment by the private sector. Most of these efforts at cooperation in economic areas other than trade have failed to produce substantial benefits. Efforts to foster integration through trade have also been unsuccessful, as we shall now see. The ASEAN Secretariat [1992, 1997b] and Tan [1996] provide comprehensive overviews of economic cooperation and integration within ASEAN.

B. Preferential Trading Arrangements (PTA)

ASEAN foreign ministers signed the agreement on Preferential Trading Arrangements (PTAs), which became the main mechanism for fostering trade among ASEAN countries during the second stage [1976-1992], in 1977. They represented the first joint commitment by ASEAN countries toward trade liberalization. More specifically, the objective of the PTAs was to encourage greater intra-regional trade through the use of long-term quantity contracts, preferential terms for financing imports, preferential treatment of

imports by government agencies, preferential tariff rates, and the liberalization of non-tariff barriers to trade. The main instrument for trade promotion has been the granting of tariff preferences for products to ASEAN member countries. Only the nominating country grants the preferential tariffs and there is no reciprocity. Although the preferences were initially given on a product-by-product basis, by 1980 all ASEAN countries joined in across-the-board tariff cuts.

The results of the PTAs were disappointing. Those agreements did not have a perceptible positive effect on the growth of intra-ASEAN trade. Tan [1992] offers several explanations for their ineffectiveness. The tariff cuts offered were relatively small, the coverage of the PTAs was limited in terms of product groups, and the estimated price elasticities of the product groups that were covered tended to be low. Moreover, many of the items included were not traded at all or imported from outside the region. The initial product-by-product selection of items for inclusion in the tariff reduction list did not help the credibility or efficiency of the liberalization scheme.

According to Tan, however, the fundamental impediment to increasing intra-ASEAN trade through preferential tariffs was that the economic structures of the ASEAN countries are competitive rather than complementary. Another possible obstacle was that all the ASEAN economies, with the exception of the Philippines, were enjoying high growth since the mid-1960s, thus greatly diminishing the urgency of the task. Nasution [1993] notes that the remarkable growth and development of the ASEAN economies arose almost entirely out of independent efforts rather than coordination. The perceived ineffectiveness of PTAs led the member states to seek alternative means of promoting growth in intra-regional trade.

C. ASEAN Free Trade Area (AFTA)

As we have just seen, up to 1992, ASEAN's achievements in the important area of regional economic cooperation have been limited at best. In particular, ASEAN's trade liberalization program has failed to restructure the trade patterns of the member countries so as to give them a more regional focus. While it is accurate to view the establishment of AFTA in the first instance as a concerted response to the collective disillusionment with the pace of

progress under the PTAs, there were also other factors at work. Most significantly, ASEAN countries felt that changes in the global economic environment in the early 1990s called for more serious efforts at economic integration. The formation of NAFTA and the European Union raised questions over the access of ASEAN exporters to major markets in the U.S. and Europe. Another source of uncertainty at that time was the collapse of the Uruguay Round negotiations on the global trading regime.

At the same time, the ASEAN economies themselves were undergoing profound changes. All of them had abandoned import substitution in favor of export promotion as the preferred mode of industrialization and economic development. This shift toward more open and outward-looking economies meant they were now keener than ever on reducing their tariffs and improving their international competitiveness. Chia [1994] notes that the heavy inflows of foreign direct investment (FDI) into the export-oriented manufacturing sectors of ASEAN has rendered the region's economies more complementary and integrated. Accelerated industrialization, development and growth throughout the region have thus created a more suitable environment for integration. Increasingly fierce global competition for FDI also pushed the ASEAN countries toward a free trade area since such an area could provide a strong incentive for foreign investors by creating a larger market.

AFTA was formally launched at the 4th ASEAN Summit held in Singapore during January 1992. The Common Effective Preferential Tariff (CEPT) has been chosen as the mechanism for achieving AFTA. The basic idea behind the CEPT is that ASEAN countries shall be given uniform preferential treatment in intra-ASEAN trade. Pangestu, Soesastro and Ahmad [1992b] note that the CEPT is much more encompassing than the PTAs because it is based on reciprocity. It will apply to all products from ASEAN member countries by January 1, 2000. A product is defined as originating from ASEAN if it has at least 40 per cent ASEAN content.

The timetable for tariff reductions consists of a fast track and a normal track. The fast track covers selected product groups such as cement, pharmaceuticals, fertilizers, plastics, rubber products, leather products, pulp, textiles, ceramic and glass products, gems and jewelry, copper cathodes, electronics and wooden and rattan furniture. The tariffs for all the items in the

fast track category are scheduled to fall to zero to five percent by 1 January 2000. All the other product groups fall under the normal track category, and the tariffs for this category are set to fall to between zero and five percent by 1 January 2003. The ultimate goal of the CEPT is, of course, to completely eliminate tariffs from all intra-ASEAN trade.

