

Regional Integration and ASEAN Economic Community

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Lecture 20

Course Syllabus

Lecture 20

- ASEAN integration is evaluated from the level of intraregional trade, investment, and capital flows.
- We discuss new economic geography and explain how the gravity model can be applied to Thailand's rising degree of trade exposure.
- The new regionalism is explained by exploring multiple free trade agreements.
- Mega Trade Blocs such as ASEAN plus 6, RCEP, and TPP are discussed.
- The lecture reviews AEC's progress and challenges by examining the ASEAN Blueprint 2025.

Key Words

1. Regional integration indicators
2. ASEAN (Association of Southeast Asian Nations), GMS, and AEC: Progress and challenges
3. Factor endowment theory and new economic geography: Gravity Model
4. Multiple Free Trade Agreements
4. Mega Trade Blocs

1. Integration indicators

Correlation of Thailand's stock market returns

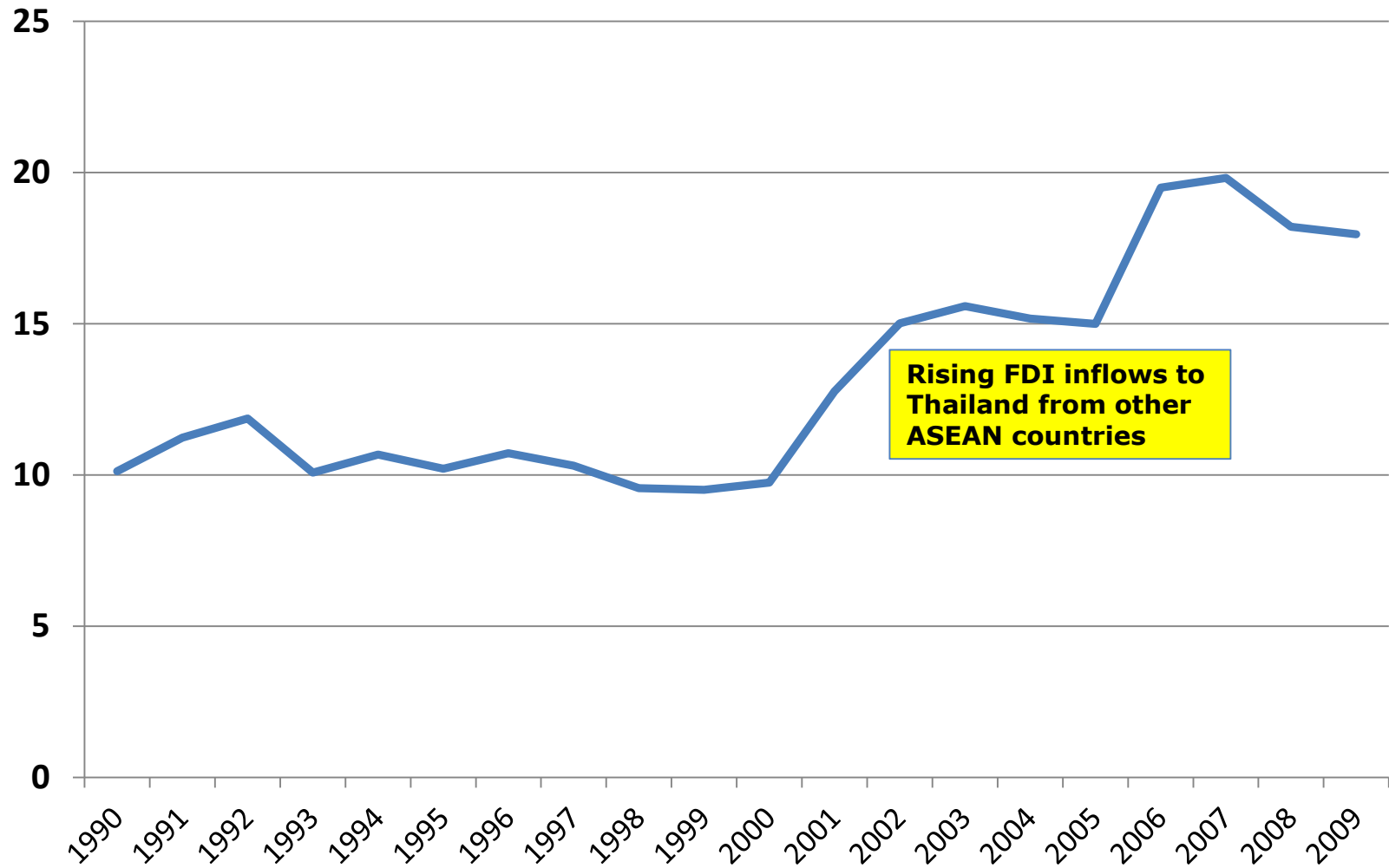


In normal times, SET index moves in tandem with other Asian stock prices (high correlation) which are also affected by the same global shocks

Regional integration through FDI

- Cumulative foreign direct investment (FDI) share *is* the percentage of regional FDI *inflows* to total FDI from the investing region.
- A higher share indicates a stronger preference for the region and a higher degree of the region's integration.

Thailand's Cumulative FDI Share (%) of all FDI inflows from ASEAN countries



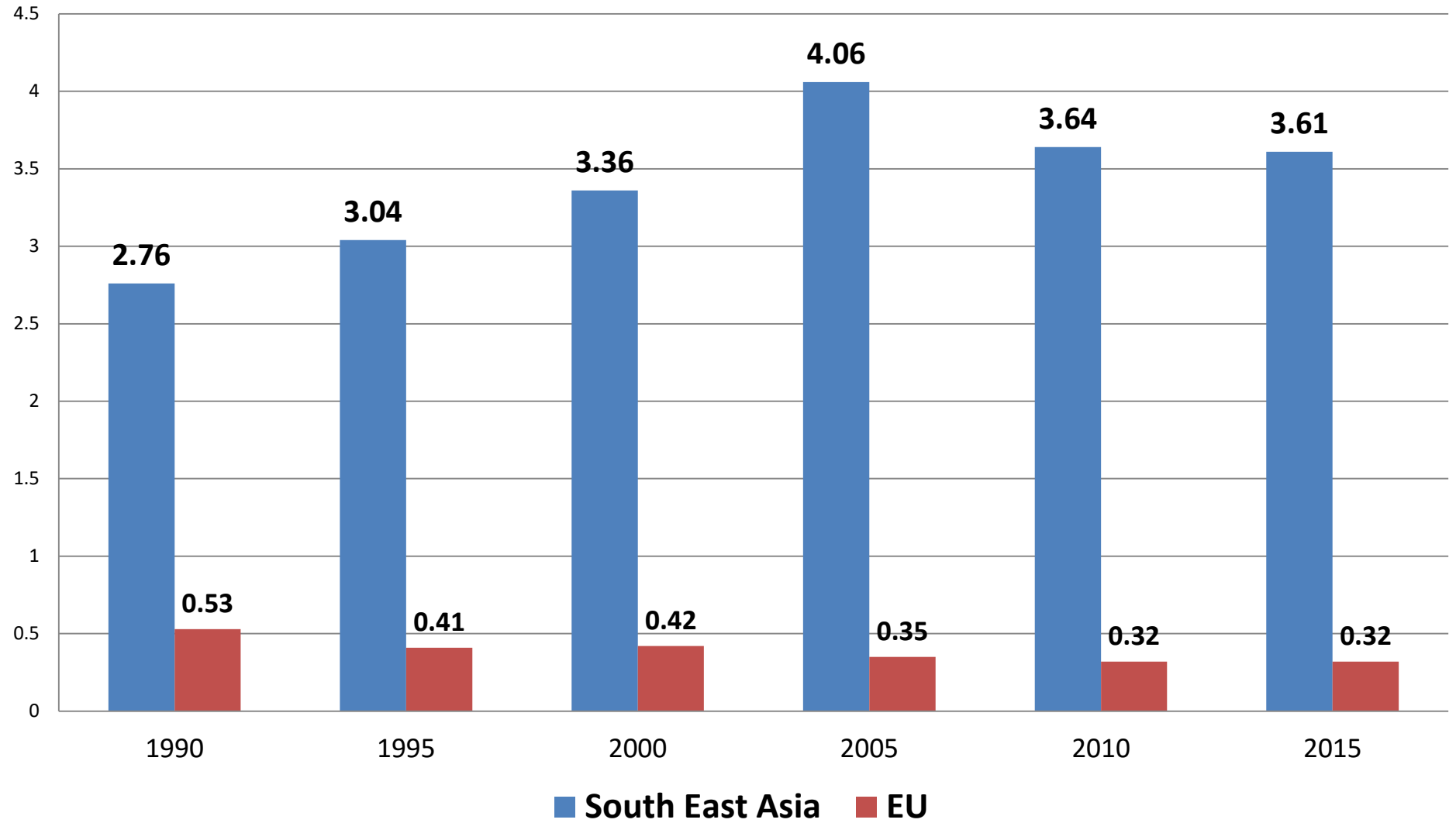
In the first half of this year, Vietnam attracted \$11 billion in foreign direct investment, surpassing that of Thailand. The trend would continue in the future.

Export intensity

- Export intensity index is the ratio of export *share of a country/region* to its *share in world* exports.
- An index of more than one indicates that trade flow between countries/regions is larger than expected given their importance in world trade.

