Global Economic Challenges to ASEAN Integration and Competitiveness: A Prospective Look

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ABSTRACT

This report takes a forward-looking view of ASEAN in the context of a rapidly changing world economy. It is concerned solely with ASEAN as an agreement affecting economic relations among the member economies, that is, with the ASEAN Economic Community. It focuses on issues of economic integration. Economic integration is equated to a single market which in turn is equated to the Law of One Price holding in all markets. The report explores what a commitment to the goal of a single market or complete economic integration implies. It requires the elimination of both border and beyond-the-border measures that discriminate against foreign goods or persons and sometimes too the harmonisation across borders of standards, laws and regulations that inhibit trade. The report also considers additional issues that have emerged in regional trading agreements concerning border–related transactions costs, fiscal union and monetary union. Forecasts are made regarding growth rates in the ASEAN economies, changes in the global trade environment and emerging risks. The policy implications for the ASEAN Economic Community of the goal of a single market are considered. Recommendations are made for the Vientiane Action Programme.

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ABBREVIATIONS AND ACRONYMS

AFAS	ASEAN Framework Agreement on Services
AFTA	ASEAN Free Trade Area
ANZAC	Australia New Zealand Army Corps
APEC	Asia Pacific Economic Cooperation forum
ASEAN	Association of Southeast Asian Nations
ASP	ASEAN Surveillance Process
BIMP-EAGA	Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area
BIS	Bank for international Settlements
BIT	Bilateral Investment Treaty
CARICOM	Caribbean Community and Common Market
CEPT	Common Effective Preferential Tariff Scheme
CER	Closer Economic Relations Agreement
CFA	Colonies Français d'Afrique
CLMV	Cambodia-Lao PDR-Myanmar-Viet Nam
ECCU	Eastern Caribbean Currency Union
EEA	European Economic Area
EEC	European Economic Community
EFTA	European Free Trade Area
EMS	European Monetary System
EMU	European Monetary Union
EU	European Union
FDI	Foreign Direct Investment
FP	Foreign Policy
FSANZ	Food Standards Australia New Zealand
FTZ	Free Trade Zone
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
HIV/AIDS	Human Immunodeficiency Virus/Acquired Immune Deficiency Syndrome
HLTF	High Level Task Force
IAI	Initiative for ASEAN Integration
IMD	Institute of Management Development
IMF	International Monetary Fund
ISEAS	Institute of Southeast Asian Studies
ISIS	Institutes of Strategic and International Studies
MERCOSUR	Mercado Común del Sur Agreement
MFN	Most Favoured Nation
MRA	Mutual Recognition Agreement
NAFTA	North American Free Trade Agreement
NGO	Non-Governmental Organisation
NTB	Non Tariff Barrier
NTM	Non Tariff Measure

OECD	Organisation for Economic Cooperation and Development
PPP	Purchasing Power Parity
PRC	People's Republic of China
REER	Real Effective Exchange Rate
ROO	Rules of Origin
RTA	Regional Trading Agreement
SREZ	Sub-Regional Economic Zone
TRIMs	Trade-Related Investment Measures Agreement
TRIPS	Trade-Related Aspects of Intellectual Property Agreement
UNCTAD	United Nations Conference on Trade and Development
US	United States of America
WEF	World Economic Forum
WTO	World Trade Organisation

EXECUTIVE SUMMARY

This report takes a forward-looking view of ASEAN in the context of a rapidly changing world economy. It is concerned with the future directions of economic policies in the ASEAN Economic Community, with what type of regional trading agreement it might become and what modalities it might adopt to implement future policies for the liberalisation of trade and the further economic integration of the area.

The world trading environment has been changing rapidly for the last two decades and continues to change rapidly. Two trends are apparent – globalisation and regionalisation.

Globalisation is the process of forming global markets for goods, services and factors. As barriers to the cross-border movement of goods have been reduced, there has been a steady and almost uninterrupted expansion of world trade in goods over the last two decades. Similar trends have been shown in the markets for services and for factors. The rate of growth of FDI flows exceeded the rate of growth of trade in goods worldwide until the year 2000 but there has been a downturn since then. These trends have been the result principally of lowering barriers to cross-border trade in these markets.

Regionalisation is the process of forming more closely linked regional markets for goods, services and factors. The mechanism which has brought this about is the formation of Regional Trading Agreements (RTAs).

The ASEAN countries have participated in the trend towards globalisation. Annual data of trade, measured in real terms, are available for 5 ASEAN countries. For these countries, the rate of growth of ASEAN goods trade and ASEAN services trade exceeded that for the world as a whole over the last two decades. These growth rates, however, have slowed markedly since the 1997 Asian currency crisis. In the ASEAN countries, unlike the rest of the world, the rate of growth of services trade has not been faster than the rate of growth of goods trade. Inflows of FDI into ASEAN countries during the decade of the 1980s and that of the 1990s until the Asian Crisis were well above world rates. These inflows slumped after the Crisis, but there are signs of a recovery in 2003 and 2004.

Apart from ASEAN, East Asia was a latecomer to the movement towards regionalism. Until the last few years a number of East Asian countries had eschewed regional trade agreements as they favoured MFN liberalisation; this was true of Japan, China, Korea, Hong Kong, Taiwan and Mongolia. That has ended. In addition, Singapore and Thailand have become members of more than one agreement, that is, they are hubs. The trend towards regionalisation is likely to be accentuated in the East Asian region in the future.

Economic integration goes further than the liberalisation of border trade. Three sets of policies are involved in the process of economic integration:

- border measures applying to imports into one member country
- beyond-the-border measures applying to imports into one member country
- harmonisation of measures across member countries

For goods trade, border barriers are the traditional tariff and non-tariff measures such as quotas or prohibitions or licensing. Beyond-the-border barriers are the measures that apply after goods have passed the border. These include technical barriers due to industrial, environmental and other standards, other regulations which discriminate against foreign goods and differences in tax treatment. The same distinction is made for barriers that restrict flows of services and of capital and labour across national borders.

The limit of the process of economic integration is a single market. A single market is an area in which there is no discrimination in the markets for commodities and for factors against foreign goods, services or capital and labour. Economists have given a precise definition of a single market. They define a single market as one in which the Law of One Price holds in all goods, services and factor markets. That is, there is a single price in the region-wide market for every tradable commodity and factor, expressing all prices in a single currency and adjusting for the real costs of moving commodities or factors between locations. Such an economy is completely integrated.

Economic integration is important because it increases the productivity of factors in the regional economy and, therefore, raises real incomes. It also tends to induce a convergence of prices of like products and factors and of incomes in the region. A number of empirical studies have shown these effects in the European Union, which is the most integrated region in the world economy. Empirical studies have shown that integrating economies also has a positive effect on the rate of growth over time.

The Law of One Price provides a means of determining what policy measures are required to ensure there is a single market. It also indicates to policymakers the policies that are necessary to ensure that trade flows freely and without discrimination in all markets.

The conditions necessary to have only a single price in the market area are very demanding. First, a single market requires the elimination of all border measures which inhibit the movement across national borders.

Second, after a commodity or factor crosses the border, a single market requires full national treatment with respect to taxes and other state charges and regulations.

Third, it requires the harmonisation of standards, laws and regulations across nations that prevent a single price from ruling across countries. In goods markets, these include standards for industrial products, health and safety of persons, and the environment, policies relating to particular sectors such as industry or transport, and business laws that differentiate between foreign and domestic supplies. In goods, investment and service markets, they include business laws.

Fourth, a single market requires equal taxes, that is, equal tax rates and other tax provisions throughout the area. This applies to taxes on goods and services and taxes on factors.

Fifth, less obviously, economists have come to the realisation that a single market requires a common currency. Transactions costs and exchange rate risk accompanying the use of foreign exchange markets to effect transactions imply real costs and lead to price differences.

Empirical studies have shown that measures that go beyond the elimination of all border measures, the first step, are more important than previously thought. For example, one recent study finds that, after controlling for other factors, countries sharing a common currency trade over three times as much with each other as countries not sharing a common currency.