While the primary thrust of AFTA is to reduce and harmonize tariffs, it also seeks to address non-tariff barriers (NTBs) to trade and other trade-related issues such as customs. In fact, a stated goal of the CEPT is to eventually do away with all NTBs, which includes anti-dumping penalties and quantitative restrictions such as quotas and voluntary export restraints. The major NTBs of the ASEAN countries are customs surcharges, technical measures and product characteristic requirements, and monopolistic measures. The 1995 ASEAN Agreement on Customs represents another step forward insofar as they help to harmonize customs valuation systems and customs procedures within the region, and thus help to reduce administrative obstacles to greater intra-regional trade.

There is some evidence that AFTA is showing promise and potential as an

Table 7
Share of CEPT Exports in Intra-ASEAN Exports
(US\$ millions)

	1993	1994	1995
CEPT	34,064 (79.6)	47,423 (82.5)	56,280 (81.8)
Non-CEPT	8,707 (20.4)	10,049 (17.5)	12,553 (18.2)
Total	42,771 100.0	57,472 100.0	68,833 100.0

Note: Numbers in the parentheses are shares of total(%).

Source: ASEAN Secretariat [1996]

engine of regional economic integration. Quite tellingly, although the initial target date for achieving the free trade area was January 1, 2008, this has been brought forward to January 1, 2003 in September 1994, reflecting the seriousness and commitment of the ASEAN governments. As we noted earlier, the total volume of intra-ASEAN trade rose from US\$81 billion in 1993 to US\$123 billion in 1995. In relative terms, the share of intra-ASEAN trade in ASEAN's total trade also rose during the same period, from 18.9% to 19.8%.

Furthermore, as Table 7 shows, the export volume of CEPT products rose from US\$34 billion to US\$56 billion in 1995. Over the same period, the share of CEPT exports in total intra-ASEAN exports also rose from 79.6% to 81.8%. Despite these encouraging early signs, we should note that the scope of intra-ASEAN trade and, more generally, intra-ASEAN economic integration remains fairly limited. This is all the more so if we take into account the fact that a significant part of the intra-regional trade reflects Singapore's role as an entrepot center rather than true international trade.

IV. Theory of Economic Integration

In this chapter, we define the concept of economic integration and look at different degrees of economic integration. We then examine the theories of customs union, free trade area and common market. Such an overview of the theory of economic integration is required to better understand next chapter's discussion about the prospects for further economic integration in ASEAN.

A. Definition of Economic Integration

Viner [1950] pioneered the theory of customs union, the forerunner of the theory of economic integration. Regional economic integration is a process whereby various economies of a region undergo a progressive removal of the barriers to free movement of goods, services, capital and labor. Reduction or removal of tariffs and non-tariff barriers among the economies of a region will obviously promote economic integration within the region by facilitating the flow of goods. Likewise, reduction or removal of restrictions and controls on the international flows of services, capital and labor reinforces regional economic integration. In the EU, the Single European Act (SEA) of 1986 established, at least in principle, completely free movement of goods, services, capital and labor in Western Europe. EU is at the most advanced stage of international integration. Robson [1998], Jovanovic [1998a, 1998b, 1992], El-Agraa [1997], Molle [1997] and Lang and Ohr [1995] provide overviews of the theory of economic integration.

B. Types of Economic Integration

There are different types or stages of economic integration. Countries usually start off at a lower level of integration and move on to higher levels of integration if and when conditions become more appropriate. Broadly speaking, there are six types of economic integration:

- **Preferential trade agreement (PTA)** is the most basic form of economic integration. It imposes lower tariffs on imports from member countries than third countries. We have already seen that ASEAN has experimented with PTAs.
- **Free trade area** is an agreement among countries whereby tariffs and non-tariffs barriers (NTBs) such as quotas, licensing and product safety regulations are abolished among members. However, each member retains its external tariffs and other regulations for trade with non-member countries. AFTA is essentially a free trade area in progress.
- In a **customs union**, member states abolish all tariffs and quantitative restrictions on trade among member states. At the same time, they impose a common set of tariffs for trade with non-member states.
- A **common market** involves a customs union as well as free movement of factors of production such as capital and labor. The European Union (EU) has been a common market since the Maastricht Treaty of 1992.
- In an **economic union** among countries, in addition to a common market, there is a high degree of coordination of the most important areas of economic policy, market regulation as well as macro-economic and monetary policies and income redistribution policies.
- A **monetary union**, in addition to a common market, creates either irrevocably fixed exchange rates, or one common currency circulating in all the partner countries. Such a union implies a high degree of integration of macro-economic and budget policies.
- The highest degree of economic integration is a **supranational union**. Member governments hand over their sovereignty for economic and social policies to a supranational government. A supranational union is unlikely since nations are generally reluctant to surrender their sovereignty.