Thailand's Export Intensity Index

EU (<1) and SEA (>1)



Trade (exports plus imports) intensity index

- The trade intensity statistic is the ratio of two trade shares.
- The numerator is the country's trade share to the area under study.
- The denominator is the share of trade of the country in the world.
- The statistic tells us whether or not a region trade more (as a percentage) to a given destination than the world does on average.
- It is interpreted in much the same way as an export intensity index.

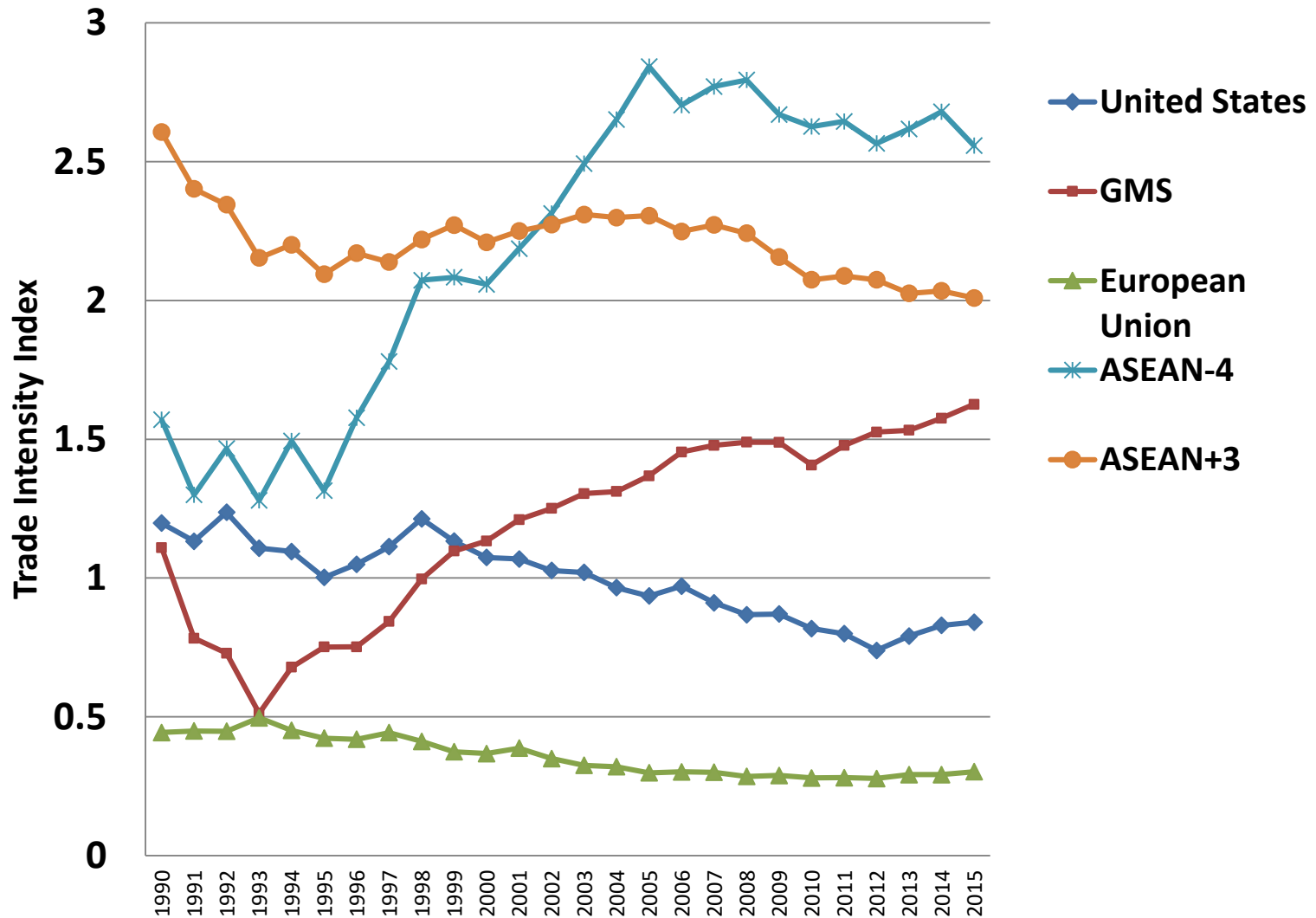
Thailand Trade Intensity with ASEAN

$$\begin{aligned} & \textit{Thailand's Trade Intensity Index with region A} \\ &= \frac{\textit{Thailand's share of trade with A}}{\textit{Thailand's share of trade in the world}} \end{aligned}$$

How about your study intensity?

- Share of your hours spent studying EE460 within a day
- Share of your 24 hours spent on studying of all subjects

Thailand's Trade Intensity



The higher the index value, the stronger the trade intensity with the corresponding area
 ASEAN-4 (without Singapore)
 ASEAN+ 3 (JCK)

An integral part of the world economy

- Thailand has increasingly become an ***integral part*** of the ***world*** economy.
- The degree of ***Asian regional integration*** of Thailand has been ***more*** pronounced through foreign investment via product fragmentation and network trade.

2. ASEAN achievements

- Common Effective Preferential Tariff (CEPT) rates are zero for ASEAN-6.
- More than **70%** of intra-ASEAN trade are now *tariff free*, and less than 5% subject to tariff above 10%.
- ASEAN-6 are near achieving international best practices in investment liberalization and facilitation.
- Agreement on Mutual Recognition Agreements (MRAs) on **service liberalization** on three types of goods and **seven professions**.

Regional economic bloc in Asia

- FDI in Asian region had been *declining*; a large part of investment was diverted into China.
- For restoring the attractiveness of FDI in the region, ASEAN countries formed a **regional economic bloc** to *attract* foreign direct investment.
- Since Japan and Hong Kong are the largest investors in Thailand, the idea of establishing **ASEAN plus 3** and **ASEAN Economic Community** (AEC) provides some hope and lessens the fear of losing FDI to China.

AEC Background

- ASEAN Free Trade Area (AFTA) has been the main vehicle prior to AEC
- Thailand is the key proponent that brokered AFTA
- Ambitious liberalization program was achieved by original ASEAN members, reducing external tariffs among members.
- AFTA has accelerated the pace of multilateral trade liberalization in the ASEAN-6.
- The long-standing commitment of ASEAN-6 to openness.

ASEAN Economic Community (AEC) Established in 2015

- The tariff rates among ASEAN countries were cut to 5 percent in 2005, covering about 95 percent of intra-ASEAN trade.
- Fully liberalized trade among ASEAN took place in 2010; for the *new* members (CLMV) by **2015**.
- The deadline had been set at **2015** for the establishment of ***ASEAN Economic Community*** (AEC).

AEC Challenges

- ASEAN obviously did not achieve all of its AEC targets by December 31, 2015.
- The followings are future challenges:
- Removing barriers to trade in sensitive areas: agriculture, steel, and important services.
- Removing behind-the-border constraints related to logistics, transport, and infrastructure.
- Promoting greater labor mobility to include unskilled not just skilled labor.

Greater Mekhong Subregion (GMS)

CLMV-TY

- GMS nations, comprising Cambodia, Laos, Myanmar, Thailand, Vietnam, and **Yunnan** province in China, have agreed to promote trade and investment in the region.
- Asian Development Bank provided loans worth 770 million USD to finance transportation projects by establishing ***networks of roads*** between GMS countries and building bridges across Mekong River.

“If you want to go fast you should go alone, but if you want to go far, we have to go together” An old African proverb

- Investments for **inclusive** regional connectivity is essential for all ASEAN countries, although progress is not as rapid as business had hoped to see.
- Connectivity between China and India to ASEAN is vital.
- There is a need to strengthen the link between Southern China and ASEAN via Laos.

