

Regional Integration and the ASEAN Economic Community

Mr. Bhanupong

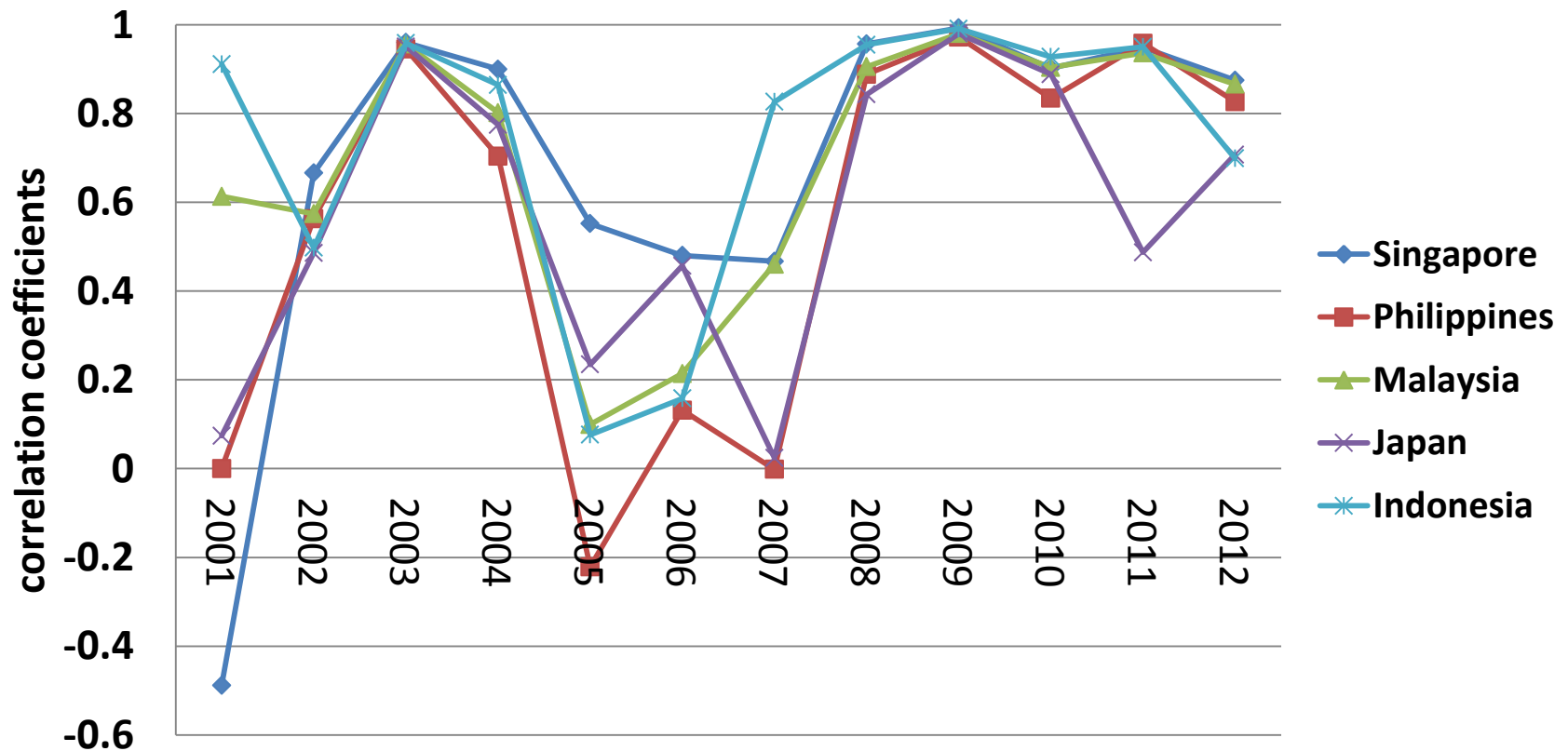
Lecture 19

Outline

- ASEAN integration: trade, investment, and capital flows
- New economic geography
- New regionalism: Multiple Free Trade Agreements
- Mega Trade Blocs
- AEC: Progress and challenges
- ASEAN Blueprint 2025

Integration indicators

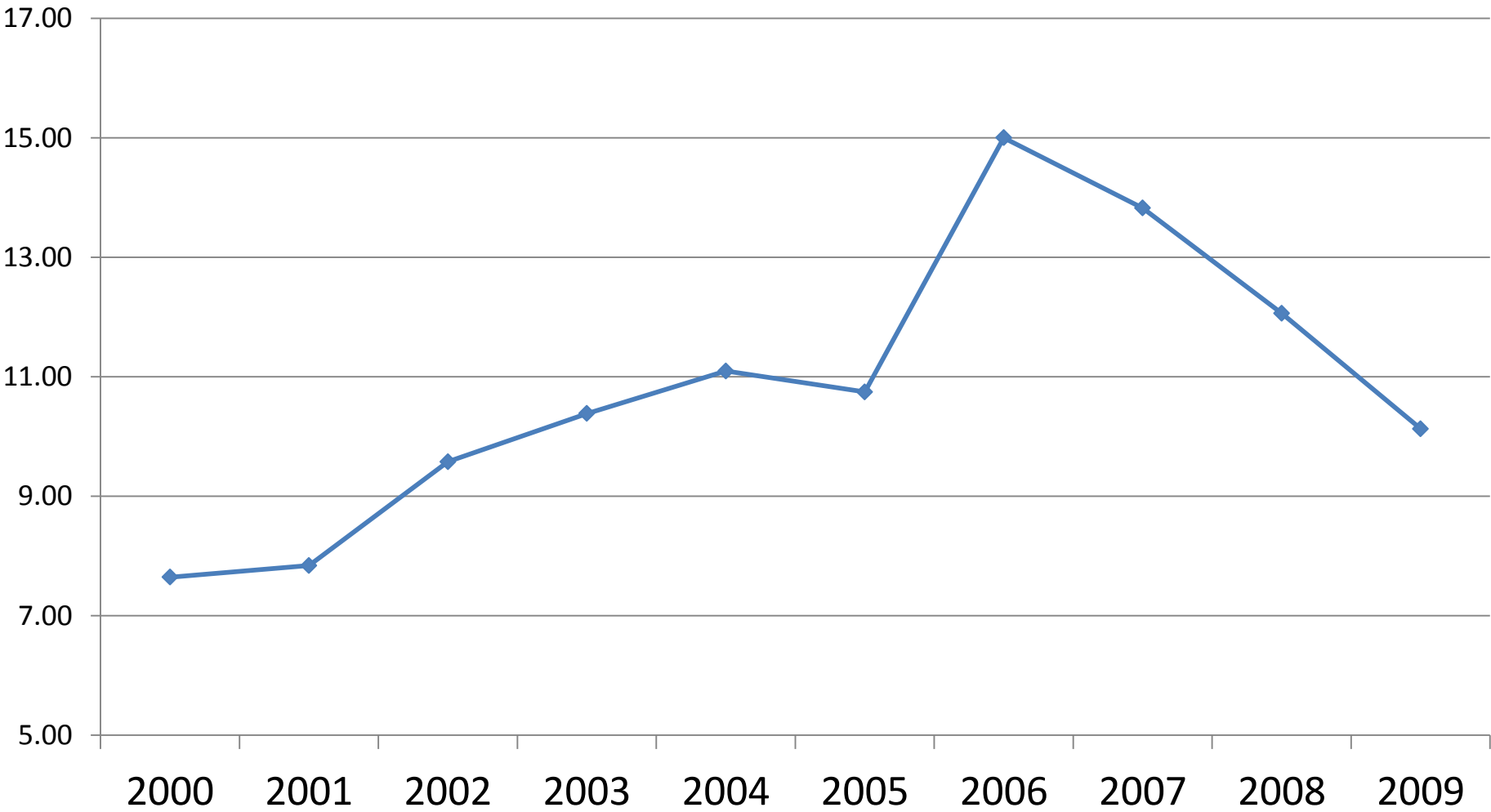
Correlation of Thailand's stock market returns