In the context of ASEAN, economic integration realistically means the expansion of intra-regional trade. The ultimate aim of economic integration is to create a larger market in goods and services for the benefit of all participating states. At this stage, however, economic integration in ASEAN is still only in its infancy and the realistic next step forward is toward the consolidation of AFTA, which would remove most impediments on trade among member states and thus help expand intra-regional trade. In other words, before more advanced stages can be even contemplated, ASEAN should concentrate on facilitating the flow of goods and services among its members.

C. Theory of Customs Union

The salient features of a customs union are (1) elimination of tariffs and other restrictions on imports from member states and (2) adoption of a common external tariff on imports from the rest of the world. In general, the establishment of a customs union will change the relative prices of goods in the member countries. The theory of customs unions examines these effects and their implications for resource allocation and for the welfare of member countries.

1) Customs Union and Resource Allocation

If the initial tariff rates of prospective member countries differ for at least some products, then a customs union will have effects on the allocation of resources. What gives rise to those effects on resource allocation is the harmonization of tariffs and the consequent change in relative prices. The theory of customs union usually looks at the effects of a customs union on resource allocation in terms of two effects - trade creation and trade diversion. The specific definitions of the two effects we give below are those of Johnson [1962]. They are more comprehensive than those of Viner [1950], Meade [1955, 1968] and Lipsey [1960]. Furthermore, Viner [1965] himself endorsed Johnson's definitions in a letter to W. M. Corden.

Trade creation refers to a shift in consumption away from high cost domestic products to low cost products of a partner country. This shift has two components - first, the reduction of the domestic production of goods

that are identical with those produced overseas and second, increased consumption of partner-country substitutes for domestic goods that formerly satisfied the need at higher cost. The first gives to the production effect – the saving in the real cost of goods formerly produced domestically – and the second gives rise to the consumption effect – the increase in consumer surplus from the substitution of lower-cost goods for higher-cost goods. The two effects jointly constitute the trade creation effect of a custom union.

Trade diversion, on the other hand, refers to the replacement of low cost imports from countries outside the customs union by higher cost imports from partner countries. This shift has two components – first, an increase in the cost of the goods formerly imported from overseas due to the shift from cheaper external sources to partner countries and second, the loss of consumer surplus owing to the substitution of higher-cost partner goods for lower-cost external goods. The trade diversion effect of a customs union comprises both of these effects.

Whether or not a customs union will produce net welfare gains depends on the relative magnitudes of trade creation and trade diversion. Economists view a union that is on balance trade-creating as beneficial to welfare whereas they view a union that is on balance trade-diverting as detrimental. The magnitudes of trade creation and trade diversion depend not only on the changes in trade volumes but also on the changes in prices and costs due to the customs union.

2) Static Conditions for a Trade-Creating Customs Union

We have just seen that a customs union is beneficial to welfare if trade creation exceeds trade diversion. We now proceed to discuss the conditions under which a customs union will be predominantly trade-creating rather than trade-diverting. Those conditions are static because trade creation and trade diversion are static effects arising from reallocation of resources. A knowledge of such conditions is obviously useful since the extent to which a group of countries satisfies them would tell us whether forming a customs union is worthwhile or not. We perform this exercise for the ASEAN countries in the next chapter. Viner [1950], Meade [1953, 1955], Tinbergen [1959] and Balassa [1961] pioneered the following list of conditions, which has become fairly standard.

- **Size of the market:** The larger the size of the customs union and hence the larger its share in total world trade, the better the prospects for specialization and the smaller the risk of trade diversion.
- **Level of tariffs:** The pre-union structure of tariffs plays a central role in determining the changes in relative prices that, in turn, determine trade creation and trade diversion. The higher the pre-union level of tariffs among members, the greater the associated inefficiencies and hence the greater the welfare gains from eliminating tariffs. The lower and the less disparate the pre-union level of tariffs against non-members, the smaller the change in relative prices between imports from members and non-members and thus the smaller the risk of trade diversion.
- **Pre-union level of intra-trade:** The greater the pre-union volume of trade and number of traded products among member countries, the better the prospects for specialization and division of labor.
- **Level of economic development:** The more similar the level of economic development among member countries, the greater the pre-union volume of trade and hence the better the prospects for specialization. In particular, product differentiation and economies of scale give rise to intra-industry trade, which is larger for similar countries.
- **Transportation infrastructure and geography:** The lower the transportation costs, the easier it is to physically realize the increased trade due to a customs union. The closer the member countries are geographically, the lower the transportation costs.
- **Substitutability between products of member states non-member states:** The less substitutable the products of the two groups, the smaller the likelihood of substituting more expensive imports from partner countries for less expensive imports from external countries and hence the smaller the risk of trade diversion.
- **Pre-customs union share of extra-union trade in total trade:** The smaller the share of extra-union trade, the smaller the risk of trade diversion. Also, the smaller the share of extra-union trade, the larger the share of intra-union trade and hence the better the prospects for trade creation.
- **Economic structures of the member states:** The more competitive the economic structures of the members in the sense that the range of products produced by the high-cost industries in the different member countries

are similar, the larger will be the possibilities of resource reallocation and specialization. The more complementary the economic structures, the smaller the reallocation possibilities.