This study measures the progress towards complete economic integration in a sample of nine regional trading agreements. For these RTAs, we have examined progress towards complete economic integration in the markets for good, services, capital and labour separately.

EU is clearly the RTA that has made the furthest progress towards complete integration. It has completed the elimination of all border measures in all four markets and almost all the beyond-the border and across-border measures. The EU has given us the term "single market".

By comparison with the EU, all other agreements have made selective progress beyond the liberalisation of border measures. The items in which progress has been made vary greatly among the RTAs. CER and NAFTA rank after the EU in terms of general progress towards the integration of the economies of the member countries. The two "New Age" agreements, the Agreement between Japan and Singapore and that between New Zealand and Singapore, are broadly similar in their pattern of progress and general level of integration. Although both have been put forward as model new style agreements, the measures they incorporate are in fact a long way from complete integration. ASEAN and MERCOSUR are the least integrated of these RTAs.

The differences between RTAs are not just a matter of different rates of progress towards the freedom of trade in the markets for goods, services and factors. They are also a matter of style in terms of choice of modalities, institutions and other general features. The two most important RTAs -the EU and the NAFTA- have very different styles. In fact, there is a new kind of competition between the EU and the US as centres of regionalisation. The EU and the US are locking those countries with which they have formed recent bilateral or multilateral agreements into their style in terms of the extent of deep integration features and the choice of modalities. In the long run, this may have a profound influence on the kind of international trade rules that emerge at both the regional and multilateral levels.

In looking to the future, some specific forecasts were made.

Per capita incomes in all ten ASEAN economies have recovered from the Asian crisis and will continue to grow at relatively high rates until 2020. However, there will be little convergence of these income levels. All CLMV countries will remain by the end of 2010 much poorer than all other richer members.

In relation to the global trading environment, the Doha Development Round will conclude in another two or three years but its achievements will be modest compared to those of the Uruguay Round and perhaps also the preceding Tokyo Round. RTAs will continue to increase in both number and in the depth of integration they achieve in all areas of the world economy. Progress towards monetary union, however, will be slow.

New risks are emerging in the 21st century. There will be increased risks to economies due to terrorism, interruptions in oil supply, more natural and technological disasters, and outbreaks of communicable diseases.

The last chapter considers the policy implications of these developments in the world economy for the ASEAN Economic Community. The landmark ASEAN Vision 2020 statement, made in 1997, declared that "we commit ourselves to moving towards closer cohesion and economic integration". It reiterated the "end-goal of economic integration as outlined in the ASEAN Vision". It then declared

> "The ASEAN Economic Community shall establish ASEAN as a single market and production base."

Thus, ASEAN has now progressed to the most far-reaching goal, that of a single market. This is a large step in the evolution of ASEAN.

However, the sense in which the term "single market" is intended is ambiguous. The Hanoi Plan of Action set the end-goal as "a free flow of goods, services and investments, a freer flow of capital". This is short of a single market in the sense of a completely integrated area in several respects. It relates only to border measures. The commitment to free flow of capital extends only to investments (presumably FDI) and there is no commitment to free flow of labour.

Further progress towards economic integration in any RTA depends on three factors

- the objective or objectives of the RTA
- the timetable or timetables for the achievement of the objective(s)
- the choice of modalities to implement the integration

The most basic of these is the choice of objective. This choice relates to the markets which are to be "single". Our preference is the choice of a single market covering goods, services and capital markets. The benefits of integrating goods and direct capital markets have been recognised in ASEAN. The exclusion of services would omit major possibilities of improved efficiency in these markets. Moreover, services are essential inputs in the production of all goods and, consequently, the liberalisation of trade in services improves productivity and competitiveness in goods markets.

The adoption of a goal of a single market should only be made in the full recognition of the changes that will be required to border and beyond-the-border measures in all markets.

The adoption of the objective of a single market will require a fundamental change in thinking. The objective of a free trade area with limited commitments to removing beyond-the-border measures that inhibit cross-border trade is a much more limited goal with no definite end-point in terms of the coverage of measures. This objective can be pursued through modalities based on consensus. However, the objective of a single market is quite definite in terms of the ultimate coverage of measures, namely, all measures required to ensure the establishment of single markets and the attainment of a single price in all markets covered.

If ASEAN is to achieve a single market in the market for goods, services and capital, many new measures will need to be adopted. ASEAN has not yet eliminated all border restrictions in trade in goods and the commitments in services are limited to those sectors where the countries have been willing to make them. Progress with respect to beyond-the-border measures in goods, services and capital markets is spotty.

With regard to the timetable, definite starting dates and end dates and timetables should be set for all countries. One issue to be resolved here is the possibility of differential dates for the CLMV countries. These countries definitely do have problems adjusting to ASEAN-initiated changes in policies as well as their own reforms and other changes to meet WTO commitments. Yet, in a single market, all member countries must make commitments to the same end-goal. While it is recognised that some countries may need more time to achieve a policy change, it is better to fix a longer implementation period and a more attenuated timetable for such countries but to then stick to that time table. Lower income countries gain access to the richer and generally larger markets of the higher income members of the RTA. Integration with other more developed neighbours with higher levels of technology, a more skilled labour force and deeper capital markets should itself assist the CLMV countries.

With regard to the modalities, experience of RTAs around the world and in the GATT/WTO shows there is wide choice. One guiding principle can be stated. The choice of modality is closely related to the objective and, in particular, to the commodity coverage of a measure. A single market requires coverage of all markets.

In goods markets, three measures warrant priority in addition to the existing efforts to reduce border and beyond-the-border measures that inhibit trade. First, the achievement of a single market requires that all tariff items be on the Inclusion List, other than GATT Article XX exceptions. Second, the rules of origin need to be reconsidered. The problem may lie in the administration of the rules. Administration should be made easier for importers. Another possibility is a waiver for goods entering under tariff items where the tariff rates in the exporting and importing country are similar. Third, a significant problem arises when producers of some product in an ASEAN country may be able to obtain raw materials and other intermediate and capital goods required for its product more cheaply than producers in another. This is inconsistent with a single market and a single production base. There are alternative solutions to this problem involving the selective reduction of the substantive tariff rates on intermediate and capital inputs to zero in countries where they are not zero or an administrative provision that lowers them to zero when the imports are used as inputs in some process that is competitive with some other ASEAN country.

In services markets, there is a strong case in building a single market for a negative list approach rather than a positive list approach; that is, all service sectors are covered unless specifically exempted on the list. A negative list should be small and the exemptions must be regarded as temporary only; otherwise, it has the same problems as a positive list in lengthening negotiations and exempting many services for a long period or permanently. NAFTA and those in the Americas that have followed the NAFTA style, and CER have successfully used a negative list in this way.

One general issue is the use of sector-based modalities. ASEAN has used this type of modality in measures affecting all four sets of markets - goods markets, service markets, investment and labour markets. Moreover, the Priority Integration Sector strategy introduced in 2003 may combine measures applying to goods, services and labour markets in these sectors. This is a sectoral view of the interaction among these markets. Thus, a sectoral approach is now a major part of ASEAN modalities in all market areas.

As a general rule, sector-based modalities are useful when there is a clear difference between sectors that requires different treatment of measures across sectors. When there is not a clear difference between sectors, it is better to rely upon modalities that apply to all sectors. For example, mutual recognition of product standards can be developed in a straightforward way for all product standards together, as some other RTAS have done. The same applies to service sectors.

A sectoral modality may play a useful role as a supplement in goods and services markets to the primary non-sectoral modalities. If a sectoral modality is used for the primary modality, as in services, or for the sole modality, as in the Priority Integration Sectors, it is essential to find a way of quickly extending the coverage to all other sectors. There should be a progression mechanism; otherwise, the sectoral coverage will remain highly selective. This is not consistent with the objective of a single market in these areas.