Integration through regional FDI flows

- Cumulative foreign direct investment (FDI) share is the percentage of regional FDI inflows to total FDI from the investing region beginning 1995.
- A higher share indicates a stronger preference for the region and a higher degree of integration.

**Thailand's Cumulative Inflow
FDI Share from ASEAN (%)**



Trade share

$$\text{Thailand's Asean Trade share} = \frac{X_T^{\text{Asean}}}{\sum X_T^i}$$

$i = i^{\text{th}}$ market destination

Trade share is the percentage of trade with a region to total trade of a country. A higher share indicates a higher degree of integration between the country and the region

Trade intensity index

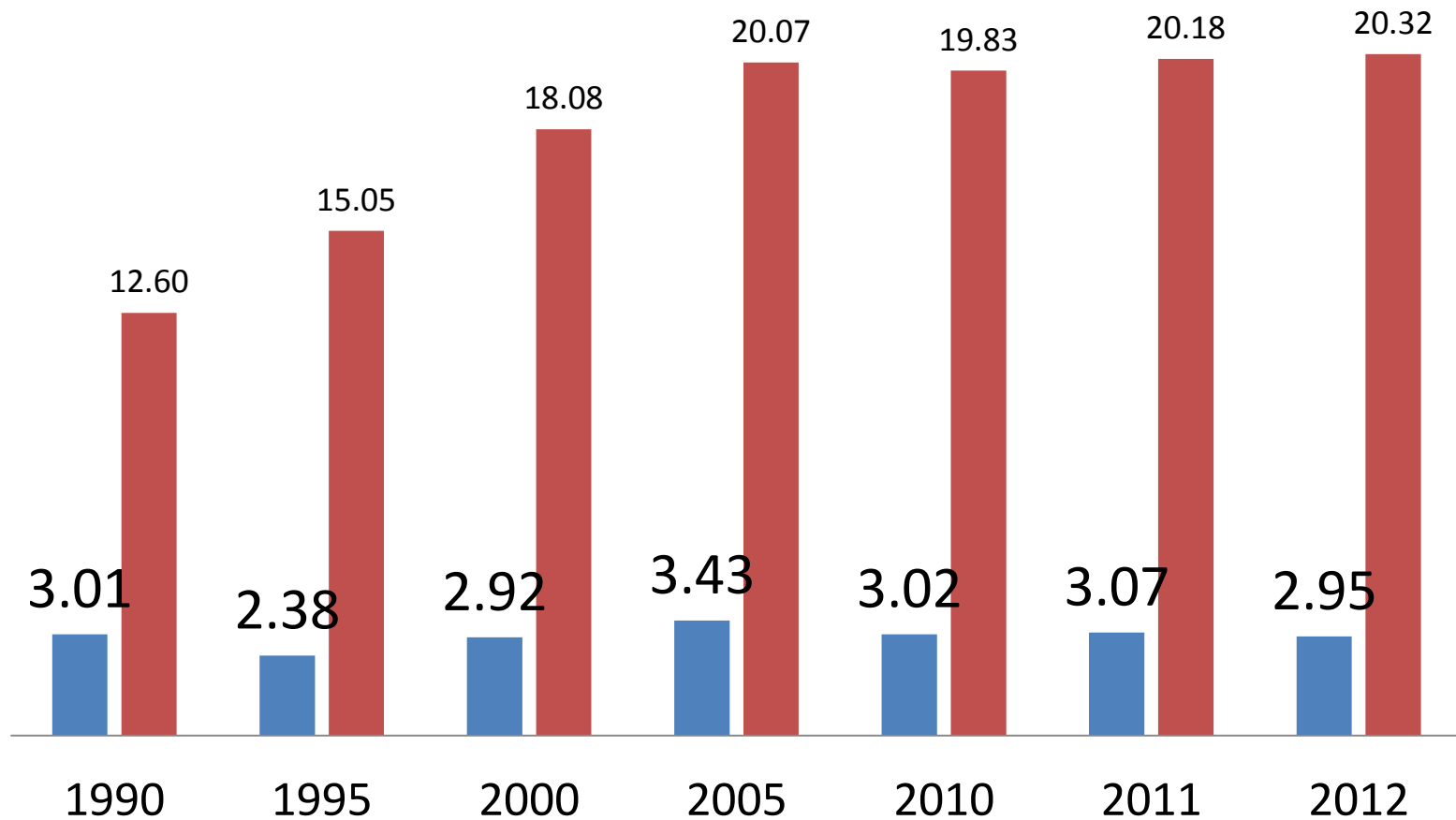
- The trade intensity statistic is the ratio of two trade shares.

$$\frac{X_T^{Asean} / \sum X_T^i}{\sum X_T^i / \sum X_{World}^i}$$

- The numerator is the country's trade share to the area under study (previous slide)
- The denominator is the share of trade of the country in the world.
- The trade intensity index 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 share.
- If the intensity index is greater than unity and rising, it means exports of the country to that region is intensifying.

Thailand: Trade with ASEAN partners

■ Trade Intensity Index ■ Trade Share (%)



Thailand's export intensity and export shares

Indicator	Partner	1990	1995	2000	2005	2010	2012
Export Intensity Index	European Union	0.52	0.4	0.42	0.35	0.32	0.29
Export Intensity Index	ASEAN	2.76	2.97	3.36	4.06	3.64	3.58
Export Intensity Index	United States	1.56	1.14	1.15	1	0.88	0.84
Export Share (%)	ASEAN	11.92	19.79	19.34	21.99	22.93	24.71
Export Share (%)	United States	22.71	16.74	21.32	15.39	10.47	9.94
Export Share (%)	European Union	23.38	16	16.3	13.57	11.18	9.43

Engaging more and more in foreign trade within the Asean region

- 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 in product fragmentation.

AEC 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 Background

- **AFTA** (Asean Free trade Agreement) 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 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 to attract FDI

- 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.

Greater Mekhong Subregion

- 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.

GMS Economic Corridors

- 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**.