3) Dynamic Effects

Up to now, we have discussed the impact of a customs union on the allocation of resources on the basis of comparative static analysis. Now we broaden the framework to discuss some dynamic effects of a customs union that evolve over time. These effects arise because economic agents do not sit back but react and adapt to the new structure of production and the economy associated with the establishment of a customs union. For example, firms facing increased competition from producers in partner countries will try to lower their costs in order to survive but lowering costs will take time.

In fact, as Baldwin [1993] and Jovanovic [1992] point out, such dynamic welfare gains are likely to be far greater than the static welfare gains and hence provide a more compelling rationale for customs union. Molle [1997] illustrates a case where the former exceeds the latter many times over. Furthermore, most empirical estimates of the static gains from economic integration reveal these to be disappointingly small. The highest estimates are around up to 1% of GNP, in the case of UK's membership in the Common Market (see Brada and Mendez [1988]). Dell [1959], Balassa [1961], Thorbecke [1963], Kreinin [1964] and Corden [1970] were among the first to formally discuss the dynamic effects of a customs union. These include the following.

- Greater competition and improvement in X-efficiency
- Gains from economies of scale and learning-by-doing
- Higher levels of investment and capital formation
- Greater research & development and more rapid technological progress
- Reduction of intra-regional transactions costs
- Some protection from adverse developments in the world markets
- Greater bargaining power vis-a-vis industrialized countries

Of particular importance among the dynamic welfare gains of customs unions is the increase in X-efficiency (see Liebenstein [1966]) or technical efficiency as opposed to the allocative efficiency emphasized in static analysis. Improvements in X-efficiency are brought about by greater competition

and enable firms to produce more with the same amount of inputs. These improvements may be due to greater R & D, adoption of new technology and better management practice. Pelkmans [1984] was among the first to formally incorporate X-efficiency effects into the analysis of customs unions. Such improvements are evolutionary in the sense that they are not one-shot but rather evolve over time as the economic structure evolves and adapts to the new competitive environment. Learning-by-doing means that firms learn to produce more efficiently by the actual production of greater numbers. Learning-by-doing further increases X-efficiency and hence the dynamic welfare gains of customs unions.

Against the potential dynamic benefits, we must weigh the dynamic cost of polarization. Integration among countries with different level of income and economic development could lead to an unequal distribution of gains (see, for example, El-Agraa [1989] and Krugman and Venables [1990]). The more developed and advanced nations tend to gain more than the less developed nations, and this may breed tension and resentment among the latter. More generally, setting aside differences in levels of income and development, any perception that the benefits or costs of integration are disproportionately falling upon a country or a subset of countries is likely to produce a backlash which will threaten the viability of the union over time. Furthermore, the restructuring of production and reallocation of resources often entails significant adjustment costs in the short run and we must also consider these against the above long-term dynamic gains.

4) Non-Economic Factors

Besides the largely economic criteria discussed in previous sections, there are a large number of non-economic factors which determines the success or failure of economic integration. According to Bulmer and Scott [1994] and Devan [1987], the experience of EU highlights the central role of such non-economic variables in economic integration. Some examples are a common desire to put an end to violent conflicts, a shared feeling of vulnerability, a shared goal of achieving power equity between countries in a particular region, and political leaders who realize that there are common problems which require common solutions.

By far the most important non-economic variable is political leadership

seriously committed to economic cooperation and integration. That is, the success of integration requires a strong dose of political will in the member states. As is well known, Franco-German political cooperation and a widespread desire among all European governments to avoid another major war has been the driving engine of economic integration in Europe. It is doubtful whether the present success of the EU and, to a lesser extent NAFTA, would have been possible without strong political leadership and commitment within the governments involved.

D. Theory of Free Trade Areas

Recall that customs unions and free trade areas share the common central characteristic of elimination of tariffs and other restrictions on trade between member countries. We can thus extend the basic theoretical framework used to analyze customs unions to analyze free trade areas as well. That is, much of the theoretical analysis above remains valid for both free trade areas and customs unions due to the essential similarity between the two types of integration.