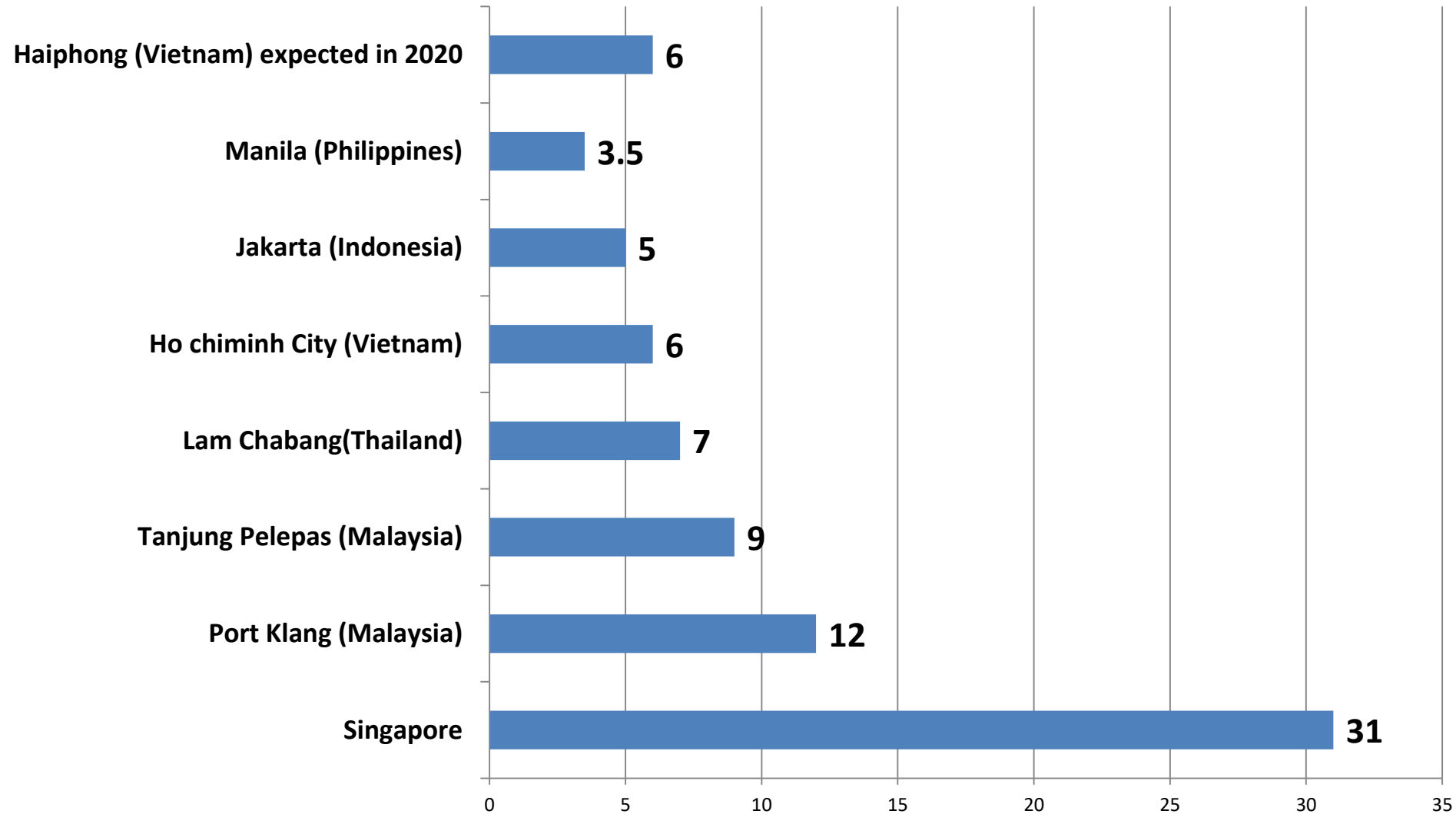
From Kunming to Vientiane



Infrastructure development and investment creation effect of regional integration

- Trade creation effect **may not be as high** as previously expected from ASEAN Free Trade Agreement
- But the impact on investment creation is **substantial** within the region
- **Infrastructure-led growth Hypothesis**

Major Ports in Southeast Asia by number of containers handled



Mitsui OSK Lines plans to take advantage of a route between Haiphong and North America
Korea's LG Group will make the port for exports to the US and Europe.

The *East-West Economic Corridor* (R9)

connects four countries from the port city of **Da Nang** on the *South China Sea* in Vietnam to **Mawlamyine**, a port city on the *Andaman Sea* in Myanmar, connecting roads passing through **Khon Khan** and **Phitsanulok** in Thailand, and **Suvanakhet** in Laos.

1300 km



Routes to link three ASEAN countries

- Laos and Vietnam jointly opened a highway for trucks in June 2009.
- The road is aimed to facilitate low-cost freight transportation.
- The 500-kilometre route links Thailand's northeastern province of Mukdahan with Laos' Suvannakhet and its Dansavan trade zone, and Vietnam's Lao bao.

North-South Economic Corridors and non-tariff trade cost

- Another route on the North-South Economic Corridor, goods can also be transported from Kunming to Chiang Rai via **Laos**.
- Bangkok can also be linked to Phnom Penh and Ho Chi Min City by the ***Southern Economic Corridor***.
- The infrastructure development in the GMS would develop **secondary cities** along the road networks and provide access of **hinterlands** to sea ports.
- The planned **road networks** would **connect** six countries in the Greater Mekong Region, integrating these countries geographically more than ever.
- ***The GMS sub-regional trading bloc is a natural consequence of a reduction in non-tariff trade cost, reinforcing the trade pattern which reflects comparative advantage.***

Very high logistic costs

- The NESDB has set a five-year target to lower logistics costs from **19%** of GDP to **15%** by the end of the 11th national economic and social development plan in 2016.
- The previous cabinet endorsed a rail system overhaul worth **1.7** trillion baht, including upgrading 660 kilometers of existing track and signaling infrastructure, buying more locomotives, and constructing five double-track routes to the northern, northeastern and southern regions.

To reduce logistic costs

- Logistics costs relative to Thailand's gross domestic product (GDP) fell just one percentage point in 2010 year from 2009, due mainly to higher oil prices and interest rates.
- **Rising oil prices** have had a significant impact on logistics costs because the country is so overwhelmingly dependent on **road transport**.
- Can infrastructure investment lead to high economic growth? If so, explain why. If not, why not?

Southeast Asia regular and *high speed* rail network likely to be substantially complete by 2022

The proposed network consists of three main routes from Kunming, China to Bangkok, Thailand:

The Eastern Route via Vietnam and Cambodia;

The Central Route via Laos, and the Western Route via Myanmar.

The southern half of network from Bangkok to Singapore has long been operational, though a high-speed line has been proposed.



If transportation cost is too high, the volume of trade will be limited and can be prohibitive if the transportation cost is higher than price differentials



3. Factor Endowment Theory

- Until the end of the 1970s, the Heckscher-Ohlin theory for which Bertil Ohlin won the prize--Eli Heckscher died before the Nobel Prize in economics was instituted--dominated the field.
- This theory explained well why **labor-abundant** countries such as China exported labor-intensive products such as apparel, toys and footwear and **capital-abundant** countries such as the United States would export machinery and aircraft.
- *What is Leontief paradox?*

What factor endowment theory *cannot* explain

- Factor endowment theory could not satisfactorily explain the two-way trade that was widely known to exist: Intra industry trade
- Many countries exported automobiles and televisions, but they also imported them (**Intra-industry trade**).
- The Heckscher-Ohlin theory also did not adequately explain why rich entities such as Europe and the United States, which had very **similar endowments of capital and labor**, traded *more intensively* than those with very dissimilar endowments.
- While descriptive explanations of these phenomena existed, a tight theory explaining them was lacking.

Krugman's international trade theory: Theory of economies of scale and product variety

- Starting in 1979, Krugman published a series of papers that successfully tackled these and many other related questions.
- He postulated that consumers like *variety* in what they consume.
- For the same expenditure, their satisfaction is greater if they have a larger variety of products available.
- This creates the incentive for firms to produce **a large variety of products**.
- How many rice varieties can we find in a super market in Bangkok?

Market size and distance

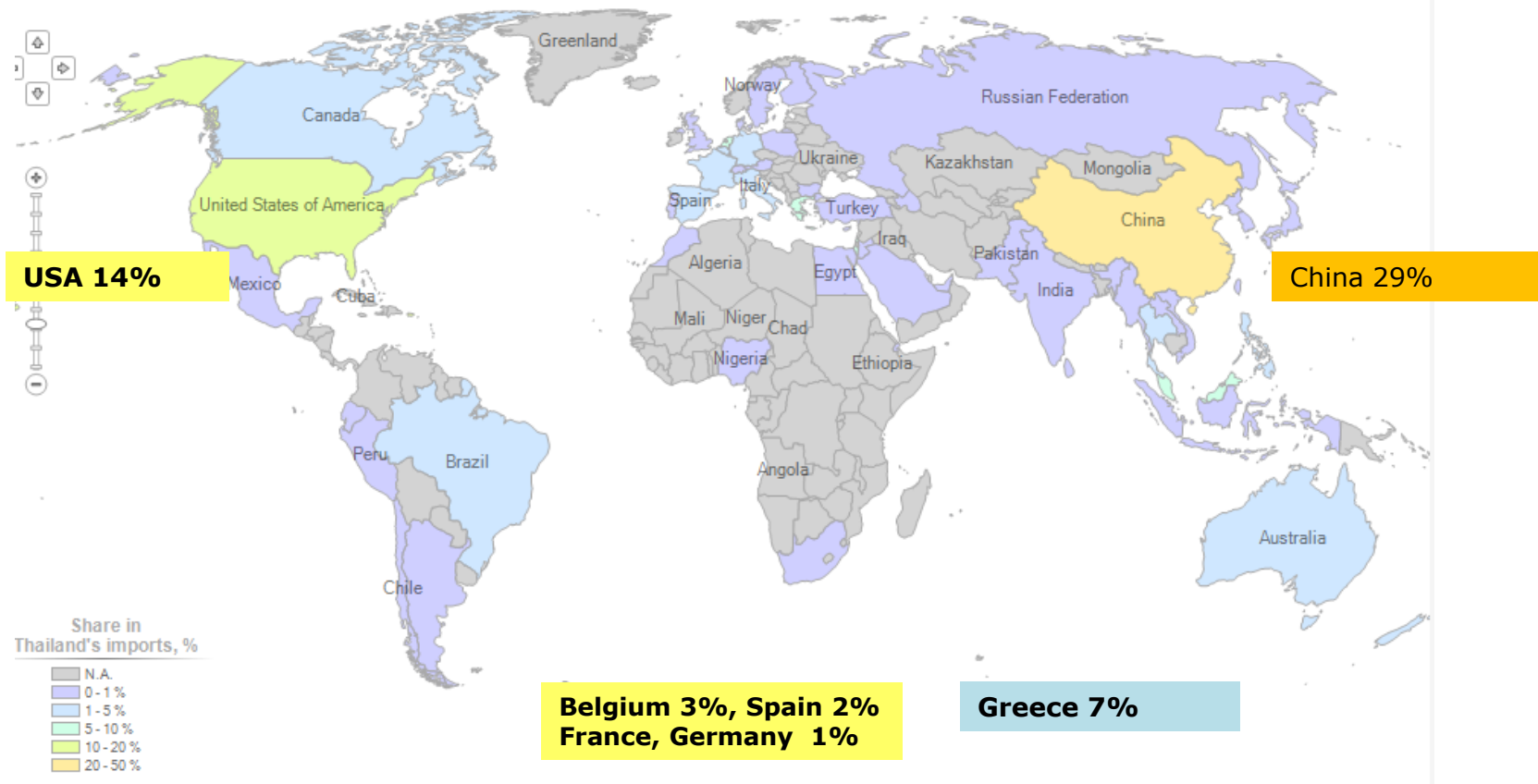
- But the production of a new variety has setup costs.
- This leads to declining per-unit costs as a larger quantity of the variety is produced and places a limit on the number of varieties the market can profitably supply.
- ***A firm produces a new variety only if it can capture a large enough market to allow profitable sales.***
- Krugman won the Nobel Prize in 2008.
- ***Economies of scale*** explains **intra-industry trade**, while H-O theorem cannot.