On the ***North-South Economic Corridor*** (R3-through Myanmar) Chiang Rai province in Northern Thailand can be linked to Kunming in Yunnan via roads passing through Myanmar

- **Infrastructure-led growth Hypothesis**

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.

Infrastructure development and *investment creation* effect of regional integration

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

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.***

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 YLC 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.
- Examine the impact of the proposed 2.2 trillion baht investment in transportation development.

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. It has been lower since the oil price decline and low interest rates since the global growth slowdown.
- **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?
- Evaluate the 3.3 trillion baht infrastructure projects of the PC-O-C government.

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

The proposed network consists of three main routes from the northern route: Kunming, China to Bangkok

The Eastern Route via Vietnam and Cambodia; the Central Route via Laos, and the Western Route via Myanmar.

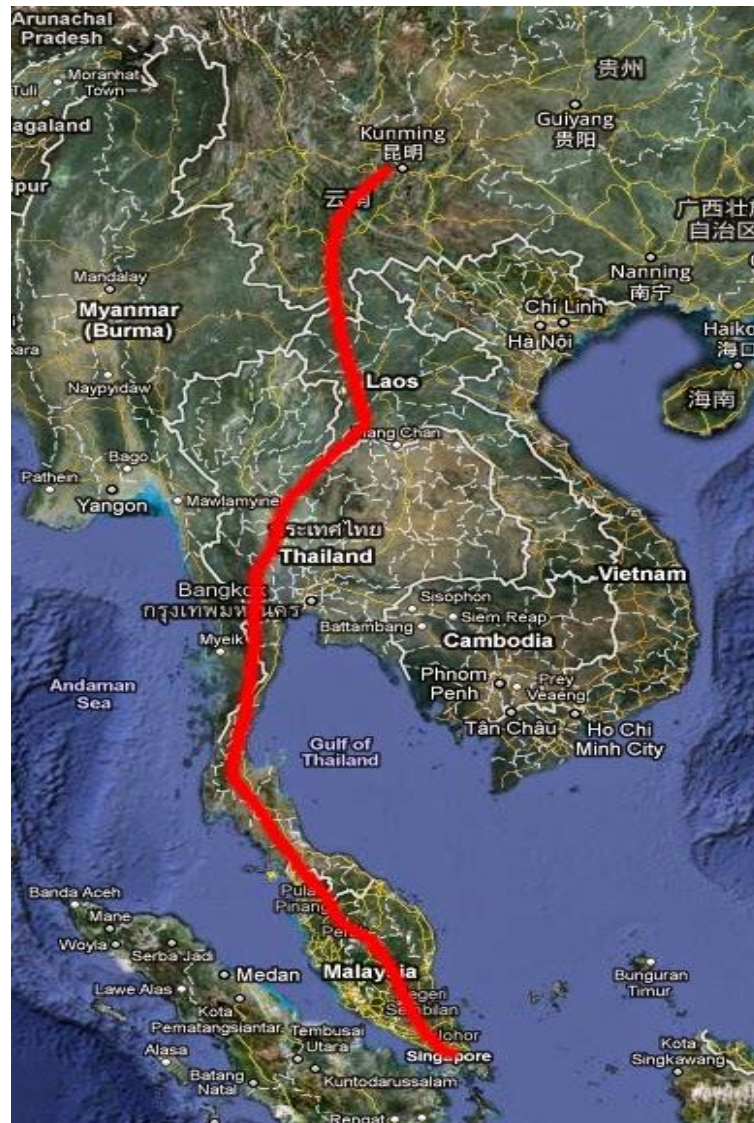
The southern half of network from Bangkok to Singapore has long been operational, though a high-speed line has been proposed.



High-Speed Train

- As of January 2014, construction of sections connecting China with Vietnam, China with Myanmar and Laos with Vietnam are under way.
- China is helping Thailand to build High speed rail starting in 2015. Laos and the Singapore -Malaysia high speed rail sections appear likely to be agreed this year with Chinese construction companies.
- [China Railway Construction Corporation \(CRCC\)](#) looks likely to win the bid for the first Southeast Asia high-speed railway line stretching from Kuala Lumpur to Singapore, expected to begin construction in 2016, Beijing-based Caixin reports.





In 2014

- General Prayut Chan-o-cha announced plans to build two high-speed rail lines as part of a 741.4 billion baht transportation program.
- The Nong Khai to Map Ta Phut line, 737 kilometres (458 mi) in length, would run from the Laotian border near Vientiane to the Gulf of Thailand. The Chiang Khong to Ban Phachi line, 655 kilometres (407 mi) in length, would run from Chiang Rai near the northern tip of Thailand to Ayutthaya just north of Bangkok.
- The two lines would allow trains to travel at a top speed of 160 km/h. Construction is scheduled to begin in 2015 and will be completed in 2021.

An example of dynamic (time) inconsistency problem

- In November 2014, after a meeting between Li Keqiang and Prayut Chan-o-cha, China agreed to lend Thailand funds to build dual-track standard gauge midspeed railways on the Bangkok-Nong Khai, Bangkok-Map Ta Phut, and Kaeng Khoi-Map Ta Phut routes.
- The loans could be repaid with rice and rubber. On December 4, 2014, the Thai National Legislative Assembly voted 187-0 with seven abstentions to approve loans for the Nong Khai-Map Ta Phut and Kaeng Khoi-Bangkok lines.
- China would undertake construction and development of the lines but would not receive land use rights along the along the routes.
- On December 19, 2014, the two countries signed a memorandum to build the railways.

Factor endowment theory of international trade

- 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 apparel, toys and footwear and capital-abundant countries such as the United States would export machinery and aircraft.
- What is Leiontief paradox?

What factor endowment theory cannot explain

- But it could not satisfactorily explain the two-way trade that was widely known to exist:
- 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 on 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.