An additional issue in ASEAN is the possibility of developing area-wide policies to assist lower income member countries or lower income sub-regions. Our forecasts show that the incomes in these countries will converge very slowly on those in the richer ASEAN economies. At present reliance is placed on facilitation type measures. Another possibility is the type of subsidies that have been developed in the EU. The higher income members of ASEAN should also consider expanding programmes for labour training at primary, secondary and tertiary levels and additional special programmes for selected groups such as public sector employees who are to administer an expanding set of single market policies and business executives who are to trade and invest across borders.

Steps to strengthen institutions in order to ensure achievement of timelines are desirable, as recommended by the HLTF. These should include the monitoring of progress in all areas.

There needs to be an ongoing review of possibilities of new areas of integration and new modalities, as the experience of the EEC/EU has shown. New possibilities emerge as old problems are solved.

One such possibility is a monetary union. However, the experience has shown that this step is difficult. It is probably premature for ASEAN at the present time because of the large differences among the ASEAN economies in terms of the structure of their macro economies, the extent of bilateral trade, the sophistication of their financial sectors and other relevant features.

One possible initial step towards unifying the fiscal systems could be taken by unifying fiscal measures applying to multinational corporations investing in ASEAN economies. In particular, the treatment of double taxation and withholding taxes on the incomes of multinational corporations could be harmonised. This would be a useful supplement to measures integrating the capital and goods markets.

Similarly, NAFTA-style provisions for the temporary movement of business persons and possibly selected professional groups would be a useful supplement to measures integrating the capital and goods markets. This would be best done as a stand-alone agreement rather than as part of service sector Mode 3 negotiations within AFAS. The former has the advantage that it could be done speedily and for all sectors in the economy.

On the basis of these findings, we make the following recommendations.

Recommendations

We recommend that

1. ASEAN states a precise objective as a basis of the Vientiane Action Programme. The choices include
    a. a single market covering all goods, services, capital and labour markets;
    b. a single market for goods, services and capital;
    c. a single market for goods and capital;
    d. a free trade area with the removal of all border restrictions on the intra-ASEAN flow of goods, services and capital plus specified beyond-the-border measures.

    Of these options, the choice of a single market covering goods, services and direct capital markets is preferred. These three market areas are closely linked and the full benefits of integration in one area require integration in the other two market areas.

    The chosen objective of a single market in the market for some commodities or assets will give strong guidance as to the desirable measures that need to be eliminated or harmonised and the best modalities. In particular, the choice of a single market requires an equal commitment by all member countries to the achievement of a single market throughout the area.

    To be implemented, this objective must have the full support of all ASEAN Leaders.

2. Definite starting and end dates and timetables are set for all border, beyond-the-border and across-borders measures covered by the choice of objective.

3. There be an investigation of all the measures which currently prevent the free movement of goods, services and capital between member economies. This investigation should include business laws and other laws and regulations affecting corporate activities, as the achievement of a single market for goods, services and direct capital will require the harmonisation of a range of business laws that affect trade in these markets. This was the strategy adopted by the EU (or the EEC as it then was) before the adoption of the EU '92 measures.

    Such an investigation will provide guidance to the choice of measures and modalities.

4. In goods markets, the achievement of a single market requires that all tariff items are on the Inclusion List, other than GATT Article XX exceptions. All non-tariff barriers must be eliminated. There should be a detailed examination of rules of origin prior to

any reform of these rules. One possible reform is a waiver of rules of origin requirements when the tariff rates in the exporting and the importing country are similar.

5. In services markets, there be a negative list approach rather than a positive list approach and those services on the negative list be reviewed with the object of removing them. If a positive list approach is continued, a mechanism should be introduced to transfer all sectors onto the positive list.

6. Sector-based modalities be used primarily where it is not possible to design rules that are uniform across sectors. Where it is possible to design uniform rules, the primary modality should apply uniformly to all sectors but sector-based modalities can be used as a supplement to the primary non-sectoral modalities, provided there is a mechanism to ensure progression of all sectors not initially included.

7. The treatments of double taxation and withholding taxes on the incomes of MNCs be harmonised across ASEAN economies. This would be a useful supplement to measures integrating the capital, goods and services markets.

8. NAFTA-style provisions for the temporary movement of business persons, and possibly selected professional groups, be introduced as another useful supplement to measures integrating the capital, goods and services markets.

9. The difficulties of the CLMV countries in adjusting to the single market measures be accommodated by more distant end dates and more attenuated timetables for this group of countries. Once set, these timetables should be adhered to, apart from limited safeguard actions under pre-specified conditions.

   Measures to promote development in the poorer sub-regions are expanded. They should be directed both at poor regions in old members and the new members. The selection of eligible areas might be based on a level of average incomes, as in the EU. Special assistance might be granted to any economy, especially a CLMV economy, which diverges from the richer economies. This will require monitoring of growth performances.

   The higher income members of ASEAN should expand programmes for labour training at primary, secondary and tertiary levels and additional special programmes for selected groups such as public sector employees who are to administer an expanding set of single market policies and business executives who are to make business decisions in a single market.

10. A monetary union be considered at a later date when the ASEAN economies are more integrated. A monetary union may then be feasible only if done on an ASEAN-X basis or even on a small group or bilateral basis. This is because of the large differences among the ASEAN economies in terms of the structure of their macro economies, the extent of bilateral trade, the sophistication of their financial sectors and other relevant features.

11. Steps are taken to strengthen institutions. These should include the monitoring of progress for all measures in all market areas, and means to ensure that all countries keep to their timetables.

12. There be an ongoing review of possibilities of new areas of integration and new modalities.

INTRODUCTION

This report takes a forward-looking view of ASEAN in the context of a rapidly changing world economy. It is concerned with the future directions of economic policies in the ASEAN Economic Community, with what type of regional trading agreement it might become and what modalities it might adopt to implement future policies for the liberalisation of trade and the further economic integration of the area. To this end, it examines trends in the coverage and the modalities used in other regional trading agreements (RTAs), especially the latest generation of agreements. It also considers recent developments in the WTO where appropriate. These policies and changes in the world trading environment provide the background for the preparation of the Vientiane Action Programme.

This report is concerned solely with ASEAN as an agreement affecting the economic relations among member countries. It does not, therefore, examine the political, security or socio-cultural dimensions of the ASEAN Community.

The main focus is on further economic integration of the ASEAN economies. The ASEAN Concord II in 2003 declared that the end goal of economic integration in ASEAN is a single market. Consequently, this report examines at some length the meaning of a single market and what policies would be necessary to achieve it.

Section 1 outlines the trends in the world economy. It compares the trends in the ASEAN economies with those in the world as a whole, to the extent that statistics are available. It also considers the nature of the process of globalisation. Globalisation is commonly discussed but is not well understood.

In Section 2 there is a discussion of the nature of economic integration. Economic integration is equivalent to the establishment of a single market. However, the meaning of the term single market is unclear. Economists give precision to this term by regarding it as the situation in which the Law of One Price holds in all markets. The Section discusses the conditions necessary for the Law of One Price to hold in a market. These are considerably more demanding than is commonly realised. This implies that the process of economic integration will be an ongoing process with the adoption of new and more far-reaching measures. The last part of this Section is devoted to the effects of economic integration on prices, incomes and the rate of economic growth.

Section 3 looks at new issues arising from economic integration. These include fiscal union and monetary union. This section also considers the issue of competitiveness.

As regional trading agreements in different parts of the world progress towards economic integration, the rate of progress and the ways in which the economies of these RTAs are being integrated differs among the RTAs. In fact, there are distinct “styles” of integration in terms of the direction of integration and the use of modalities to achieve this integration. Section 4 examines the styles in the EU area, the NAFTA area and the CER area.

Section 5 makes some forecasts that are relevant to the evolution of the ASEAN Economic Community. These are forecasts of the rate of growth of the ASEAN economies, changes in the WTO environment and in regional trading agreements around the world, monetary unions and emerging risks.

The policy implications of the aspects developed in the preceding Sections are stated in Section 6. This includes some recommendations concerning the development of the ASEAN Economic Community. This section is designed as a stand-alone section that can be read by itself.