Supplying markets for preparations of vegetables, fruit, and nuts (product 20) imported by Thailand in 2015

Share in Thailand's imports

List of supplying markets for a product imported by Thailand in 2015

Product : 20 Preparations of vegetables, fruit, nuts or other parts of plants



New Economic Geography

Paul Krugman: Four propositions

- **Transportation costs**, or more broadly **transaction costs across distance**, play a crucial role in shaping international and interregional trade. (**Distance matters**)
- The interaction of **market size** with **increasing returns** (economies of scale) plays an important role in determining the location of production.
- ***Home market effect*** is a major explanation of trade through differences in **population density** and ***localized specialization***.
- A cumulative process in which **large markets attract production** leads to **agglomeration**.
- The same processes that shape economic geography **within** countries also shape international trade.

Newton and law of gravity

- Newton's law of gravity: ***the gravitational attraction between any two objects is proportional to the product of their masses and diminishes with distance.***
- Large economies tend to spend large amounts of imports because they have large incomes.
- They tend to attract large shares of other countries' spending because they produce a wide range of products.
- Trade between any two economies is larger, the larger in ***either*** economy.

Gravity model

- The value of trade between any two countries is proportional, other things equal, to the product of the two countries' GDP, and diminishes with the distance between the two countries.

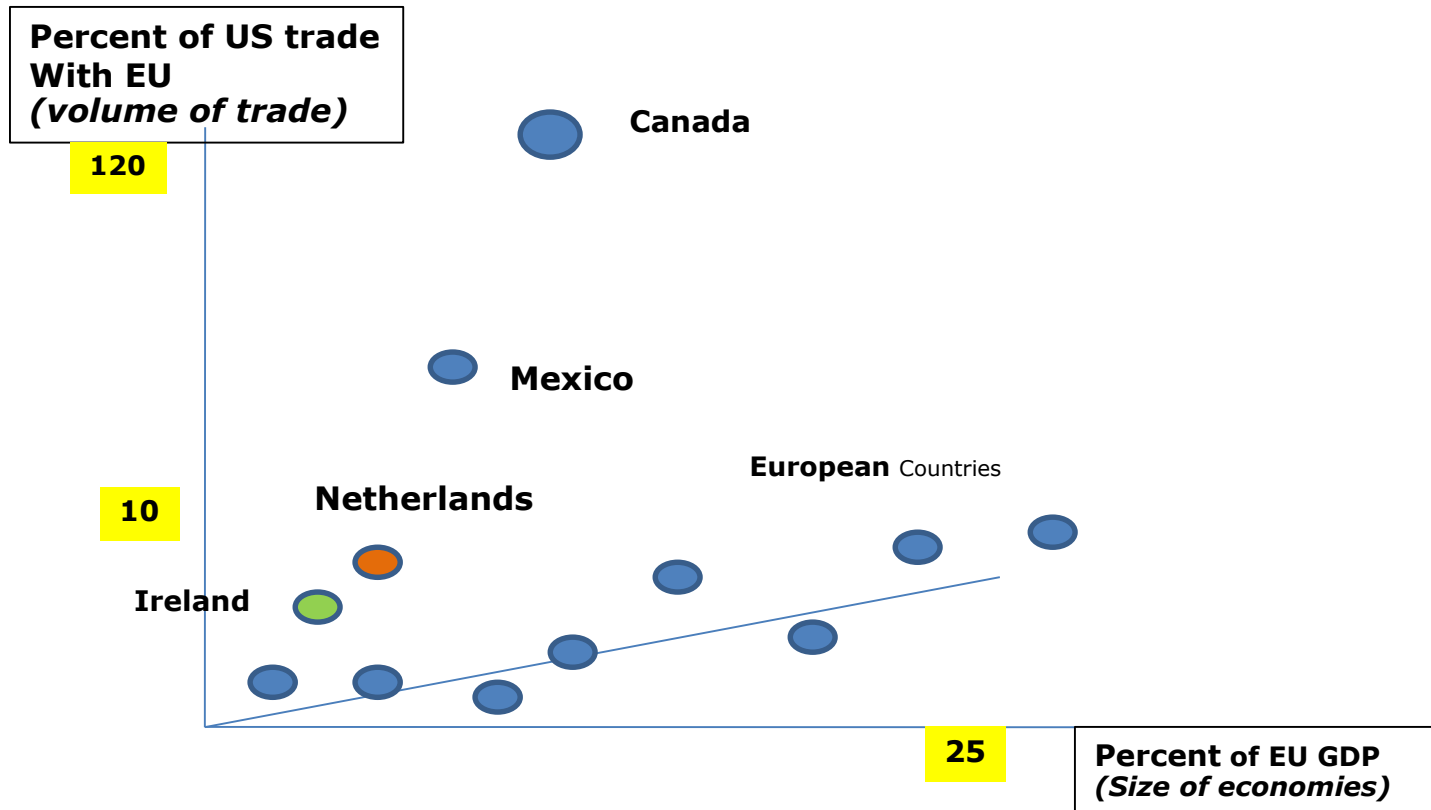
$$T_{ij} = AY_i^\alpha Y_j^\beta / D_{ij}^\delta$$

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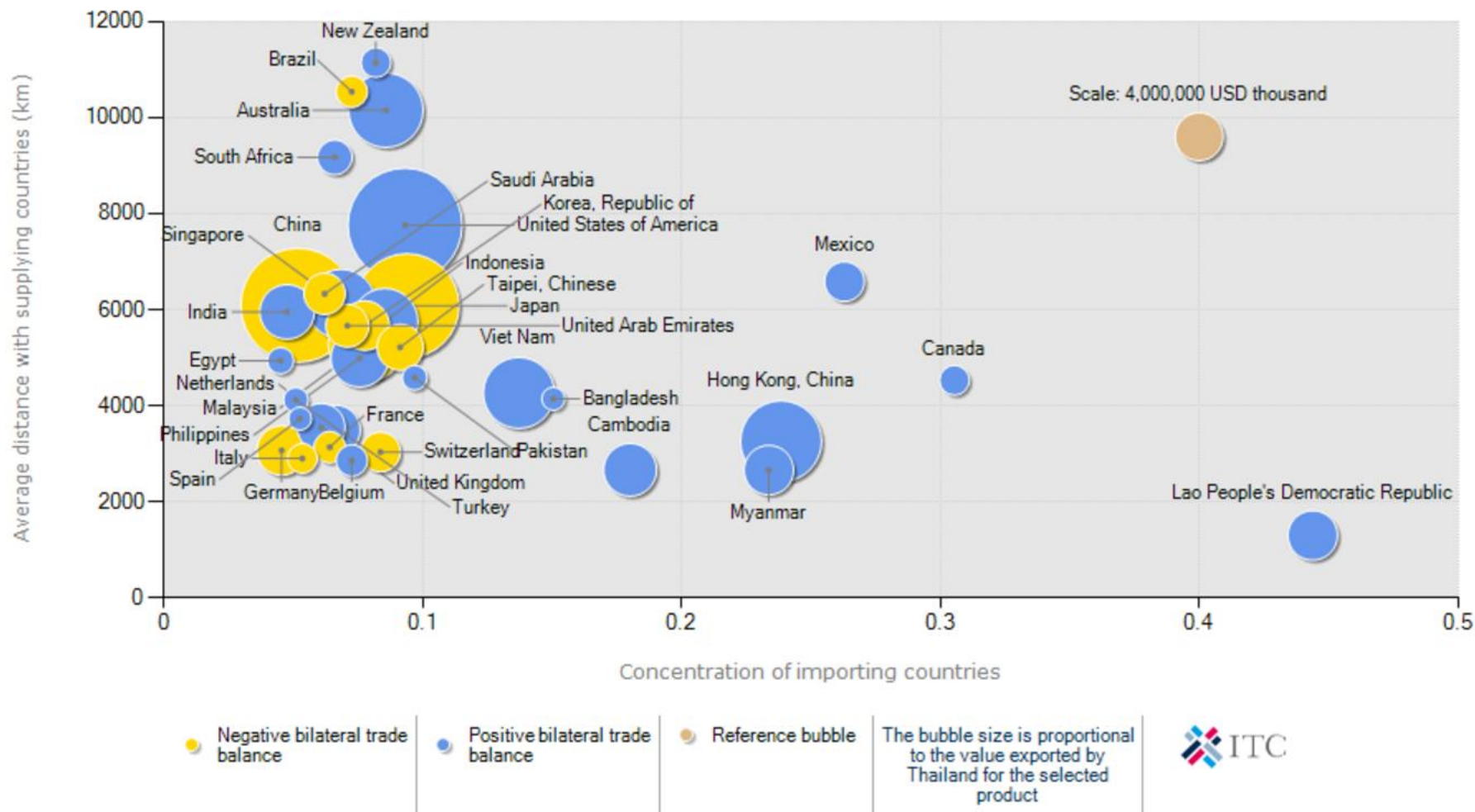
$$\log(T_{ij}) = \ln(A) + \alpha \log(Y_i) + \beta \log(Y_j) \\ - \delta \log(D_{ij}) + \varepsilon$$

Trade volume depends on sizes of both economies and the distance between them.