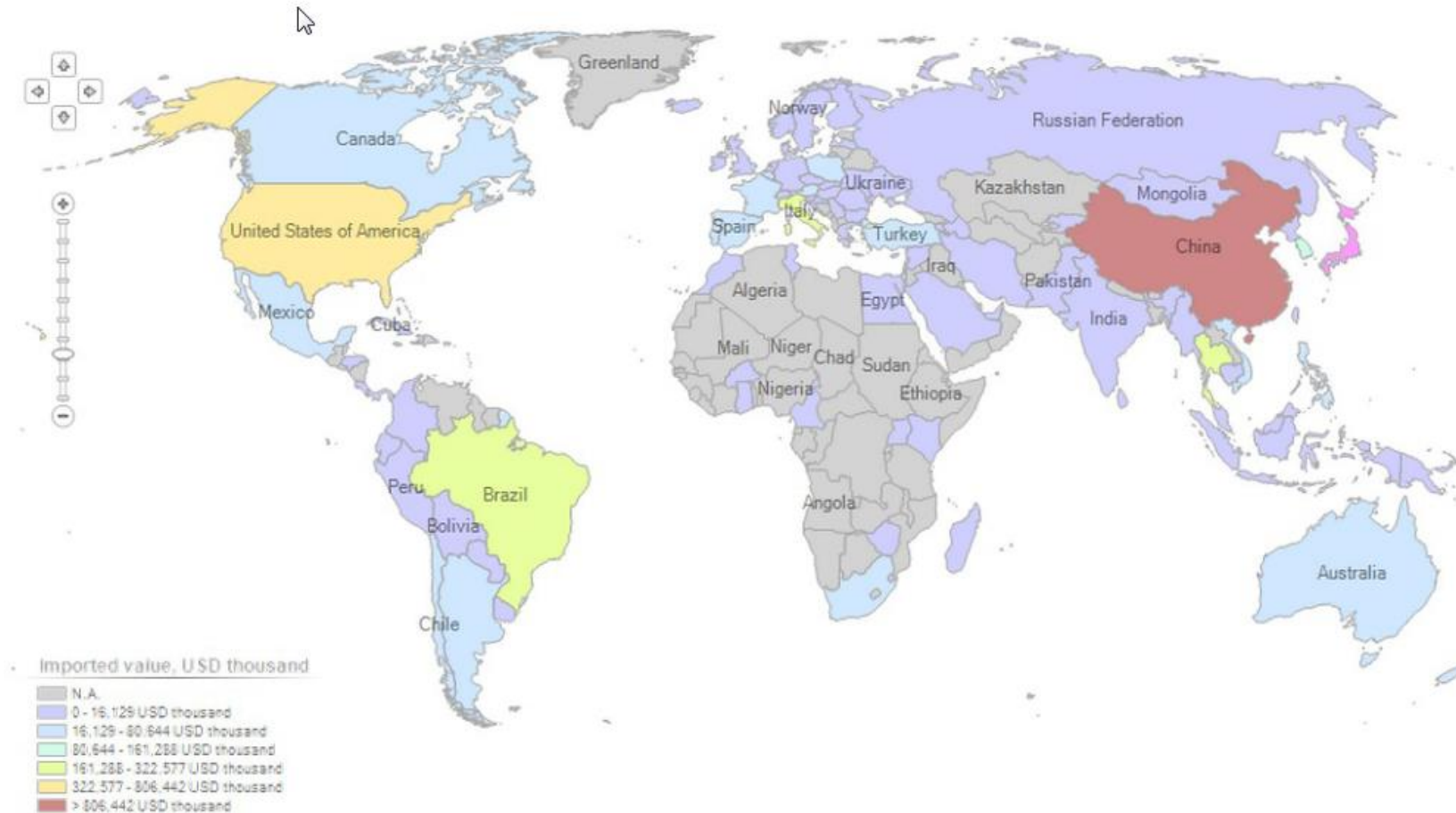
Market size and distance

- 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. Hence **the economies of scale offered by international trade matter.**
- Krugman won the Nobel Prize in 2008.
- Economies of scale explains **intra-industry trade**, while H-O theorem cannot.

Supplying markets for vegetables, fruit imported by Japan in 2013

List of supplying markets for a product imported by Japan in 2013

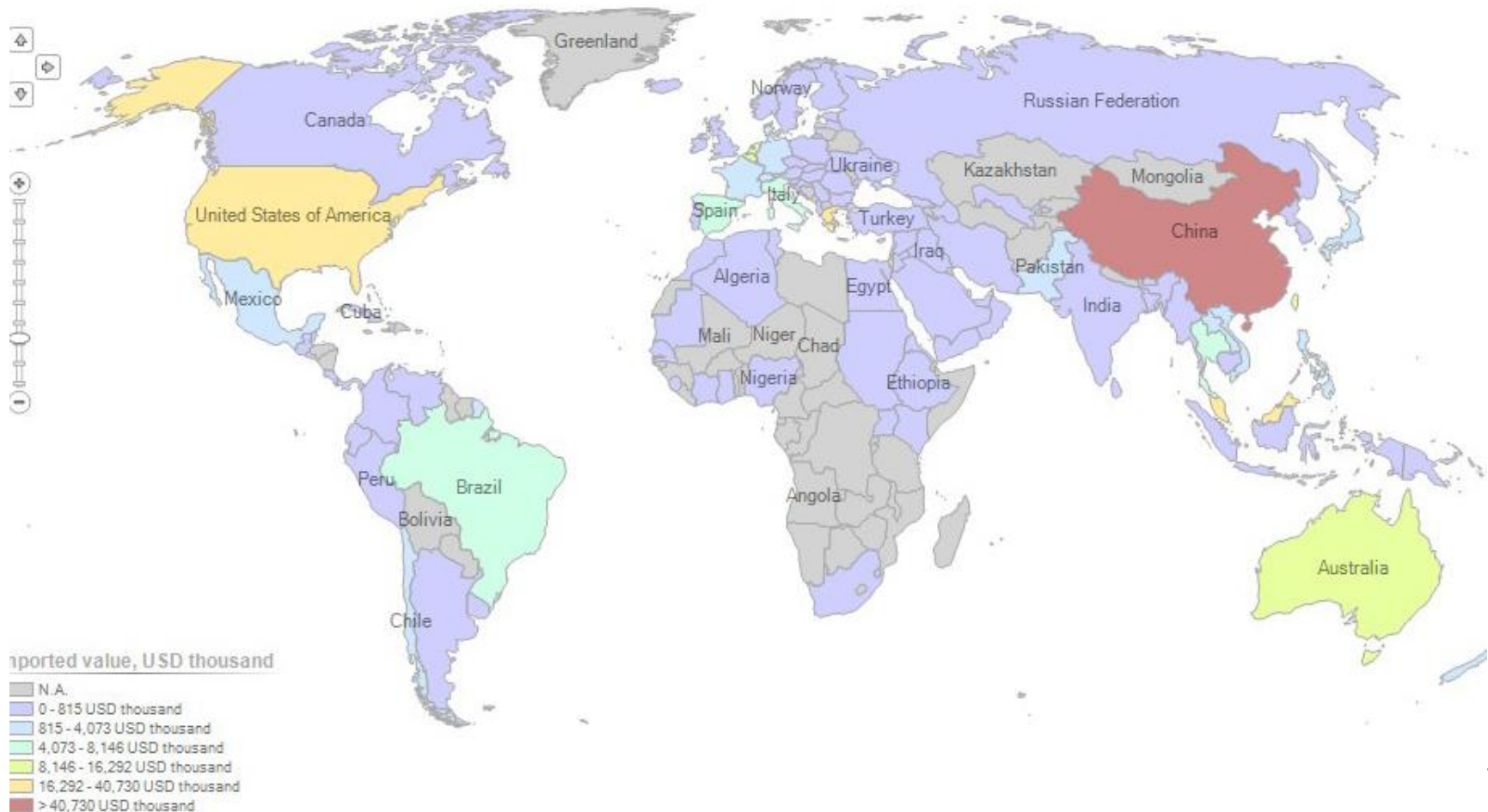
Product : 20 Vegetable, fruit, nut, etc food preparations



Supplying markets for vegetables, fruit imported by Thailand in 2013

List of supplying markets for a product imported by Thailand in 2013

Product : 20 Vegetable, fruit, nut, etc food preparations



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.