1. THE CHANGING WORLD ECONOMY

There is a complex two-way relationship between trends in multilateral trade policies and trends in regional trade policies. Each affects the other. Indeed, there is a constant interaction between them.

Until recently, the changes at the multilateral level dominated those at the regional level. As the attempts of the WTO to start a new round of multilateral trade negotiations stalled in Seattle and Cancún, and as the negotiation of more RTAs has gathered pace in the last few years, the relative importance of regional trade policies has grown. Yet, many of the changes in the scope of regional negotiations and the modalities used in these negotiations have borrowed heavily from developments in multilateral trade policy in the Uruguay Round.

As a background to the study of global and regional trade policy developments, it is necessary to look briefly at trends in the world economy. These trends reflect the combined influence of multilateral and regional policy changes.

1.1 Trends in World Trade

1.1.1 Trends in trade in goods, services and FDI

Figure 1.1 plots the growth of the volume of trade in goods, trade in services and world GDP over the twenty-one year period 1981-2002. These series, sourced from the WTO Statistics Database, are expressed in constant prices. Service trade is trade in “commercial services” which is less comprehensive than trade in services as defined by the four modes of the General Agreement on Trade in Services (GATS). No statistics of service trade on a GATS basis are collected currently. The series are in the form of indices, with 1980 as the base year. They are plotted on the semi-log scale and adjusted so that all series have an initial value of 100. The difference in the value of the series between two data points may, therefore, be interpreted as the percentage change over the period and the slope of the graph between any two points represents the percentage rate of change.

All three series have grown almost without interruption over the whole 21-year period. This was a period of sustained economic growth in all regions of the world economy.

It is apparent from this figure that trade in goods has grown at roughly twice the rate of growth of global output over the period; world trade in real terms increased at an annual percentage rate of about 5 per cent compared to about 2 and 1/2 per cent for world output. Consequently, more of the world’s output is exported and, since world output of goods must equal world expenditure, more of the world’s expenditure on goods is expenditure on imported goods. Global trade in services has been growing at a rate about half as fast again as global trade in goods.

These trends are not independent of each other. The continual expansion of world trade during the period has been the single most important factor in the continual expansion of real output in the world economy, though other factors have also contributed. In turn the expansion of real world output has led to increased demand for international trade in intermediate inputs and final outputs.

Figure 1.2 plots the growth in global FDI inflows and global foreign exchange turnover from 1989-2002. This is the longest period available for these series. The data were obtained from UNCTAD and the BIS Triennial Central Bank Survey respectively. As foreign exchange transactions involve the conversion of one currency into another, there is no quantity series for this aggregate. Similarly, there is no price deflator for FDI. Thus, both series are expressed in current prices. The series are plotted on the semi-log scale.

Figure 1.1 Volume of World Trade in Goods and Services and Global GDP, 1981-2002

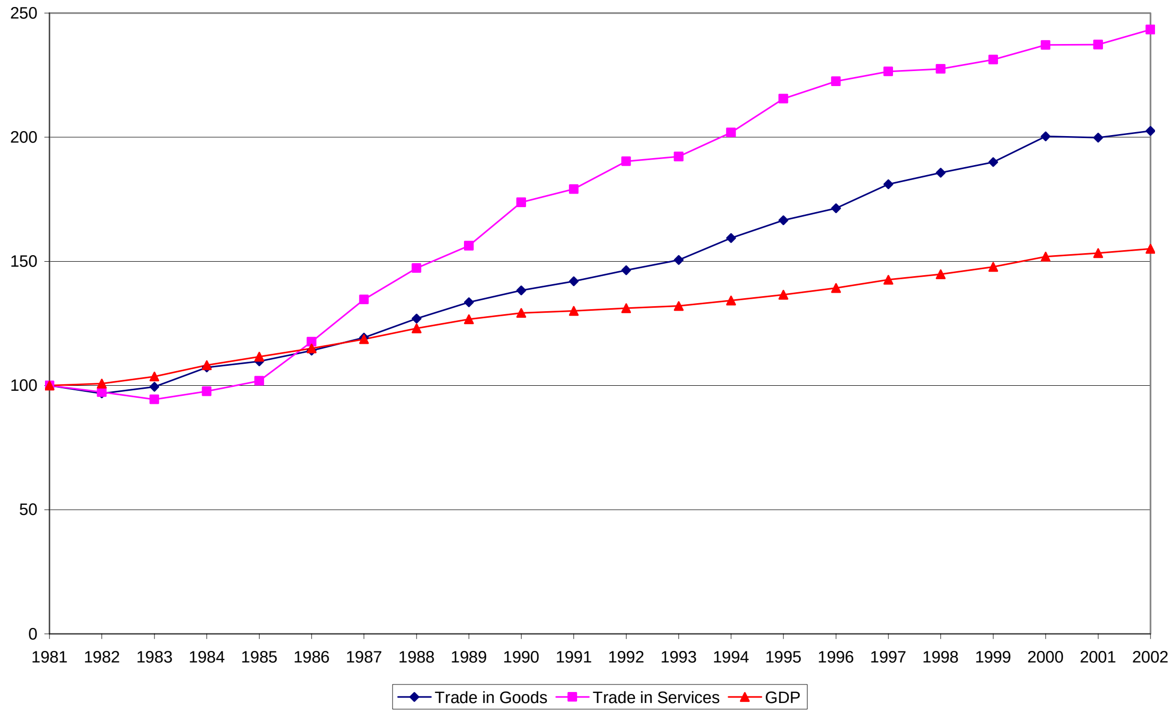
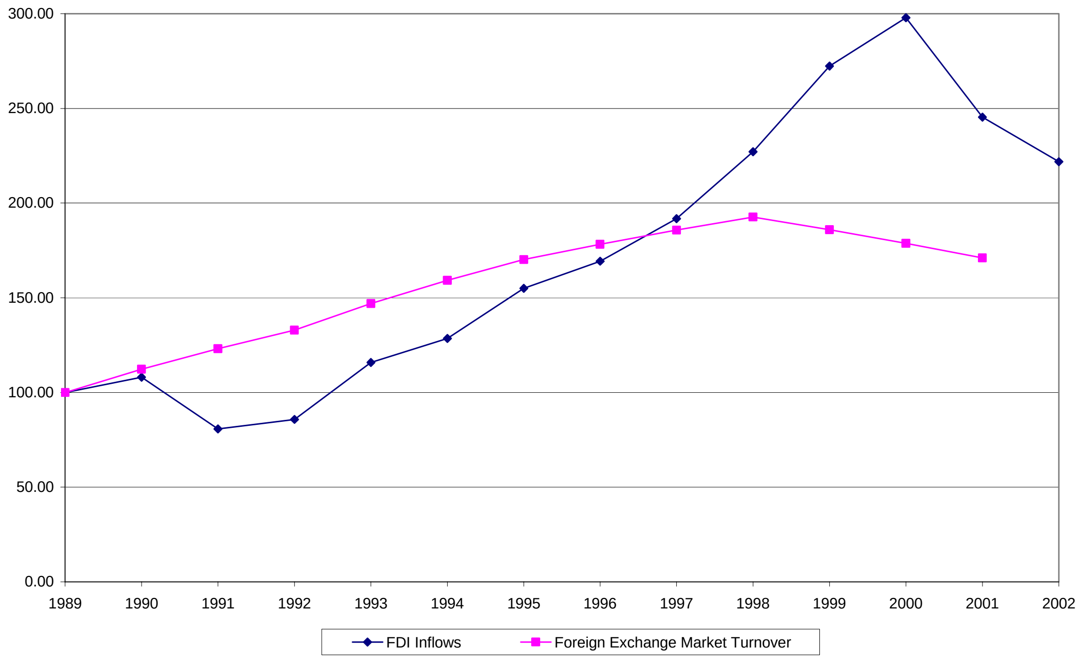