Size and distance matter for trade among nations



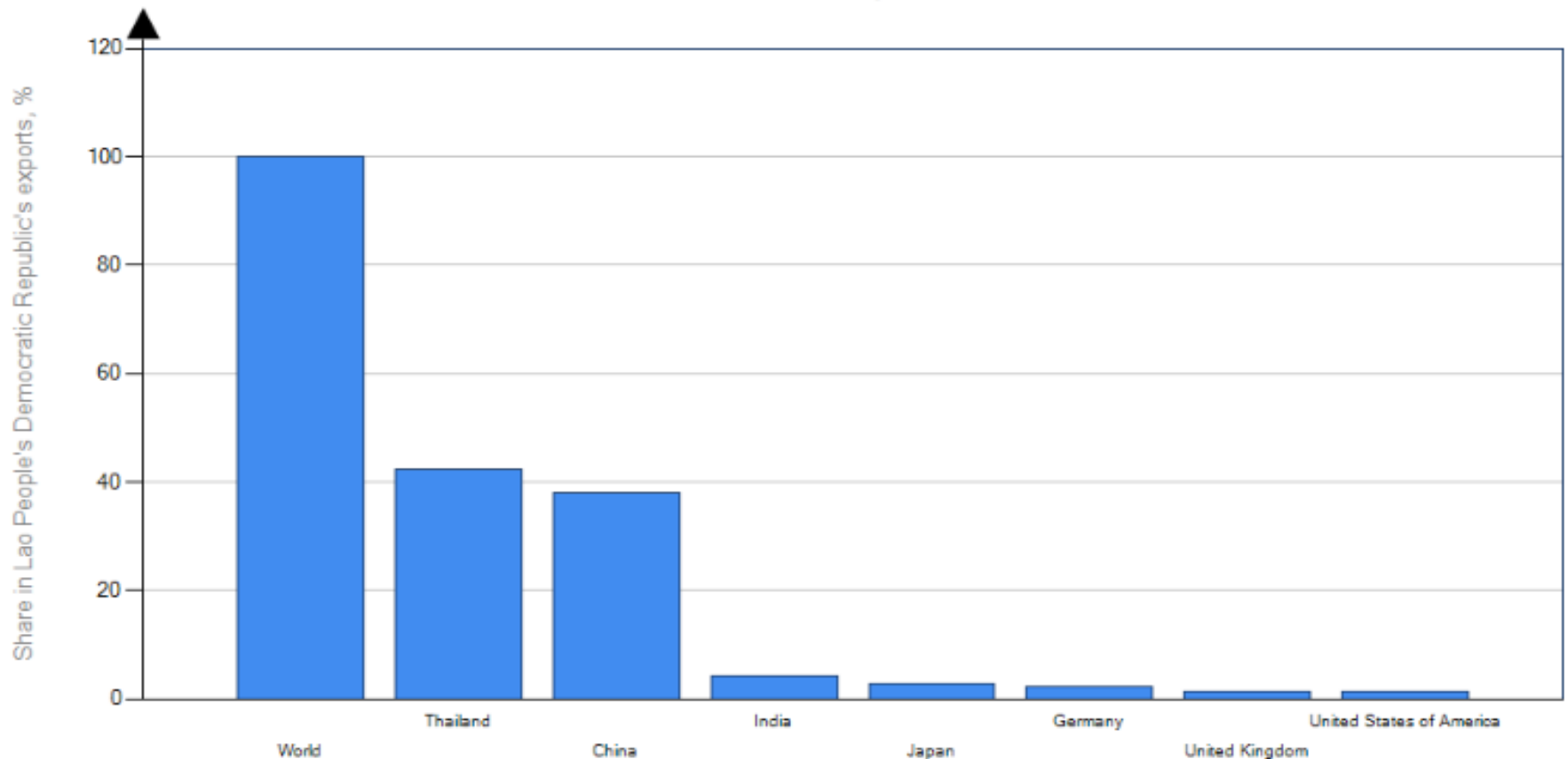
Given country sizes, the greater the distance, the lower the trade volume



Distance matters, despite size S

Lao's export markets in 2015

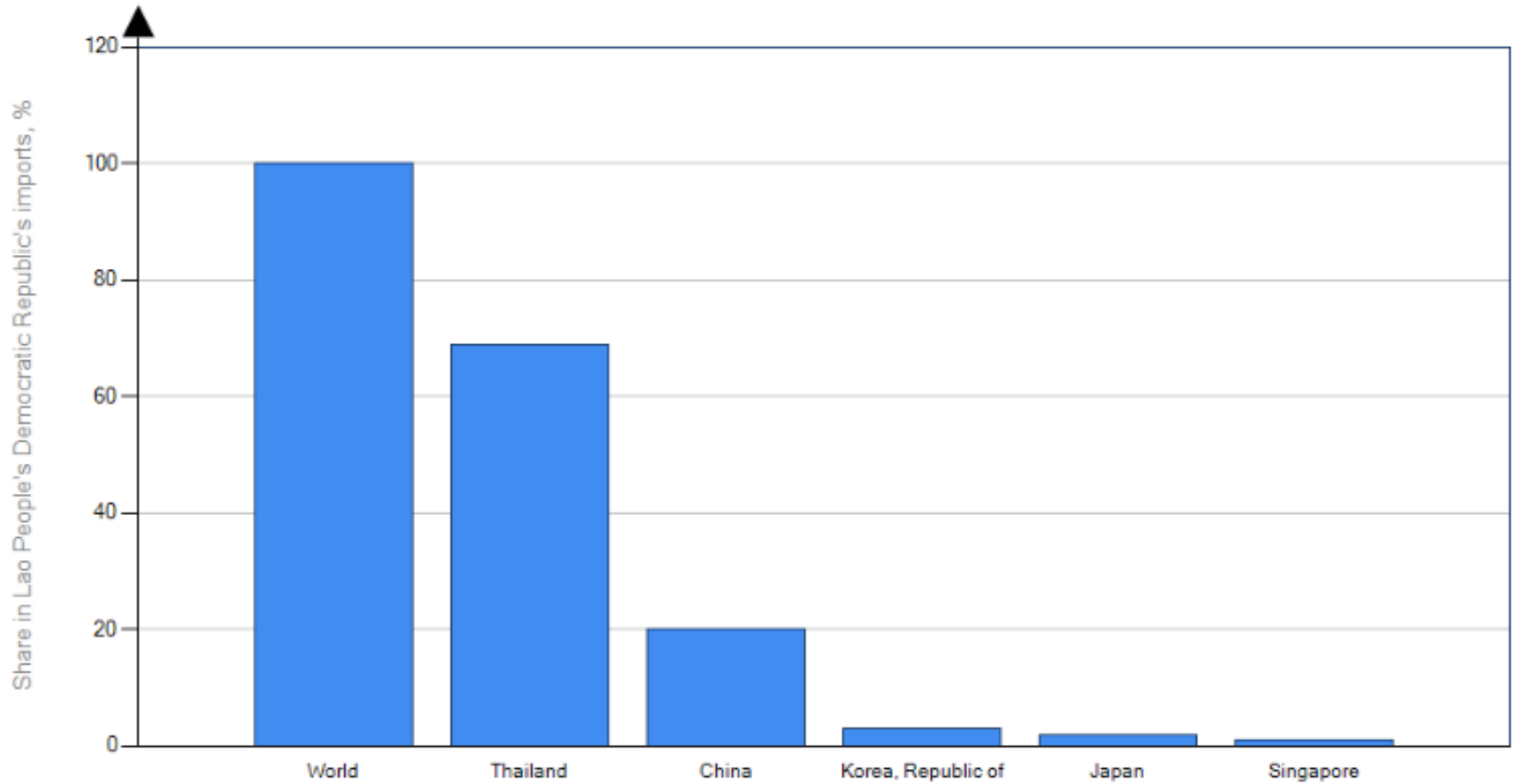
List of importing markets for a product exported by Lao People's Democratic Republic in 2015
Product : TOTAL All products



Does common language matter?