Therefore, we simply point out that there are some differences between the theoretical effects of free trade areas and customs unions on allocation of resources and welfare. Those differences follow from the following two basic features that distinguish a free trade area from a customs union. First, member countries retain the power to fix their own tariffs on imports from the rest of the world and second, a free trade area is equipped with rules of origin, designed to limit intra-area free trade to products mainly produced in the area. The purpose of rules of origin is to prevent trade deflection, or the redirection of imports through the country with the lowest tariff for the purpose of exploiting the tariff differential.

As an example of the differences between customs unions and free trade areas, a free trade is probably more beneficial to a country which is highly specialized than a customs union. The reason is that such a country is more likely to have a large number of zero duty items that are likely to be replaced by higher duties if it joins a customs union, resulting in a significant welfare loss to consumers. At the same time, the country's specialized industries are probably export industries that do not require any protection from common external duties.

On a more general note, it is impossible to make generalizations about whether free trade areas more beneficial than customs unions or vice versa because this depends on a large number of variables and parameters. Balassa [1961], Johnson [1962] and Snider [1963] were among the first to theoretically compare free trade areas and customs unions, and Shibata [1967] was instrumental in refining the comparison more rigorously. Robson [1998] and El-Agraa [1997] provide comprehensive overviews of the differences and similarities between the two forms of integration.

E. Theory of Common Markets

A common market involves a customs union as well as freedom of movement of factors of production within the area. The central difference between common markets and both customs

unions and free trade areas lies in the mobility of capital and labor among the member countries. Meade [1953] pioneered the theoretical analysis of common markets. Comprehensive overviews of common market theory include Molle [1997] and Lang and Ohr [1995]. As noted earlier, at this stage ASEAN is a long way from forming a common market so we limit our discussion of the theory of common markets to some of its features.

From a static viewpoint, the gains to welfare due to a move from a customs union to a common market are largely allocational gains. If significant differences in the marginal productivity of different factors of production persist within a customs union, a reallocation of factors that further reduces those differences can increase income and welfare of the participating countries. The migration of factors from countries where such productivities are low to countries where such productivities are high will be beneficial.

If, as stated in standard international trade theory, trade is a perfect substitute for factor movements, then there would be no advantages in moving from a customs union to a common market. However, the conditions required in order for trade alone to equalize factor marginal productivities among countries are extremely restrictive and furthermore, it is generally accepted that there is only extremely limited empirical evidence in support of the factor-price equalization theorem.

There are also some modifications required to the orthodox criteria for evaluating the welfare effects of a customs union once we assume international mobility of factors and thus a movement towards a common market. For example, consider the presence of foreign firms and foreign direct investment. If foreign firms earn net economic rents from their exclusive assets, a consideration of the gains and losses of integration cannot be limited to the orthodox trade creation and trade diversion effects. To illustrate, if the price of an importable good produced by a foreign firm falls after integration as a result of trade creation, the host country will gain from the reduction in the foreign firm's rents (see Tironi [1982]).

V. Prospects of Further Economic Integration in ASEAN

In this section, we ask ourselves the following central question: "Do the theoretical considerations discussed above favor further economic integra-

tion of ASEAN?" Broadly speaking, to repeat, economic integration in ASEAN at this stage realistically means more trade among its members. As a practical matter, integration for ASEAN means integration among the inner core first and after the periphery has reached a certain level of development, integration of ASEAN as a whole. A single market like the EU remains a distant vision and the next practical step for ASEAN is to promote greater intra-regional flows of goods and services. That is, a move towards an effective free trade area represents the next step forward for ASEAN under the present circumstances.

A. Static Conditions

Here we look at the various static conditions that impinge upon ASEAN's ability to transform itself into a mechanism for active economic integration among the states of Southeast Asia. We have earlier examined each of these in Section IV.C.2).

1) Size of Union

The larger the size of the customs union, the more likely it is that its members will realize significant gains from intra-union specialization and division of labor due to the reallocation of resources resulting from the changes in relative prices. While ASEAN is small compared to NAFTA and EU in terms of collective economic power, it seems to be large enough for an effective customs union. As noted earlier, ASEAN includes 10 countries and almost 500 million people, with a combined GDP of US\$750 billion in 1996. Even the inner core alone appears to be large enough for a viable customs union. Although there are no objective criteria as to the optimal number of countries or the size of the market, ASEAN appears to pass the test.

2) Initial Tariff Structure

The initial structure of tariffs in the member countries plays a key role in determining the effects of the customs union on relative prices and thus allocation of resources. First, the higher the initial intra-regional tariffs, the greater the change in intra-union relative prices and hence the larger the potential for trade creation. Despite the recent progress of AFTA, intra-

ASEAN tariffs remain high enough to create significant opportunities for trade creation. Table 8, which shows the average tariff rates for imports of CEPT products, bears this out. Second, the higher the level and variance of tariffs against non-members, the greater the change in relative prices between intra-union products and extra-union products and hence the larger the possibility of trade diversion.