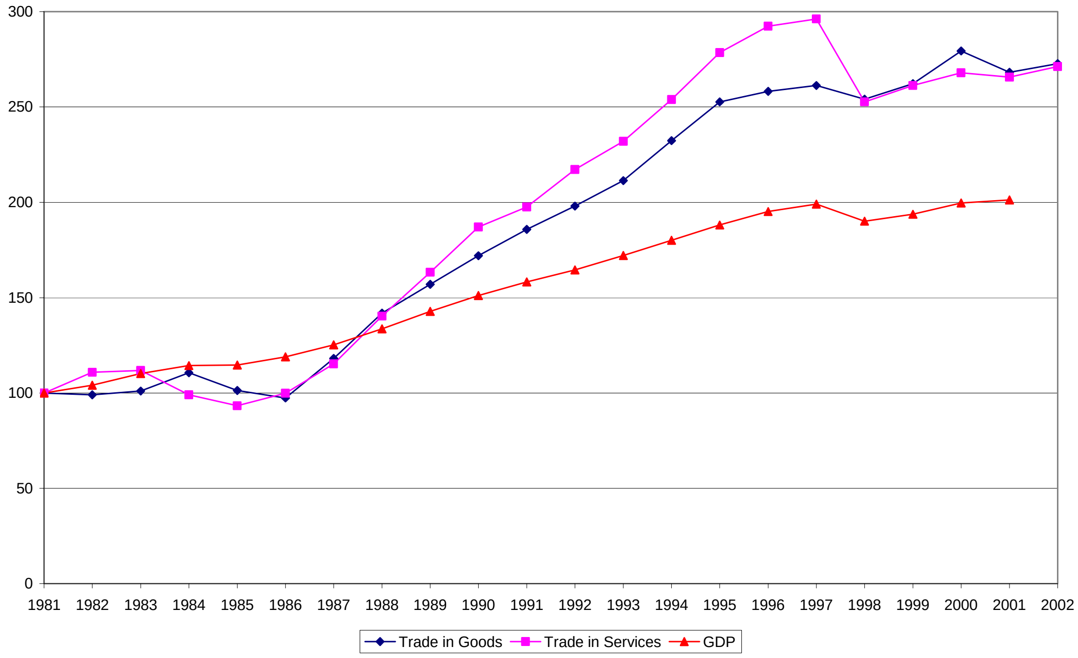
Figure 1.2 Global FDI Inflows and Foreign Exchange Turnover, 1989-2002



Again there has been rapid growth in both FDI flows and foreign exchange market turnover over the period. Average growth in global FDI inflows has been higher than growth in global foreign exchange transactions over the period. Foreign exchange transactions involve the sale of goods, services, labour and capital. As a source of demand and supply of foreign exchange, capital transactions have become relatively more important. However FDI inflows have been the more volatile series.

The striking feature of this figure is the reversal after 1997, the time of the East Asian currency crisis, of the trend of strong growth in foreign exchange market turnover, seen in the early part of the period. Similarly, there has been a sharp decline in the growth of global FDI inflows associated with the 2001 global slowdown in economic growth. This decline is much sharper and appears to be more persistent than a similar decline in global FDI inflows which occurred concurrently with the 1991 global slowdown in economic growth.

Figure 1.3 ASEAN-5 Volume of Trade in Goods and Services and GDP, 1981-2002

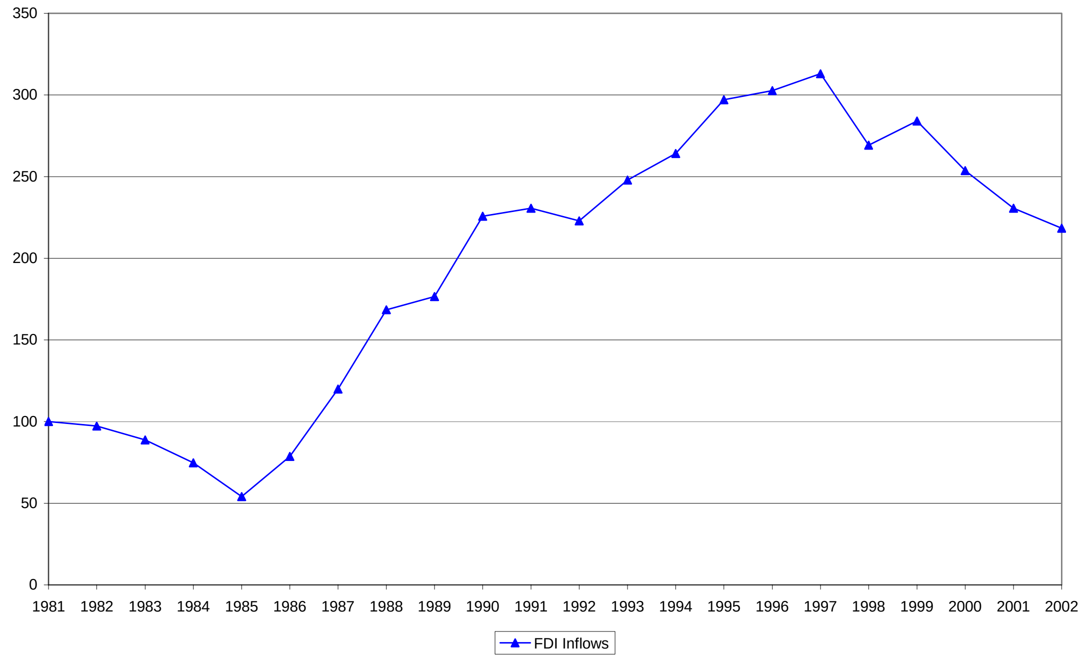


Trends in the ASEAN-5 (Indonesia, Malaysia, the Philippines, Singapore and Thailand) can be compared to those of the world economy over the same period. The trends in the ASEAN-5 are presented in Figures 1.3 and 1.4. These series begin for the ASEAN countries in 1981. The series used in these graphs were constructed by aggregating country data for the five countries from the same WTO, UNCTAD and BIS databases. No data on foreign exchange turnover are available for the ASEAN countries.

The ASEAN-5 economies have experienced higher average growth of trade in both goods and services over the period than the world economy. Prior to the Asian currency crisis, trade in services was growing more rapidly than trade in goods for the ASEAN-5. This pattern is similar to that witnessed in the global economy, although the faster growth of services is not as marked as in the world economy. However, associated with the crisis, there was a larger fall in exports of services from the ASEAN-5. This brought the average growth in trade in services over the whole period in line with that of trade in goods.

Figure 1.4 plots FDI inflows over the period. The data are taken from the UNCTAD foreign investment database. Prior to the Asian crisis, FDI into ASEAN economies had been growing more rapidly than world FDI. However, FDI inflows have been steadily falling since 1997. The negative growth experienced after 1997 has seen average growth in FDI inflows to the ASEAN-5 over the period fall below that of the world economy. There are, however, signs of a recovery in the statistics of FDI inflows in the ASEAN area in 2003 and 2004.