Lao's supplying markets (imports) in 2015

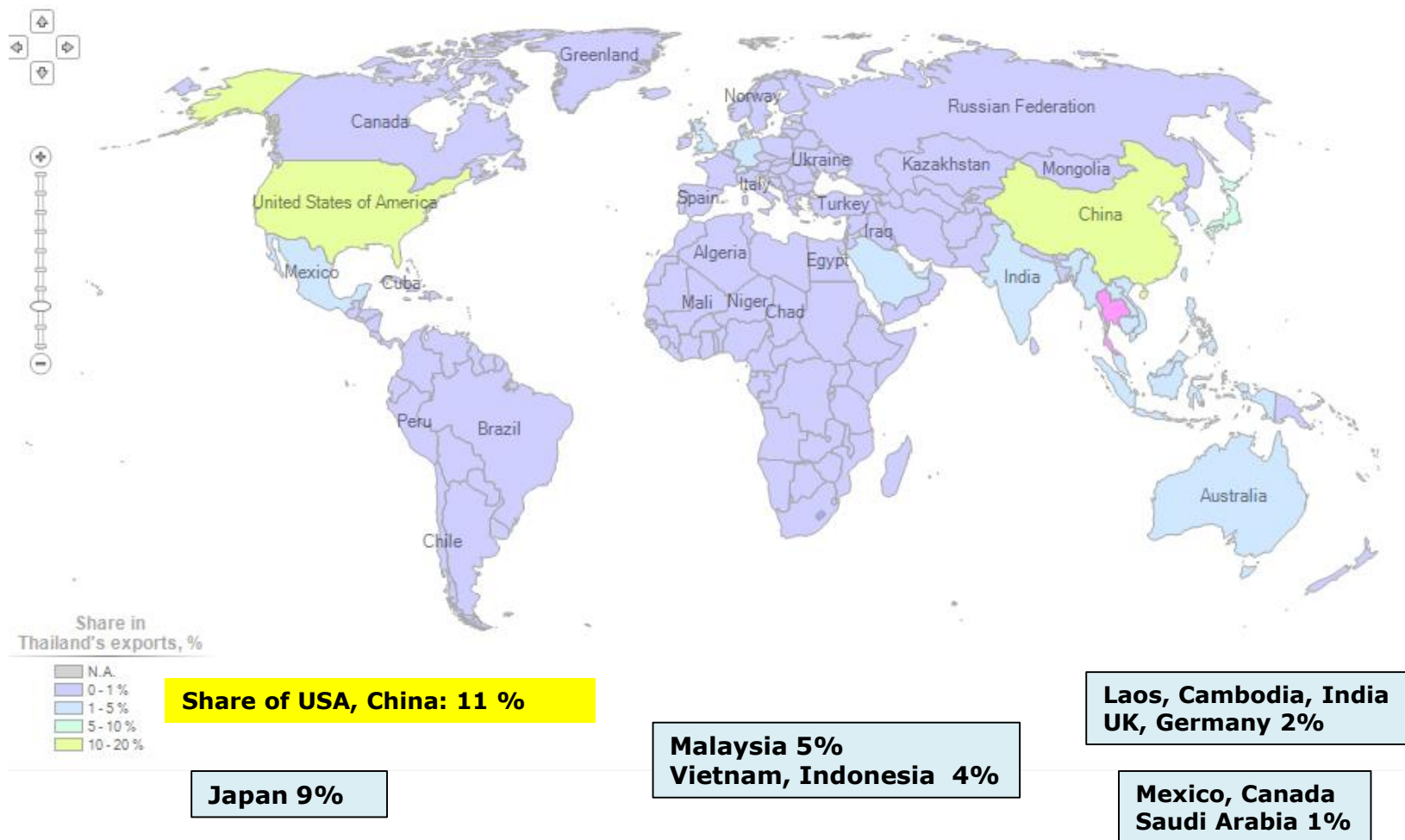
List of supplying markets for a product imported by Lao People's Democratic Republic in 2015
Product : TOTAL All products



Gravity Force: Importing markets for products exported by Thailand in 2015

List of importing markets for a product exported by Thailand in 2015

Product : TOTAL All products



Cross-border trade and disruptions

- In July 2010, the ***closure*** of the Thai-Burmese border checkpoint between Mae Sot and Myawaddy ***cost*** traders about 88 million baht a day, according to Commerce Minister. Both sides negotiated to settle the problem.
- Cross-border trade had suffered significantly as goods could not be transported between the two countries.
- In 2016, Thailand and CLMV are discussing the way to use local currencies, rather than the dollar, to facilitate border trade.
- “Changing the battle field to the market place”

Trade diversion vs. creation

- Lower tariff rates among CLMV countries in the region would not create much **trade diversion** because their trade volumes with countries **outside** the bloc are small.
- On the contrary, **trade creation** effect would be welfare improving for the sub-region.
- Always check these two static impacts of trade integration

4. Multiple FTAs

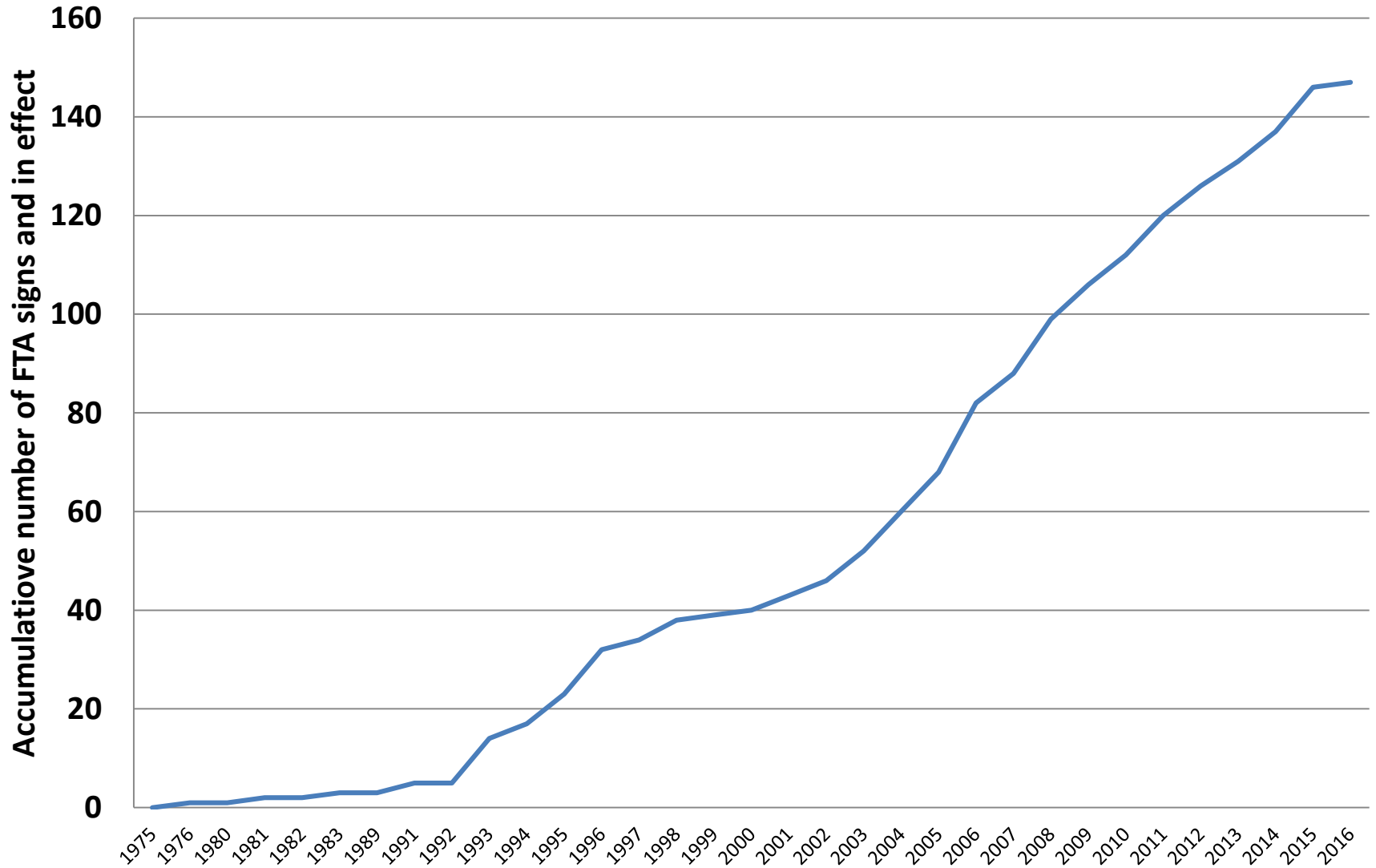
- Thailand's rush to negotiate FTAs with many countries, including USA, Japan, Australia, New Zealand, Bahrain, India, China, Chile, and Peru, can be described as ***new regionalism***.
- Although Japan had already established FTAs with Singapore, Thailand was a ***more difficult*** case for Japan, since negotiations involved agriculture and labor issues.
- ***Singapore*** had already removed most of her tariff barriers, while the two countries' levels of per capita income do not differ much.

Regrettably?