According to Imada, Montes and Naya [1991], with the exception of Singapore, the average tariffs in ASEAN tend to be higher than in the developed countries but lower than in most developing countries. Kumar [1992] points out that there is a wide variance in the tariffs of ASEAN countries among different product groups. Table 9 confirms that the structure of external tariffs

Table 8
Inner Core: Average CEPT Tariff Rates (1996)

Country	Average Tariff Rate (%)
Indonesia	11.6
Malaysia	5.9
Philippines	9.2
Singapore	0.0
Thailand	14.1

Source: ASEAN Secretariat [1995]

Table 9
Inner Core: Overall Tariff Average and Standard Deviations (1993)

Country	Average Tariff Rate (%)	Standard Deviation (% point)
Indonesia	20.0	11.0
Malaysia	11.0	9.0
Philippines	30.0	10.0
Singapore	0.5	3.0
Thailand	40.0	26.0

Source: Pacific Economic Cooperation Council [1995]

in ASEAN does not rule out significant trade diversion. It is thus unclear whether ASEAN's initial tariff structure will promote more trade creation than trade diversion.

3) Pre-Union Intra-Regional Trade

The larger the pre-union volume of trade and the number of traded products among member countries, the more relevant will be the changes in relative prices among the products of member countries and hence the larger will be the scope for trade creation. The change in relative prices will matter little if the product is not traded at all or only in small quantities. Countries that trade heavily with each other stand to gain the most from the elimination of impediments to trade. As we saw earlier, intra-ASEAN trade has been disappointing at best. Most of the intra-ASEAN trade that does take place is bilateral entrepot trade between Singapore and the other countries in the region rather than intra-regional trade in a deeper sense of the term.

4) Substitutability Between Intra-Union and Extra-Union Products

The smaller the substitutability between products of member states for those of non-member states, the less the chances of trade diversion. Trade diversion arises out of the change in relative prices between intra-union products and extra-union products. By lowering the price of intra-union products relative to extra-union products, a customs union creates incentives for member countries to substitute intra-union products for extra-union products. The extent to which such substitution is possible depends, of course, on substitutability. ASEAN countries import broadly similar goods, primarily capital goods and high-tech goods, from primarily extra-regional sources and these goods tend to be produced, if at all, in only limited quantities within ASEAN. Such stylized evidence points to limited substitutability and hence limited trade diversion.

5) Disparity in Pre-Integration Level of Development

If the pre-integration levels of development and income are similar among members, the gain from integration will be larger and integration will also be easier. In particular, intra-industry trade is likely to be an important component of trade. Specialization and division of labor can occur within an indus-

try under product differentiation and economies of scale. The best example of the prevalence of intra-industry trade within a customs union is the European Union. As we saw earlier, ASEAN is far from being a homogeneous grouping. The range of economic development ranges from Singapore - a mature and developed economy - to Vietnam, Laos, Cambodia and Myanmar, which are all among the world's poorest economies. Even for the inner core, there are wide disparities in income and economic structures.

6) Transportation Infrastructure and Geographical Proximity

High transportation costs are as much of a barrier to trade as protectionist restrictions. The scope for greater intra-union trade due to the removal of such restrictions within a customs union will be more limited if the intra-union transportation structure is poor. Although the ASEAN countries are close to each other geographically, the transport network connecting them is under-developed at present. Even the internal transportation infrastructure is inadequate in countries like Philippines and Indonesia, and worse in the periphery countries. These add significantly to the costs of trade and impede intra-regional trade. The ASEAN countries will have to make major investments in their air, land and sea links in order to fully realize the potential benefits of integration.

7) Economic Structure

Viner [1950] pointed out that with complementary production structures, the partner countries most probably have already specialized to a high degree in one type of product, which means that there are only limited possibilities of specialization and reallocation of resources. On the other hand, the production structures of the partner countries are mutually competitive, specialization in the products that the countries can make best and cheapest is probable and the advantages of a customs union are likely to be relatively important. The economic structures of ASEAN countries do appear to be more competitive than complementary since they export broadly similar products to the same main markets. This suggests at least some potential for specialization and division of labor within the ASEAN region.

8) Summary of Static Considerations

All in all, in terms of the criteria derived from static theoretical considera-

tions, it is unclear whether ASEAN is a natural candidate for a free trade area or a customs union. The most compelling evidence against the prospects for further ASEAN integration is the low level of intra-ASEAN trade. Wide disparities in the level of economic development and poor regional transportation infrastructure also work against greater integration. At the same time, ASEAN appears to pass the test in terms of the large size of the market, limited substitutability between intra-union and extra-union products, and the competitive nature of economic structures. Finally, the initial tariff structure of the ASEAN countries works both in favor of and against integration. On balance, the most we can say is there are grounds for both pessimism and optimism with respect to the issue of whether ASEAN can become an effective engine of economic integration among the Southeast Asian countries.