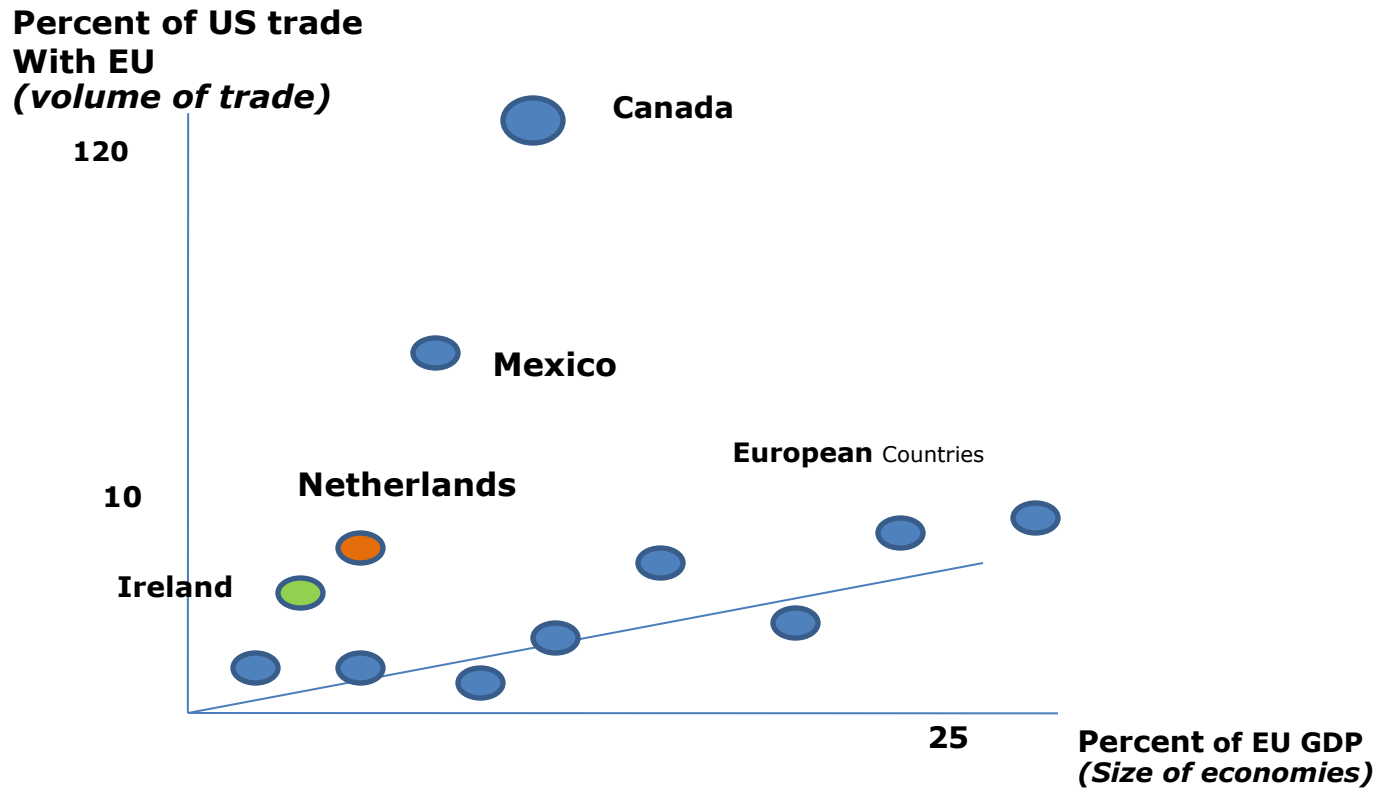
$$T_{ij} = AY_i^{\alpha} Y_j^{\beta} / D_{ij}^{\delta}$$

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

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

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

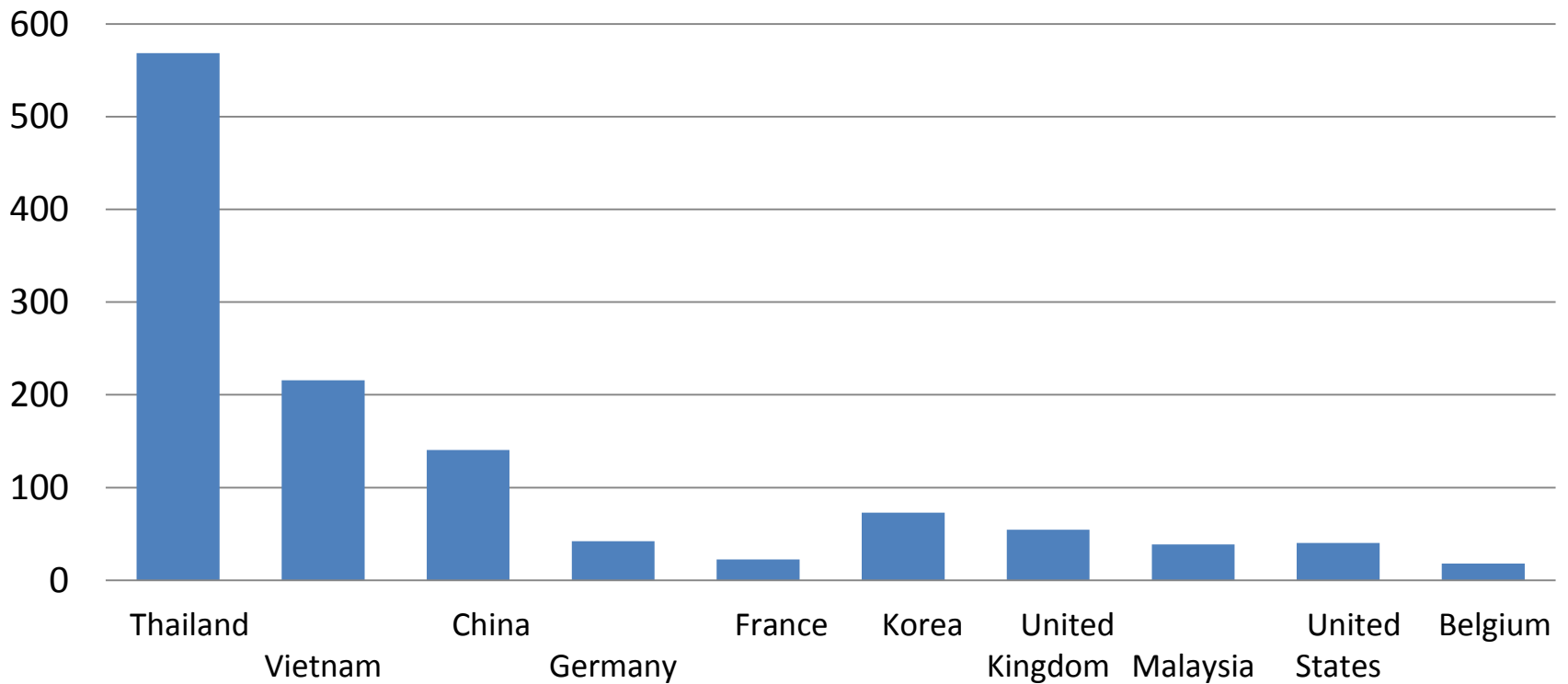
Size and distance matter for trade among nations