Figure 1.4 FDI Inflows to the ASEAN-5, 1989-2002



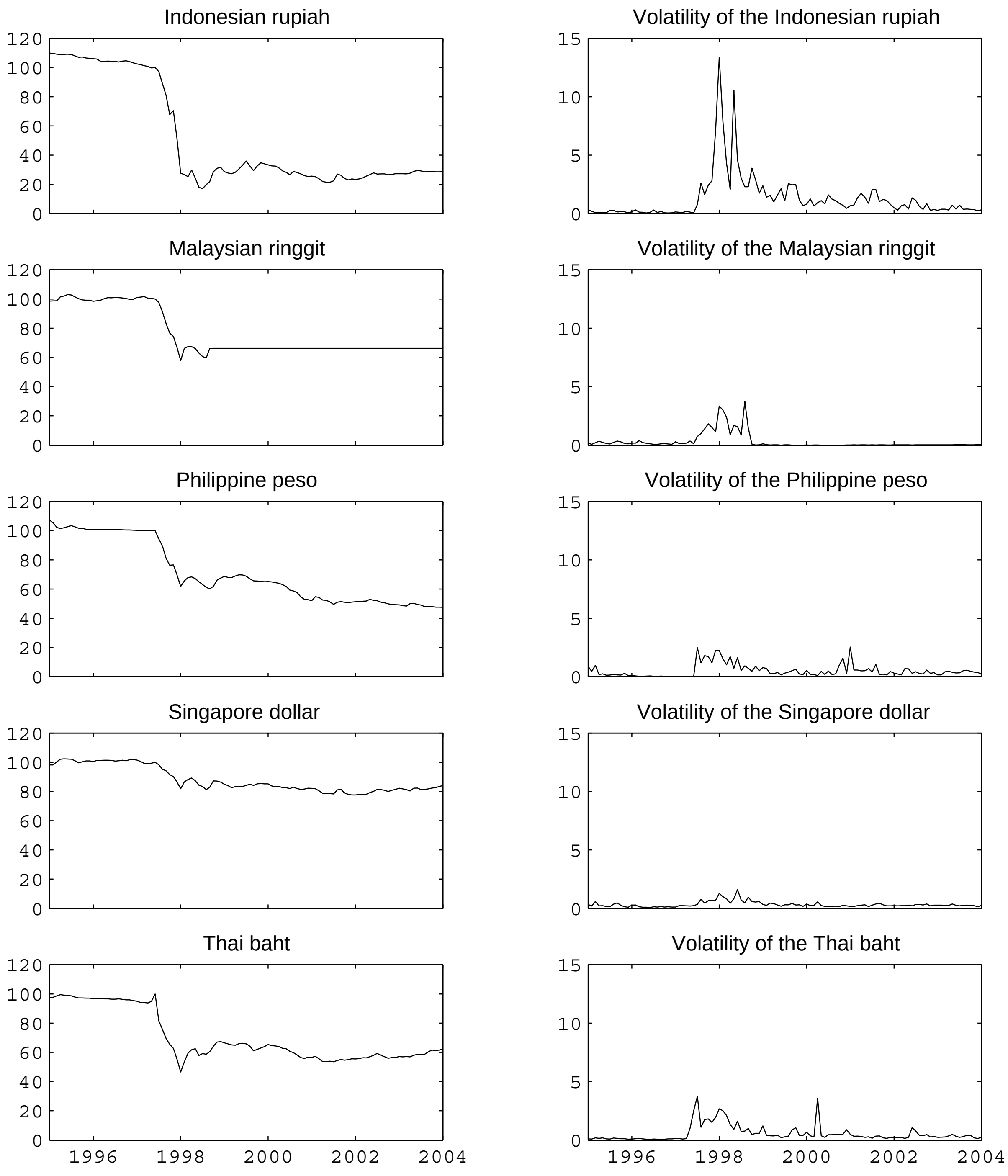
1.1.2 Trends and changes in foreign exchange markets

The most basic measure of one country's exchange rate is the nominal bilateral exchange rate, defined as the price of a unit of the domestic currency in terms of a foreign currency. Figure 1.5 presents trends in the level and volatility of nominal bilateral exchange rates for each of the ASEAN-5 economies against the US dollar for the period 1995-2004. The data are sourced from DataStream.

Monthly averages of levels of the exchange rates are plotted in the panels to the left of the figure. Each of these series is normalised to equal 100 at June 1997, the period immediately preceding the East Asian financial crisis. This normalisation demonstrates the importance of the changes in exchange rate behaviour during and after the Asian Crisis and assists in examining the extent to which these currencies have recovered in the post crisis period. The panels to the right of Figure 1.5 present trends in volatility as measured by the one month standard deviation of daily percentage changes in the exchange rate against the US dollar.

The dominant feature of Figure 1.5 is of course the 1997 Asian Crisis. For all five ASEAN currencies, there is a sharp break at the end of June 1997 in both the series for the bilateral exchange rates and the series measuring daily volatility. The bilateral rates *vis-à-vis* the US dollar plunged for all five economies within one or two months of the onset of the crisis. In terms of the magnitude of the fall, the smallest was Singapore, where the rate fell to 80 per cent of the pre-Asian Crisis values and the largest fall was in the case of the Indonesian rupiah, which fell to only 20 per cent of the pre-Crisis level.

Figure 1.5 Bilateral US Dollar Exchange Rate Indices (Jun 1997 = 100) and Their Volatility



The right-hand graphs show a great leap in volatility in the one or two years following the Crisis. The effect of the Crisis continues to the end of the period. By 2004 none of these bilateral exchange rates had recovered to their pre-Crisis levels. The volatility of all currencies dampens down, though for the Indonesian rupiah, the Philippines peso and the Thai baht volatility remains at levels well above those that prevailed in the pre-Crisis period.

These figures show clearly the lasting effects of the Asian Crisis on currency markets. The lasting effects on exchange rate levels and volatility are important for international trade in goods and services and for capital flows. Stocks and securities and other asset markets also exhibited increased volatility in the period of the Asian Crisis. Indeed, it was the flight from capital markets, together with the speculation in the currency markets themselves that induced the collapse of the currencies of five East Asian countries and the subsequent volatility of the currencies.

1.2 Globalisation

The term “globalisation” came into frequent usage around 1990 and it is now used in everyday parlance. It indicates a growth of trade between nations and a rise in the share of national output and national expenditures accounted for by goods traded across national borders, as noted above. But it is more than this. Unfortunately, it is a vague term and is interpreted by different writers in different ways.

One way of giving precision to the term is to ask what is being globalised. Different authors have discussed the globalisation of products (e.g. the “global car”), of tastes or preferences, technologies, the environment (the “global commons”) and of markets. Perhaps the most useful of these is the concept of global markets as it lends itself to analysis in terms of economic theory of the behaviour of markets. We shall take “globalisation’ to mean the formation of global markets.

Even this interpretation is not free from ambiguity. The formation of a global market for some commodity does not simply mean that the commodity is sold on the markets of all or nearly all countries in the world. This can hold and yet markets can be segmented by quantitative restrictions and regulations so that the movement of prices in one market is not translated into the movement of prices in other markets. We shall take a global market to be one in which the prices in national markets are not segmented, that is, the movement of prices in one national market is accompanied by movements in other national markets.

The globalisation or linking of markets can hold for goods markets or for markets for services or markets for capital assets and labour. All of these are important. A general interpretation of globalisation is the movement towards global markets for goods, services and for the factors, capital and labour. There has been globalisation in all four markets over the last 20 years in particular. Furthermore, the movements in these four sets of markets have reinforced each other; for example, there is complementarity between much FDI and goods trade in that an increase in the quantity of trade in goods induces an increase in the quantity of capital and *vice versa*. (See Ethier, 1996 for a discussion of complementarity between goods trade and factor trade.) This complementarity helps to explain the rapid growth in the volume of trade and factor flows noted in the previous section.

Section 2 examines in some detail the meaning and implications of economic integration at the global and regional levels. We can use the meaning of integration to give greater precision again to the concept of globalisation. The process of economic integration is the movement towards the Law of One Price in the markets for goods, services, capital and labour. Now, we may take globalisation to mean the convergence of prices in all of these markets. This brings about greater price interdependence among national economies.

This price convergence has many consequences. It brings gains from trade in all of these four sets of markets. It brings greater competition across national borders in the markets for produced goods and services. It brings greater transmission of price shocks across national borders and new problems of managing interdependent macro economies over the business cycle. It brings greater volatility in some markets, such as foreign exchange markets, and new problems of managing this volatility. It is a mixture of opportunities and problems.

1.3 Regionalisation

Regionalisation is the process of forming more closely linked regional markets for goods, services and factors. The mechanism which has brought this about is the formation of regional trading agreements (RTAs).

The formation of RTAs has exhibited clear trends in recent years. First, there has been acceleration in the number of new agreements since the conclusion of the Uruguay Round. Second, the membership of RTAs increasingly overlaps, giving rise to “hubs-and-spokes” patterns of multi-layered discrimination. These are discussed in Section 5.2.2 below. Third, the scope of these agreements is widening, including many new areas of beyond-the-border measures and other new issues such as e-commerce, investor protection, dispute settlement procedures and intellectual property rights protection.