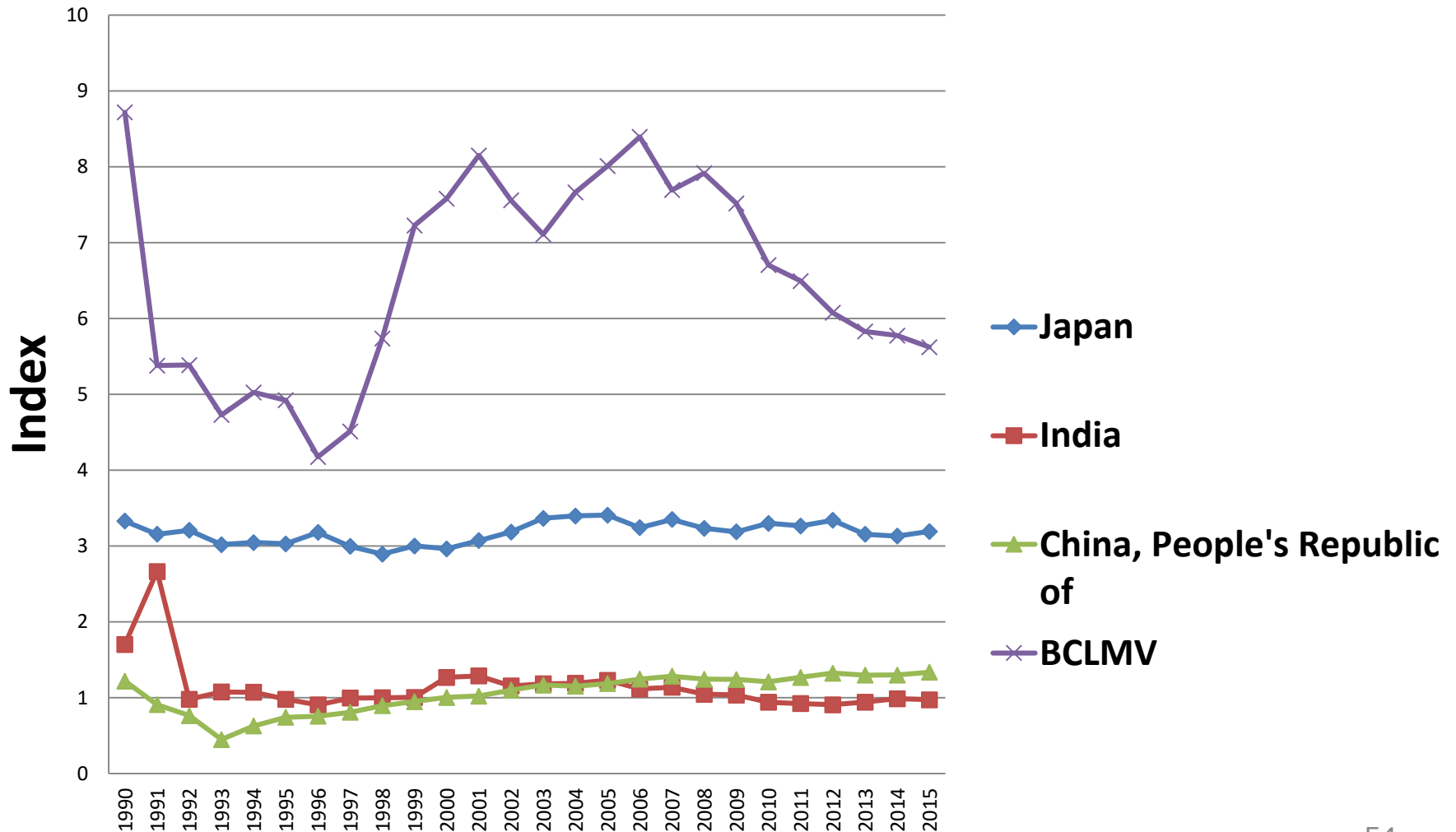
- Thailand had to withdraw *rice* from the FTA negotiation with Japan.
- Rice is also excluded from Korea's FTAs with other countries
- Most of bilateral trade agreements **exempt** agriculture.
- *What commodity was exempted from the FTA between USA and Australia?*

FTAs: Cumulative Agreements in by Asian Countries: 1973-2016

Source: Asia Regional Integration Center



Thailand's Trade Intensity index is highest with CLMV countries



Economic Partnership Agreement (EPA): Beyond the FTA

- **EPA** between Thailand and Japan includes cooperation in education, environment, energy, sciences and technology, tourism, and human resource development.
- EPA goes ***beyond*** what WTO has stipulated since it allows partners to take advantage of **each other's strength** and recognize the **value of cooperation**.

Roo and NTBs

- **Rules of Origin (Roo)** must be simplified to facilitate administration procedure without causing trade diversion or act as a hidden instrument to protect domestic industry. The *spaghetti bowl* effect has been exaggerated.
- **Non-Tariff Barriers (NBT)** such as Sanitary and Phytosanitary Standards (SPS) must be agreed upon to make sure that they are not substitutes for the tariff reductions.
- If Thailand continues to reduce **Most Favored Nation tariff** rates, the cost associated with the rules of origin can also be reduced.

Most Favored Nation

- The members of the WTO agree to accord MFN status to each other.
- Exceptions allow for preferential treatment of developing countries, regional free trade areas, and customs unions (eg. The EU)
- In bilateral reciprocal relationships a particular privilege granted by one party **only** extends to other parties who **reciprocate** that privilege, while in a **multilateral reciprocal relationship** the same privilege would be extended to the group that negotiated a particular privilege.
- MFN is one of the cornerstones of WTO trade law.

To forge ahead with FTAs

- There are **trade-offs** between benefits and adverse consequences of new regionalism.
- As long as the net benefits of expansion along the line of globalization exist, we should **cautiously** go ahead **with multiple FTAs**.
- We should not let **short-term micro** adverse impacts obscure the **long-term macro dynamic gains** from rapid integrating into the world economy.

Suspended FTA: Thailand and USA

- In October 2003, G.W. Bush announced the US's intention to negotiate an FTA with Thailand to deepen trade and investment and encourage economic and regulatory reform, improving IP protection, transparency, and the rule of law.
- But the negotiations were suspended in 2006 following the dissolution of Thailand's parliament and subsequent military coup.
- The US is Thailand's third-largest trading partner, after China and Japan. The two-way trade between Thailand and the US amounted to \$38 billion in 2015.

5. Mega Trade Blocs

- The stalemate in the WTO Doha Round negotiations gave rise to a surge in FTA activities.
- The latest emergent negotiation of mega-trade blocs in 2014: Asian RCEP, the trans-pacific TPP, and the Transatlantic Trade and Investment Partnership (TTIP).

Asia RCEP: Regional **Comprehensive** Economic Partnership

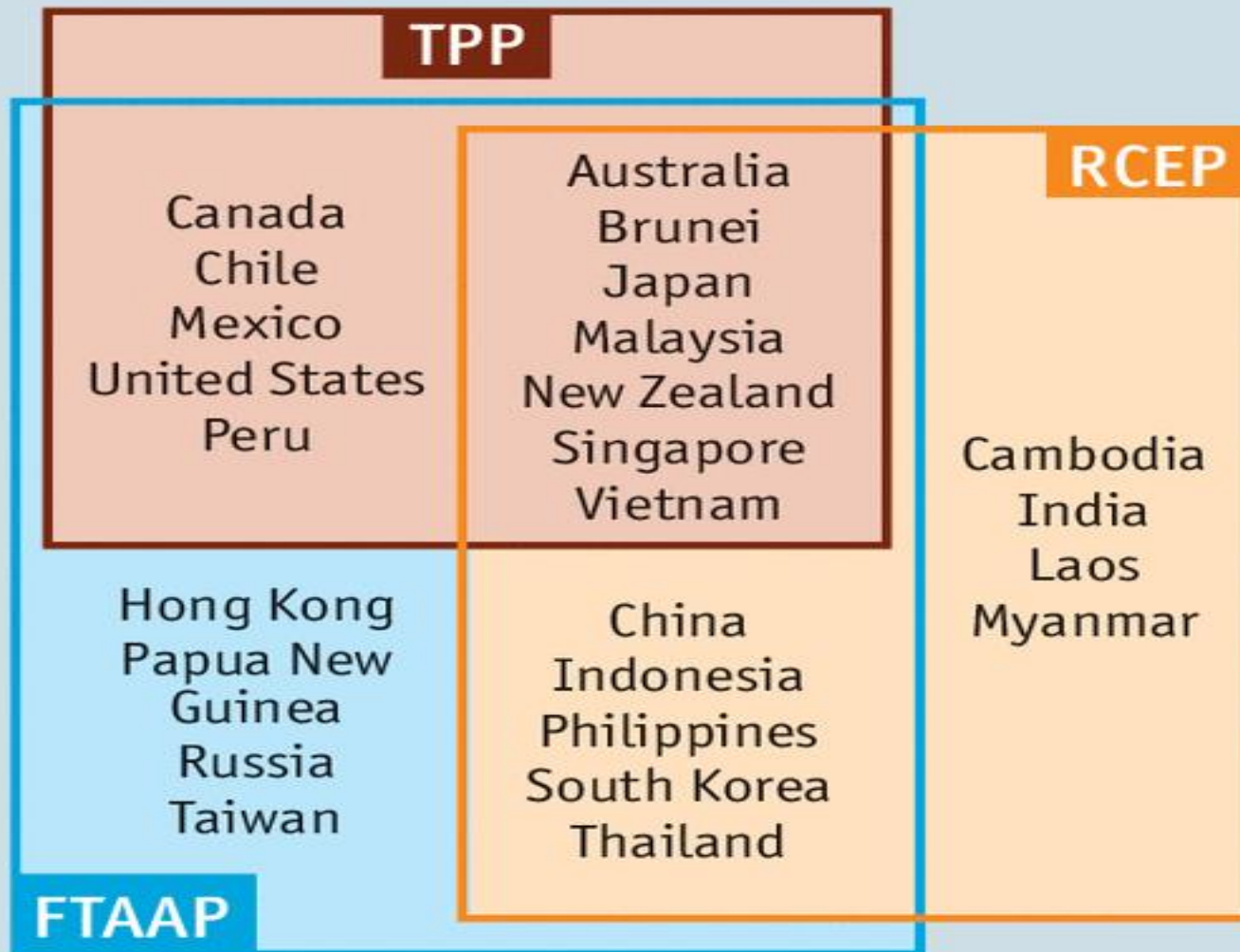
- Launched in November 2012, RCEP (16 countries) with 3.4 billion population (48.6% of world), 21.1 trillion dollar GDP (29.2% of world) and 10.3 trillion dollar goods trade (27.9% of world) in 2012.
- RCEP reinforces ASEAN centrality in regional economic integration, using framework set by ASEAN+1 FTAs, EAFTA, **ASEAN+6** proposal (Japan, Korea, **China**, India, Australia, and New Zealand)
- ***RCEP targets removal of 95% of tariff on goods*** and achieve sizable liberalization in services and investment
- Special and differential treatment for CLMV.