Distance matters

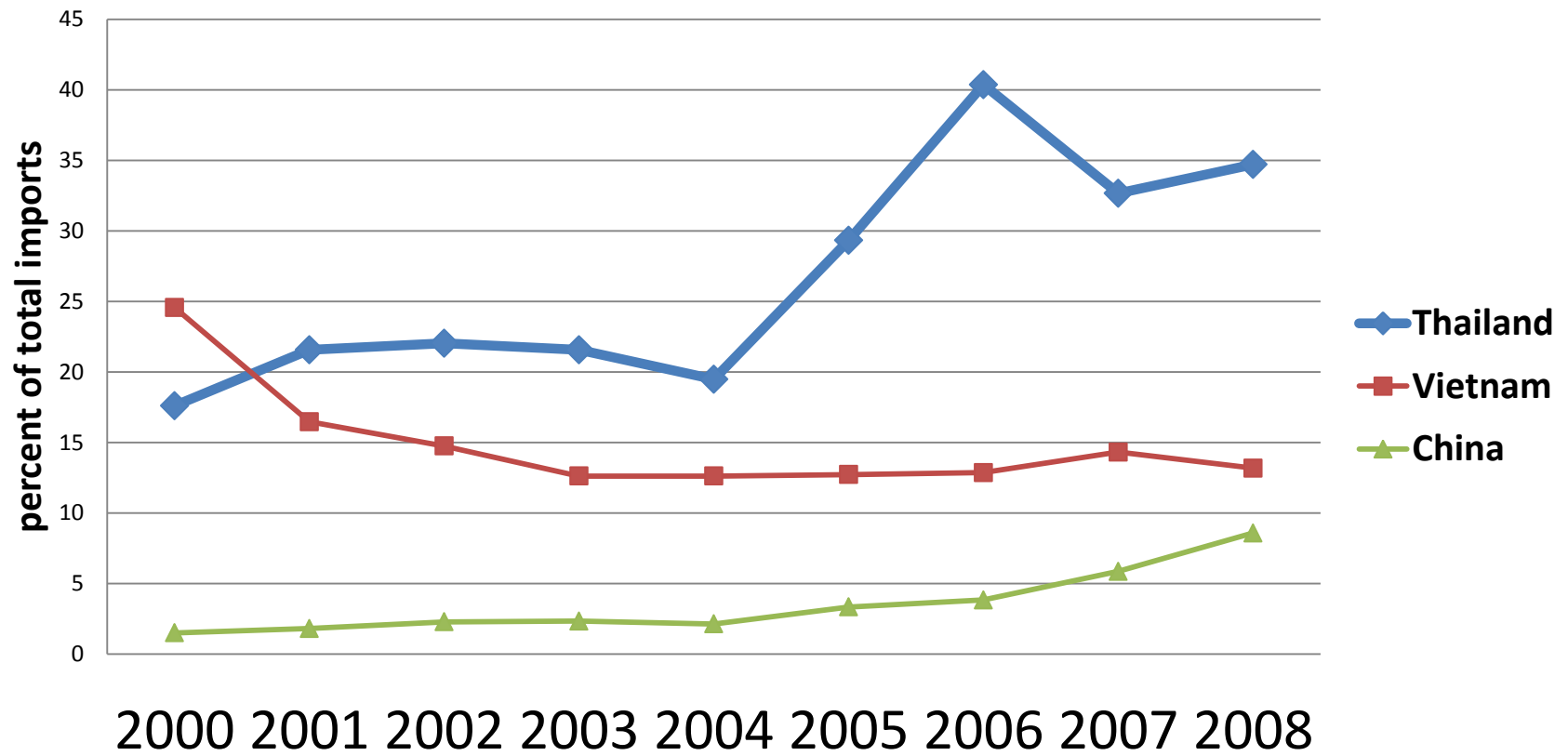
Lao's exports in 2008

Million USD



Does common language matter?