B. Dynamic Considerations

As we have just seen, an ASEAN customs union would generate at most only limited static welfare gains. The smaller the static gains, the less likely are dynamic gains. For example, if the trade creation effect is small, competition from the products of partner countries and hence potential improvements in x-efficiency will also be small. Nevertheless, we saw earlier that dynamic benefits are likely to be more significant than static benefits. Therefore, in theory at least, even where the static gains are not large enough to justify economic integration, the dynamic gains may be sufficiently large to justify integration.

In this connection, we have to take into account the greater competition and improved X-efficiency that will lead to positive welfare gains for the ASEAN economies. The economic crisis currently engulfing the entire region is highlighting the need for the region's economies to make themselves more competitive and efficient in the global context. Fostering greater intra-regional competition through more vigorous regional integration can be highly useful in this regard. In the long term, increased productivity and efficiency is their only route to a sustained recovery from the crisis.

In this light, the dynamic benefits of economic integration are potentially large indeed. The scope for inter-and intra-industry specialization as well as learning-by-doing will also increase over time, producing further welfare

gains. In addition, integration will create a large ASEAN market, thereby helping ASEAN countries expand production and exploit greater economies of scale. For example, Thailand could specialize in the production of automobiles for the entire region while Singapore can become the regional hub for financial services.

ASEAN can learn from the experiences of MERCOSUR in the broad sense that a custom union among developing countries can be quite effective in promoting trade. Argentina, Brazil, Paraguay and Uruguay launched MERCOSUR on 26 March 1991 with the aim of forming a customs union from January 1, 1995. According to Castillo [1993], the ultimate aim of MERCOSUR is to eventually establish a common market among the four member countries. While MERCOSUR is far from a qualified success and there have been no estimates of its welfare gains and losses, trade among the member countries has grown substantially since its formation (see Coffey [1998] and Olarreaga and Soloaga [1998]). However, we should note that ASEAN's structure is significantly more heterogeneous than that of MERCOSUR, which is dominated by the partnership between two upper middle-income countries - Argentina and Brazil. This means the applicability of MERCOSUR's experience for ASEAN is limited.

C. Non-Economic Factors Relevant to Further Integration

In section III.D, we discussed a number of non-economic factors which can act as catalysts to further integration. It is fair to say that ASEAN countries, like the EU countries, share a sense of common destiny and vulnerability. The sense of common destiny is evident in the high inter-dependencies among ASEAN countries in non-economic fields built over the decades. In the political, cultural and social arenas, ASEAN countries are involved in active interaction and becoming more integrated. Some examples of common vulnerabilities include fear of China's growing economic and military might, and the exposure of their financial markets and economies to volatile foreign capital flows, as witnessed most dramatically in recent months.

As we have previously emphasized, ASEAN countries have been able to maintain peace and stability through discrete consensus-building based on the principles of non-interference and mutual respect. It seems that ASEAN

countries are able to bury their differences and work together. The unqualified success of ASEAN in promoting intra-regional goodwill and harmony is, in turn, promoting a sense of regional identity. While the cautious, minimalist approach of ASEAN has been criticized by some as lacking vision, boldness and substance, it has nevertheless served the countries of the region well because it has laid the foundation for effective political cooperation.

As we have already discussed earlier, such cooperation is the most significant non-economic determinant of the success or failure of economic integration. Strong political will in the governments involved is a key pre-condition for a successful customs union or any other form of integration. In this respect, as opposed to the purely economic criteria discussed earlier, there are strong grounds for optimism. It is ultimately up to the governments to take the initiative in fostering economic integration and the ASEAN governments enjoy excellent working relationships with each other. Those governments have always shown unyielding political will in cooperating in the arenas of politics and diplomacy. There is every reason to believe that they are capable of showing the same level of commitment and sense of purpose in the sphere of economic cooperation as well.

D. Effects of the Current Economic Crisis

Since Thailand was forced to float the baht in July 1997, the currency crisis quickly spread to all the other economies of the region. The ASEAN economies have been experiencing economic difficulties of varying degrees over the last eleven months or so. The immediate cause of the crisis was a realization among both foreign and domestic investors that the region's economies will be unable to service their debts. The increasingly unsustainable current account deficits were a major tell-tell sign, as well as a glut of property and other "unproductive" investments. Table 10 shows the effects of the crisis on the region's currencies and stock markets. Even Singapore, which has strong economic fundamentals such as a sizable current account surplus and a healthy government budget surplus, was not immune from the effects of the regional crisis. The effects of the crisis on the real economy, as opposed to the financial sector, are beginning to be felt, with a growing incidence of bankruptcies, closures and layoffs. All of the region's countries are expected to achieve much less rapid economic growth than before the advent of the current crisis.