TPP: Trans Pacific Partnership

- Brunei, **Singapore**, Chile, New Zealand, Australia, Peru, **Vietnam, Malaysia**,
- Canada, Mexico, Japan, and **USA (?)**
- TPP (12) involves 11 % of world population, 39% of world income, and 25 % of world goods trade.
- The US president must get approval from the congress.
- Participating of mega blocs would have liberalized and rationalized their trade rules than under WTO.
- Now TPP involves only 11 nations after President Trump says no to TPP.

Overlapping, underwhelming

Proposed Asia-Pacific trade agreements, 2016



Source: *The Economist*

The Differences

- RCEP and TPP overlap in many areas: trade in goods, services, market access, rules of origin, trade remedies, sanitary standards, technical barriers to trade, investment and intellectual property (IP).
- Unlike TPP, RCEP has no environment and labor standard provisions, which are pushed by the US but unpopular with other countries, most importantly, China which is a member of RCEP.

Global trade slowdown

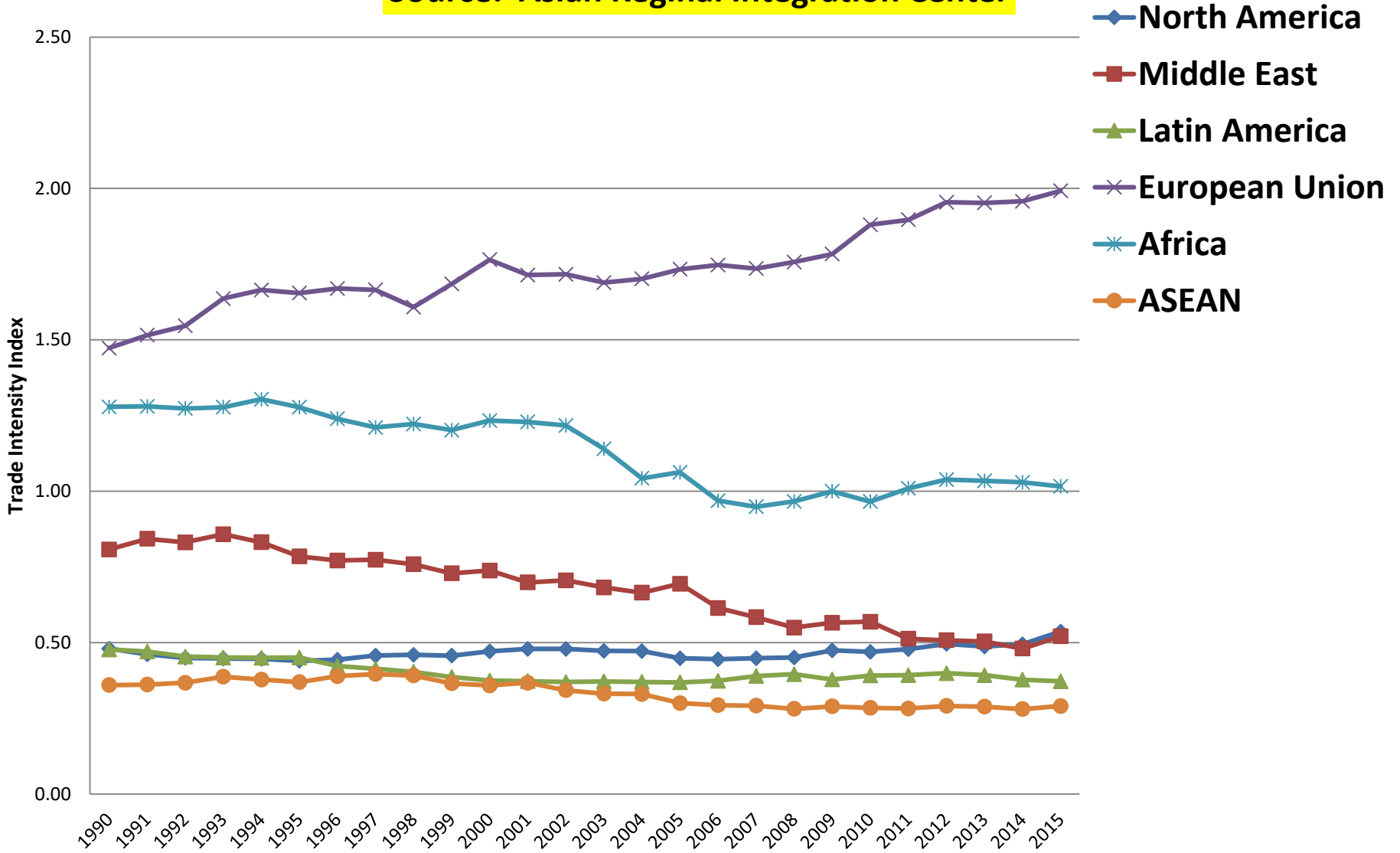
- Global trade is on track to expand more slowly than world GDP this year for the first time in 15 years, according to the World Trade Organization.
- In Asia exports are set to grow just 0.3% in 2016 in volume terms, well below the 8% average of the past 20 years.
- For poorer countries, exports have long been the most reliable way to kick-start development.
- That route to poverty reduction now looks less accessible.
- If Mr Trump keeps on slapping fearsome tariffs on Chinese goods, the fallout could easily tip global trade into outright contraction.

A TPP trade deal's demise leaves a worrying void in Asia

- Rather than a conventional focus on cutting tariffs, TPP emphasized stronger safeguards for intellectual property, the environment and labor rights.
- TPP collapse is a “body blow” to American economic policy in Asia. It is also a blow to the global economy.
- Over the years rich countries have cut tariffs to the point where the main obstacles to commerce now lie in regulations that discriminate against foreign companies.
- TPP took aim at barriers hidden in government-procurement guidelines and investment restrictions

The EU Trade Intensity

Source: Asian Regional Integration Center



Another Mega Bloc: Transatlantic Trade and Investment Partnership (TTIP)

- TTIP is a proposed trade agreement between the EU and the US, with the aim of promoting trade and multilateral economic growth.
- The American government considers the TTIP a companion agreement to the TPP.
- The agreement is under ongoing negotiations and its main three broad areas are: **market access; specific regulations; and broader rules** and principles and modes of co-operation.
- The negotiations will not be finished by 2020.

In theory and in practice

- Asia now has 147 free-trade agreements in force, up from 82 a decade ago.
- A further 68 are under negotiation.
- From the perspective of trade theory, these are suboptimal: a jumbled, overlapping mess.
- In practice, they may well be Asia's best hope for getting more goods and services to flow across borders.

A big push by Mega trade blocs to achieve structural reforms

- Vietnam had hoped to use the TPP deal to pressure sluggish state-owned companies to shape up.
- Shinzo Abe, Japan's prime minister, viewed it as part of his program of structural reforms, since it would have exposed coddled Japanese industries.
- Even in China, liberal officials thought TPP might prompt the government to loosen its grip on markets in order to join one day.

Concluding remarks

- Integrating the Thai economy with regional trade blocs can serve as an instrument to speed up **domestic reform**
- **Temporary subsidies** must be given to adversely *affected* industries to ease adjustment costs during the transition period to free trade agreements.

Concluding remarks

- Without **firm datelines** imposed by trade agreements, there would be less enthusiastic efforts to carry out difficult reform.
- Utilization of FTA provisions remain relatively low due to high marginal transaction costs imposed by Rule of Origin.
- A surge in the number of Thailand's FTA negotiations should not be interpreted as diminished **commitment** to the **multilateralism**.

Never closer union: ASEAN

- The ten countries of the Association of South-East Asian Nations banded together two years ago to launch an “economic community” that, according to its most optimistic backers, will someday rival the European Union.
- Trade is hindered by a hodgepodge of national regulations within the bloc, even as tariffs come down.
- Agreements to give special treatment to investors from other ASEAN members are still elusive.
- And rather than make it easier for workers to move across borders, several governments have added restrictions over the past year.

Never closer union: ASEAN

- The best hope for integration comes from the Regional Comprehensive Economic Partnership (RCEP), a tariff-slashing free-trade pact being pushed by China.
- ASEAN will try to project a united front but ultimately it is the big countries, especially China and India, that will determine its success.