These trends together herald a great increase in the importance of RTAs in the world trading system. With regard to market access for industrial and agricultural goods, they imply that regional lowering of border barriers has become much more important relative to multilateral lowering of barriers.

Our focus in this study is on the third trend, the increasing scope of RTAs. Many RTAs go far beyond the removal of border measures that restrict the movement across borders of goods, services and factors. Some RTAs are explicitly concerned with the integration of the economies of the member countries, not just the removal of restrictions on trade among them. To understand this process, we explore in the next Section the meaning of regional integration and how it is interacting with global integration.

2. GLOBAL AND REGIONAL INTEGRATION

Recently formed RTAs are setting precedents with respect to the coverage of instruments and policies and with respect to modalities that might be followed by other RTAs, new or old. Similar issues are arising in the multilateral trade negotiations at the WTO. This Section examines these trends. In order to give this examination a clear analytical structure, the discussion centres on the notion of economic integration and the extent to which different RTAs are progressing towards an integrated area.

The notion of economic integration is widespread but the meaning of it is unclear. Both the terminology of a single market and the terminology of National Treatment exist along side each other. The relationship between a single market and National Treatment of beyond-the-border measures is also unclear. Section 2 explores the meaning of economic integration and its relationship to the related ideas of National Treatment and a Single Market.

2.1 What is economic integration?

2.1.1 "Economic integration" = A Single Market = the Law of One Price

Taken literally, integration is a process, that is, the removal of some measures which discriminate against foreign suppliers of goods and providers of services and suppliers of factors. Two or more national economies will be *completely integrated* if all measures that discriminate against foreign suppliers are removed. The concept of complete integration provides a standard by which we can assess the extent of economic integration at any one time in an RTA, and in some RTAs it may be the stated objective of present policies. When two or more economies are completely integrated, they have established a single market.

The idea of a single market comes of course from the EEC/EU. Initially the European Economic Community created by the 1957 Treaty of Rome was a Common Market. This European concept of a common market was expressed in terms of the "four freedoms", that is, freedom of trade in goods, services, capital and labour. A Common Market required the abolition of all *border* restrictions on the movement of goods, services, capital and labour. It also required the establishment of "common policies" in four designated areas: external trade, agriculture, transport and competition.

However, the 1985 White Paper (Commission of the European Communities, 1985) identified some 280 restrictions on these movements and proposed measures to abolish all of these restrictions. The White Paper did not use the term single market. It spoke instead of a "fully unified internal market". The implementation of these measures and the associated debate soon gave rise to the idea of a Single Market. The Single European Act of 1987 formally created a Single Market that came into operation on 1 July 1987.

The Single Market is something more than the Common Market yet the concept is imprecise. The 1985 White Paper began with the statement:

> "Unifying the market (of 320m million people) presupposes the member States will agree on the abolition of all barriers of all kinds, harmonisation of rules, approximation of legislation and tax structures, strengthening of monetary cooperation and the necessary flanking measures to encourage European firms to work together. (Commission of the European Communities, 1985, p.4).

The Single European Act describes the Single Market as "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured".

The central idea of a single market is that there should be *no discrimination* according to source in the regional markets for goods, services or factors, thus creating a market that should in all respects be a single market with no geographic segmentation. It was realised that the cross-border freedoms were not sufficient for foreign suppliers to have access equal to that of domestic suppliers.

> "The elimination of border controls, important as it is, does not of itself create a genuine common market. Goods and people moving within the Community should not find obstacles inside the different member States as opposed to meeting them at the border." (Commission of the European Communities, 1985, p. 17).

The restriction of imports by measures *beyond-the-border* is usually couched in terms of the principle of National Treatment. National Treatment is the rule that a good or factor that crosses the border should receive the same treatment[1] as a like product produced domestically or a like factor with respect to taxes and charges and regulations. Is national treatment enough to ensure a single market? We need to look more closely at the notion of National Treatment.

For goods, the interpretation of this term has been given great precision by the development of the law in the GATT and later the WTO. In considering whether National Treatment has been granted to an imported good under GATT/WTO law, the WTO considers three elements: it compares "like products"; it considers all government measures in the sense of "a law, regulation, or requirement affecting their internal sale, offering for sale, purchase, transportation, distribution or use"; and it then requires that the treatment of the imported product be "no less favourable" than the treatment of the like domestic product(s). Thus, the scope of the government measures is broad. It applies if the discrimination is implicit rather than explicit, that is, there is no explicit discrimination against foreign goods but, because of some characteristic of the foreign good, it is subject to a higher tax rate. It applies even if the measures are not mandatory or if they result from actions initiated by private parties. The important consideration is that the measure has an effect on decisions of private firms with respect to the sourcing of products. Under the GATT/WTO, National Treatment has been applied to a wide range of government taxes, charges and product standards which provide discrimination against foreign goods. (For a good introduction to the GATT/WTO interpretation of National Treatment, see Jackson, 1997, chapter 8).

There are exceptions to the National Treatment rule in the GATT/WTO. The most blatant is subsidies. A subsidy paid to a group of domestic producers is a negative tax and as such subsidies should, in principle, be treated in the same way as domestic taxes. Full National Treatment requires the elimination of subsidies restricted to domestic producers. However, all subsidies were exempted from the National Treatment requirement. The second notable exception is government procurement of goods. At the time the GATT was negotiated, subjecting these measures to National Treatment was regarded as an unacceptable restriction on national sovereignty and consequently they were exempted and continue to be so. We shall use the term *full National Treatment* to cover National Treatment as in the WTO plus the areas which are exceptions in the WTO, that is, National Treatment with no exceptions.

The principle of National Treatment was not stated in the Treaty of Rome, though there was a general prohibition in Article 30 preventing members from applying "measures having equivalent effect" to quantitative restrictions. Standards relating to health and safety, the environment, the workplace and consumers were all regarded by the EC as technical barriers to trade. This term covered such areas of goods standards as chemicals, pharmaceuticals, food, and construction and construction products. However, Article 36 of the Treaty of Rome allowed derogations to protect the health and life of humans, animals or

[1] In the WTO and in many treaties, National Treatment is couched in terms of treatment which is "no less favourable" than the treatment accorded national products or corporations or persons.

plants. Consequently, there was some ambiguity and a lack of a general Community approach to these barriers to trade. (See Pelkmans, 1990). The idea of a Single Market introduced into the EU a new approach to standards, based on minimum essential standards and using new modalities such as mutual recognition.

Increasingly, it has been realised that even full National Treatment is not enough to remove all measures which inhibit cross-border trade. With some exceptions, standards for industrial products, the environment and other areas are not discriminatory; they apply equally to goods produced domestically and goods imported. However, in some cases, to meet these standards foreign producers have to modify their products. A simple case is one in which one member uses metric standards for goods sold within its jurisdiction and another uses non-metric, say Imperial, standards. Another way of expressing this point is to note that, in such cases, there is no question of a violation of National Treatment yet there is a barrier to trade. The same result may apply where there are differences in business laws. The solution to these barriers to trade may be the harmonisation across member countries of the relevant standards or laws. For some standards, we require in addition the harmonisation across the member countries of these standards. To distinguish this set of measures from the sets of border and beyond-the-border measures, we shall use the term *across-borders* measures.

Thus, three sets of policies are involved in the process of economic integration

- border measures applying to imports into one member country
- beyond-the-border measures applying to imports into one member country
- harmonisation of measures across member countries

Lawrence (1996) made a distinction between shallow and deep integration. “Shallow” integration refers to the elimination of the traditional border measures, tariffs and non-tariff measures for goods trade and other border barriers to trade in services and factors. “Deep” integration refers to the elimination of measures that are beyond-the-border. This terminology has been widely adopted in the literature on regionalism. As used by Lawrence and others, the term deep integration seems to cover both the second and third sets of measures. It is probably better to use the threefold classification as the second and third sets specify distinct modalities.