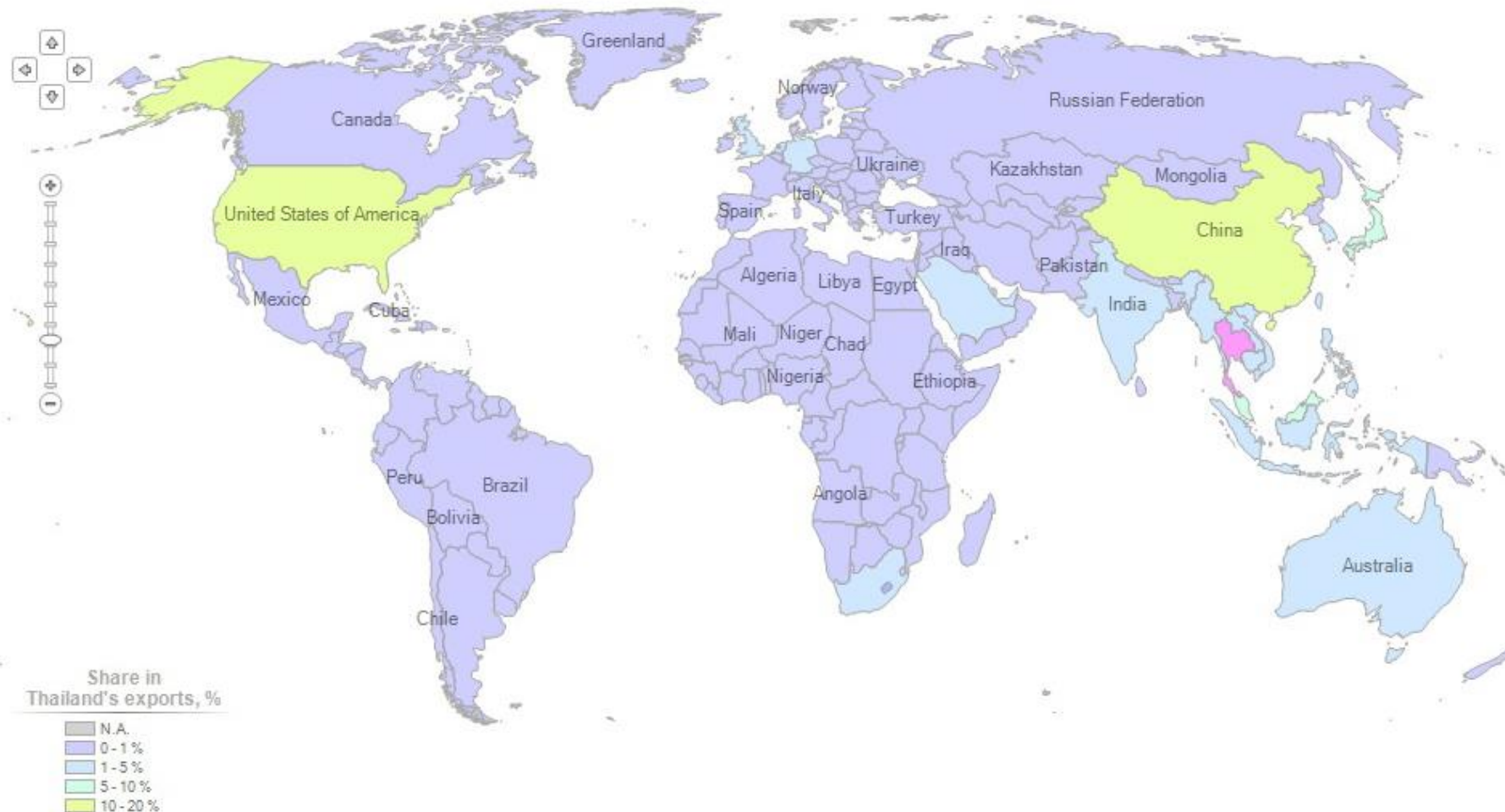
Sources of Lao's imports



Force of gravity: Thailand's export markets

List of importing markets for a product exported by Thailand in 2013

Product : TOTAL All products



Cross-border trade and its impediments

- The ***closure*** of the Thai-Burmese border checkpoint between Mae Sot and Myawaddy since early July 2010 ***cost*** traders about 88 million baht a day, according to Commerce Minister (August 8, 2010).
- Both sides must negotiate to settle the problem. Cross-border trade had suffered significantly as goods could not be transported between the two countries.
- “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

New Regionalism: 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?*

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.
- If Thailand continues to reduce **MFN tariff** rates, the cost associated with the rules of origin can also be reduced.
- The *spaghetti bowl* effect has been exaggerated.
- **Non-tariff barriers** such as Sanitary and Phytosanitary (SPS) conditions must be agreed upon to make sure that they are not substitutes for the tariff reductions.

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.

Multiple FTAs, as of January 2010

COUNTRY	UNDER NEGOTIATION			CONCLUDED		TOTAL
	Proposed	Framework Agreement Signed/Under Negotiation	Under Negotiation	Signed	In Effect	
Australia	6	1	5	0	8	20
China	8	2	4	1	9	24
India	12	4	6	1	10	33
Philippines	4	0	1	0	7	12
Singapore	5	0	9	2	18	34
Viet Nam	2	0	2	0	7	11
Thailand	6	4	3	0	11	24

Concluding remarks

- Integrating the Thai economy with regional trade blocs can serve as an instrument to speed up **domestic reform**.
- **Temporary subsidies** to adversely *affected* industries are required to ease adjustment costs.
- Without **firm datelines** imposed by FTAs, 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**.

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 for the Asian RCEP, the trans-pacific TPP, and the trans- Atlantic partnership.

Asia RCEP: Regional **Comprehensive** Economic Partnership

- RCEP (16) 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.**
- **China, Japan, and Korea are in RCEP but not USA.**
- RCEP targets removal of 95% of tariff on goods and achieve sizable liberalization in services and investment
- Special and differential treatment for CLMV.

Failure to join TPP cited as obstacle to Korean investment in Thailand

- *THE NATION*
SEOUL March 24, 2016
- **THAILAND'S** missing out on the Trans-Pacific Partnership is one of three major obstacles to Korean investment in the country, according to the Federation of Korean Industries.
- Investors from many countries are considering relocating their bases from Thailand because it did not join the US-led trade pact, Lee Seung-cheol, vice chairman and chief executive of the FKI
- Lack of technical personnel and restrictions on hiring foreign workers were cited as the other two major problems that Korean investors are facing in Thailand.

TPP: Trans Pacific Partnership with 12 members, excluding China, including USA

- Brunei, **Singapore**, Chile, New Zealand, Australia, Peru, **Vietnam, Malaysia**,
- Canada, Mexico, Japan, and **USA**
- It involves 11 % of world population, 39% of world income, and 25 % of world goods trade.
- Obama must get approval from the congress.
- Participating of mega blocs would have liberalized and rationalized their trade rules than under WTO.
- RCEP and TPP are likely to merge and consolidate into the APEC-wide FTAAP (Free Trade Agreement Asia and Pacific)

AEC Challenges

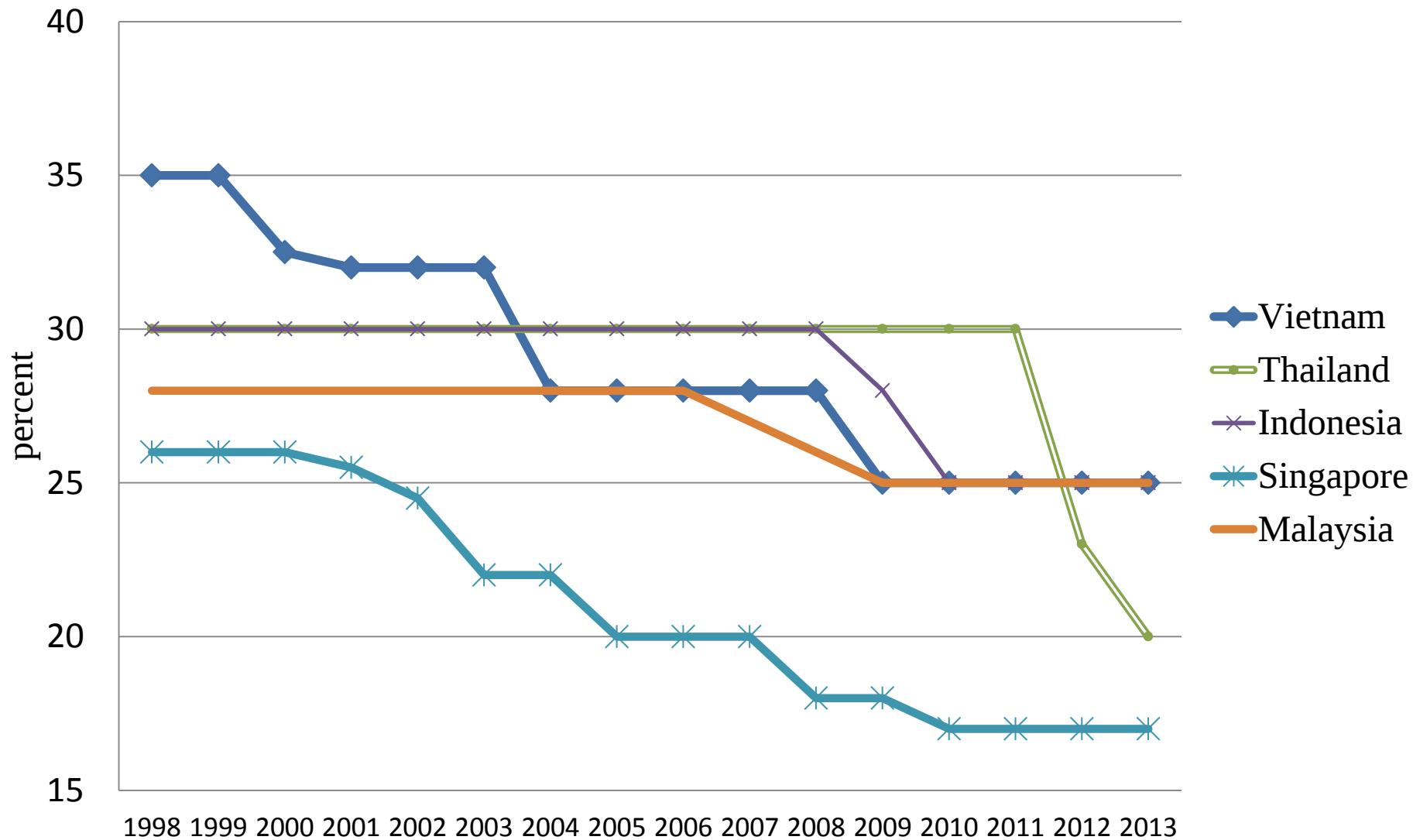
- December 31, 2015 did not see ASEAN achieving all of its AEC targets such as
- Removing barriers to trade in sensitive areas: agriculture, steel, and important services.
- Removing behind-the-border constraints related to logistics, transport, and infrastructure.
- Promoting greater labor mobility to include unskilled not just skilled labor