Table 10

The Exchange Rate and Stock market Index on May 23, 1998

Country	Exchange Rate: Units of Local Currency/US\$	Stock Market Index in Local Currency
Indonesia	11,700 (2,432)	424 (712.5)
Malaysia	3.82 (2,52)	569.2 (1,070)
Philippines	38.8 (26.4)	2,100.3 (2,829.3)
Singapore	1.65 (1.43)	1,273.8 (2,023.9)
Thailand	39.4 (25.3)	355.5 (496)

Note: Numbers inside parentheses are figures for June 28, 1997.

Source: Economist (23 May [1998] and 28 June [1997])

In the first instance, the crisis will have a negative impact on the prospects for economic integration. As a general rule, recessions and downturns are not an opportune time to push for integration because each country wants to export as much as possible and import as little as possible. That is, the stagnant domestic economy and the associated high unemployment rates will create strong political pressures for protectionist, "beggar-thy-neighbor" policies. Given the severity of the downturn engulfing the region, those pressures will be all the more virulent. Another consideration is that the officials of the economic ministries will have their hands full with trying to spur their economies out of their current difficulties, leaving precious little time and effort available for discussions about regional cooperation.

On the other hand, the present crisis may galvanize the ASEAN member states into a more vigorous pursuit of integration. At a broader level, the crisis is likely to foment a deeper sense of an ASEAN identity as well as belonging to the ASEAN family. This is because the crisis has shown that foreign investors, rightly or wrongly, do not discriminate between the different countries of the region and treat them as a homogeneous whole. For example, Singapore has not been able to escape the consequences of the crisis altogether despite its strong fundamentals. The sense of belonging to the same group can only be beneficial for integration.

At a narrower level, the current crisis shows that all ASEAN members share the costs of economic mismanagement by any single member due to the contagion effect. This may motivate ASEAN to develop mechanisms for member states to exchange information about economic data with each other so as to be able monitor each other. This kind of mutually beneficial monitoring is itself an important means of economic cooperation. At the same time, it can also help lay the foundations for trade-based regional integration by facilitating the intra-regional flow of economic information that, in turn, would allow for better informed decision-making on integration issues.

VI. Conclusion

We have evaluated the prospects for further economic integration in ASEAN through the litmus test of the economic theory of integration. In particular, we applied the theory of customs unions to assess the extent to

which ASEAN satisfies the theoretical criteria for a customs union or free trade area. As stated earlier, much of the theory of customs unions is valid for analyzing free trade areas as well. Whereas ASEAN appears to be a good candidate for integration in terms of the large size of the market, low substitutability between intra-union and extra-union products and the competitiveness of economic structures, the low pre-union level of trade, dissimilarity of development levels and under-developed transportation infrastructure suggest otherwise. The initial structure of tariffs favors both trade diversion and trade creation. Overall, it is far from clear whether ASEAN constitutes an optimal customs union or free trade area.

This suggests there would be at best only limited static welfare gains from further economic integration among the ASEAN countries. However, this does not rule out the presence of potentially significant dynamic welfare gains from integration. Even in regions such as the European Union that satisfy the criteria for an optimal customs union much better than ASEAN, it is the dynamic benefits rather than the empirically small static benefits that ultimately provide the main justification for pursuing integration. While the static and dynamic welfare gains are not independent of each other but it is still possible for the latter to be sizable enough to justify a customs union or free trade area even when the former is relatively small. As noted earlier, dynamic improvements in x-efficiency and productivity are urgently needed if the ASEAN countries are to remain competitive in the global marketplace in the long run.

Furthermore, the most serious obstacle to an effective ASEAN customs union or free trade area, namely the low volume of intra-regional trade, may not be as serious as it seems. The reason is that it is precisely the central objective of economic integration to promote greater intra-regional trade. That is, to the extent that the low volume of intra-ASEAN trade reflects protectionist barriers, the move toward a customs union or free trade will significantly increase the volume of trade. Moreover, ASEAN countries could substantially improve the poor intra-regional transportation infrastructure by making investments in air, land and sea links. This would further facilitate and promote intra-regional trade.

Last but not least, we should not ignore a major factor that bodes well for greater economic integration in ASEAN - the organization's history of suc-

cessful political cooperation. As the experience of the EU so clearly demonstrates, political commitment and will are indispensable for integration. Although at present all the ASEAN governments are preoccupied with overcoming economic crises, the commitment to political cooperation with neighboring countries appears to remain fairly strong. ASEAN has been and still remains a genuine community of countries. This provides grounds for some optimism concerning ASEAN's prospects for transforming itself from a largely political community to a deeper and broader community of effective cooperation in both the political and economic spheres.

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