ASEAN Blueprint no 1.

Measures to straighten trade in good agreement, International property right, tax cooperation, ICT

- Do we still compete each other by lowering corporate income tax to lure international investors?

ASEAN Corporate Income Tax Rates



B2. Commitment to tackle remaining measures from the AEC 2015 Blueprint

- NTB Elimination: How far can we go?
- Substitution between tariff and NTB
- SPS Standards will always remain.
- How do we deal with protection in agriculture and sensitive industry?

B3. Acceleration on the harmonization of standards and of E-commerce regimes

There is still a great digital divided among ASEAN-10.

A gradual approach and ongoing process as regional income convergence is taking place.

B4. Straightening of services and financial integration

- Opening up of the protected service sector is required.
- Implications on labor and capital movements.
- Intensifying the competition of service industry.
- Do we really need free flows of capital funds within the region?
- Lesser degree of capital controls

B5. Encouragement for deeper insurance penetration

- Fundamental determinants of insurance services
- Long-term savings and better utilization of financial resources
- Efficiency rises with intensifying competition from foreign participation.

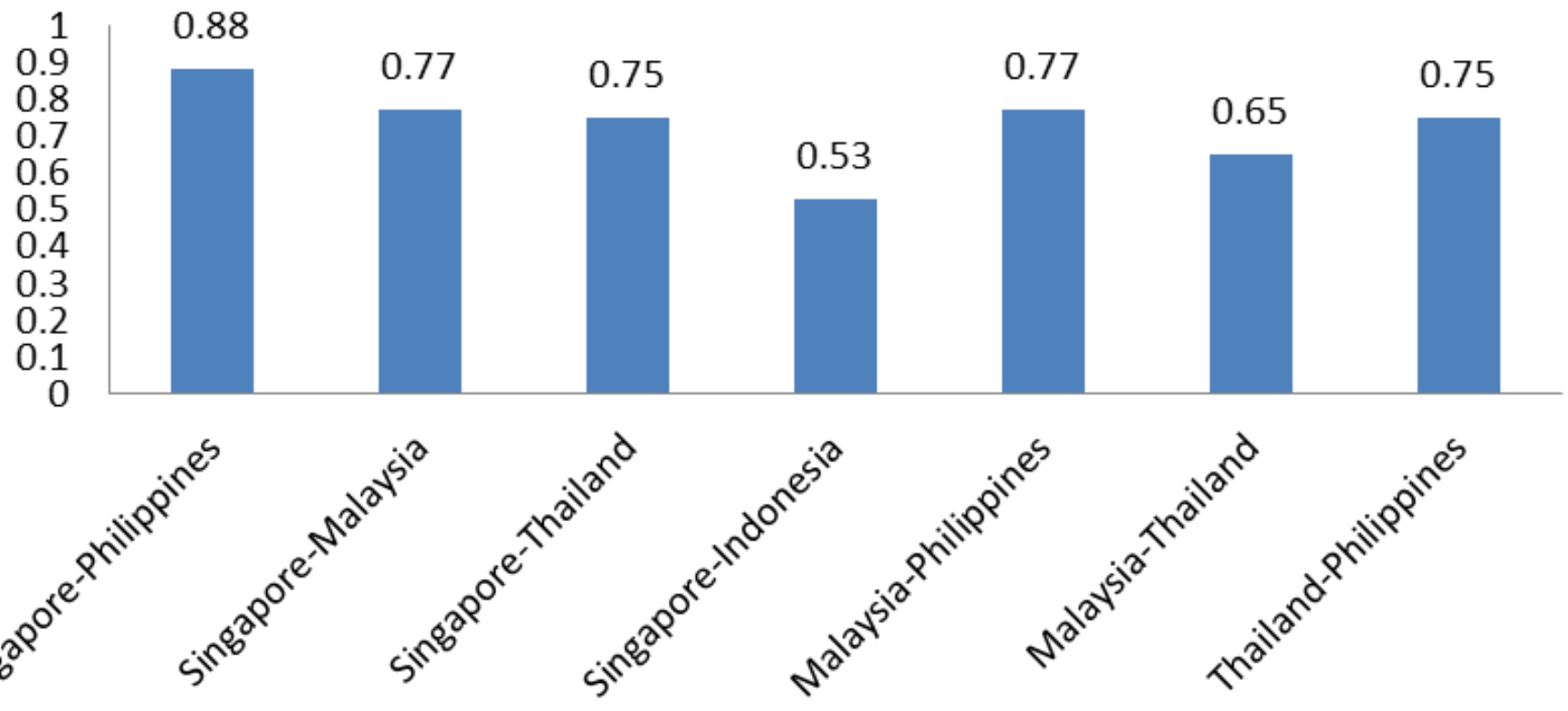
B6. Development of ASEAN wide payment and settlement systems

- Dollarization and de-dollarization
- Asian Currency Unit?
- This goal remains elusive unless regional macroeconomic stability can be obtained before 2025.

B7. Strengthen Global Value Chains, Capital Markets and Bond markets

- China factor and world business cycles
- High correlation between ASEAN and the wall street
- ASEAN Business Cycle has become more synchronized.
- More complications on stabilization policy

Growth Correlation: ASEAN-5



B8. Encouragement of competition laws and cross border policy

- The importance of service liberalization: poverty reduction and employment generation
- Efficiency vs. solvency

B9. A common ASEAN Consumer Protection framework

- The role of private sector
- Not just consumers, migrant labor must be protected

B10. Healthcare and Agri-food issues

- Public spending on healthcare: peace dividends
- Food security and grain surplus
- Falling commodity prices and the role of state

Forging Ahead Together

- “A single market and production base”
- Can investors see ASEAN as a single investment destination rather than 10 distinct economies?
- TPP vs. RCEP
- “Unity in diversification”
- Cautiously optimistic: willing to accept a step backward in order to go two steps forward