To give precision to the concept of a single (regional) market, economists have defined a single market as one in which the Law of One Price must hold in all goods, services and factor markets; see, for example, Lloyd, 1991 and Flam, 1992. (Cooper, 1976 first gave this interpretation of a single market at the global level.) That is, there should be a single price in the region-wide market for every tradable commodity[2] and factor, expressing all prices in a common currency and adjusting for the real costs of moving goods or factors between locations. This definition allows for the real costs of moving goods or factors from one location to another. Hence, a single market is synonymous with complete economic integration of the area.

This definition of a single market (or complete economic integration) can be applied to any set of countries. This may be just one country, a region comprising several countries or the whole world economy.

The establishment of a single market is much more demanding than the establishment of a common market. To see how demanding it is, we shall consider the conditions necessary for the Law of One Price to hold.

[2] Obviously the Law will not apply to non-tradeable services. Services delivered by Modes 1 and 4 are tradeable across borders. Those delivered by Modes 3 and 4 are not themselves tradeable but even here the liberalisation of these modes as in GATS will create pressures for some price convergence.

2.1.2 What is required for the Law of One Price to hold?

The conditions for the Law of One Price to hold in one market are much more demanding than is generally recognised. These conditions are relevant to regional trading agreements as they show what policies must be in place if a region is to be a single market.

The Law of One Price has been extensively discussed in relation to individual markets in the theory of spatial arbitrage for commodity markets, the literature on the nature of competition and the literature on foreign exchange markets. It is useful to begin with this discussion. It gives us a number of conditions that are additional to the straightforward removal of border restrictions on trade.

Consider a commodity market which is a national market or a part of a national market. By restricting our attention at the moment to trade within a nation, we are abstracting from international trade aspects of the Law of One Price. These non-trade aspects are more basic than the traditional focus on trade aspects.

A single market requires a competition law and other competition policies to promote competition. First, in the absence of perfect competition, markets will be segmented by having different prices in different segments of a market which will not equalise prices across segments. Second, a single market also requires full information for buyers and sellers. Positive costs of gathering information lead to deviations from the Law. If these two conditions are met (spatial) arbitrage will establish a single price within the nation, adjusting for the costs of transport between locations.

One must be careful with the definition of price. Transport takes time and some commodities require costly storage. With non-instantaneous transport and positive storage costs, commodity spot prices will deviate from the Law for One Price even if there is perfect arbitrage and no barriers to trading. The law should be interpreted in terms of the equality between the spot price in one location with the expected future price minus storage costs in another location. (See Williams and Wright, 1991).

When a single market crosses national borders other conditions are required.

A single market crossing national borders requires the removal of all border restrictions and full National Treatment with respect to taxes and other state charges and regulations. These steps may need to be supplemented by the harmonisation across national borders of standards, laws and regulations which otherwise prevent a single price from ruling among the countries. In goods markets, these standards include industrial products, health and safety of persons, and the environment, policies relating to particular sectors such as industry or transport. The laws include business laws that differentiate between foreign and domestic supplies. In labour markets, full National Treatment requires measures such as the recognition of foreign labour market qualifications. In capital markets, it requires full national treatment with respect to taxes and business laws and regulations. It implies the absence of such measures as performance requirements that apply to foreign-owned enterprises but not like domestic enterprises.

If all of these conditions are met, there are no impediments to the sale or purchase of commodities and factors imported from other countries. Perfect arbitrage will then establish a single price for a like product or factor that can be traded across borders.

In the markets for services, some services can be traded across borders; for example, international goods and passenger transport. In these markets, the Law of One Price will hold. In services markets supplied by the mode of consumption abroad (such as international tourism), the Law will hold in the country in which the services is consumed. Other services cannot be traded in a way in which arbitrage can establish one price; for example, those supplied by the mode of commercial presence. In these cases, however, there will be a tendency towards convergence of price across borders due to factor price equalisation in a single market and to competition from substitutes supplied by other modes; for example, financial services supplied by the mode of commercial presence in the country in which the consumer is located compete increasingly with financial services supplied by mode 1, across the border, especially services provided to business customers.

What does a single market imply with respect to taxes on goods and services? Here a distinction is sometimes made between a "fiscal union" and a "unified fiscal system". A fiscal union is the weaker arrangement. It does not entail a single set of taxes within the area. Rather, it entails equal tax treatment within a member country of all taxpayers in the sense that there is no geographic discrimination among member citizens or corporations paying taxes *in one country*. This is national treatment in the fiscal area. Tax rates and other provisions affecting tax liability may still be different in each member country. Thus, with respect to the treatment of domestic taxes, a fiscal union stands in relation to a unified fiscal system in the same way, with respect to border taxes, as a free trade area stands in relation to a customs union. This terminology is unfortunate as a "fiscal union" does not imply the same degree of unification as does a "monetary union". It is better to define a fiscal union as one in which there is no tax discrimination in the area defined by two or more countries; that is, no discrimination against foreigners within each country and tax rates and other aspects of tax treatment are equal across countries. We adopt this definition.

A single market certainly implies no tax discrimination. It, therefore, excludes tax breaks and other incentives which go to domestic investors but not foreign investors in the same country and the converse, tax breaks which go to foreign investors but not domestic investors. A single market also implies a unified fiscal system with equal tax rates and other provisions that determine effective tax rates.[3] It also requires no double taxation of corporate income earned in one member country and paid to shareholders in a second member country, but this is usually taken care of by a Double Taxation Treaty or a Bilateral Investment Treaty. Thus a single market goes beyond the removal of tax discrimination against foreigners in all markets. It requires no discrimination within countries plus the harmonisation of effective tax rates. Differences in tax rates across member countries may be regarded as a form of discrimination; they discriminate against agents operating in the higher tax jurisdiction. A single market requires the removal of all discrimination.

If the locations are in different countries and the bilateral exchange rates vary, one must also take account of behaviour by risk-averse agents in foreign exchange markets. It is usually assumed that a single market does not imply a common currency. However, there is substantial evidence from foreign exchange markets that, in the presence of exchange rate uncertainty and aversion to exchange rate risk, the pass-through of foreign prices to domestic markets is incomplete. (See, for example, Maloney, 1999 and Menon, 1995). Hence, there will be less than full price equalisation if two countries do not share a common currency, even if the other conditions for goods price equalisation are satisfied.

2.2 Why integration is important; an efficiency issue

A single market, or complete economic integration, is important for a set of countries because it removes all discrimination in goods and factor markets against goods and factors supplied by all producers in those countries.

[3] Alternatively, the definition of the equality of prices across countries could be stated in terms of pre-tax prices. This separation treats taxes-subsidies in effect like the costs of transporting goods between nations. Arbitrage will then equate pre-tax commodity and factor prices. However, this alternative hides the differences in prices due to non-equal tax rates.

Standard general equilibrium theory for a competitive world economy shows that integration in this sense of the removal of discrimination, with the attendant removal of all border and non-border distortions, is a necessary condition for Pareto-efficiency in the world economy, that is, for Pareto-efficient production and distribution allocations. As Ohyama (2002, p. 75) has expressed it

> "If the price of good i relative to good j is higher in the home country than in the foreign country, one may infer that the buyers' evaluation of good i relative to good j is higher in the home country than in the foreign country, or conversely, the buyers' evaluation of good j relative to good i is higher in the foreign country than in the home country. It would then be possible to increase the welfare of both countries by decreasing the usage of good j and increasing the usage of good i slightly in the home country and increasing the usage of good j and increasing that of good i by the same amount in the foreign country. This conclusion is applicable to any pair of goods irrespective of whether they are consumption goods or intermediate goods."

This argument applies equally for the whole world economy (the set of all countries) or for a set of countries in an RTA.

For a region as defined by some RTA, any tax, standard, law or regulation which discriminates at or within national borders against a like product from a member country creates an inefficiency in the relevant market. The only exceptions to a rule of non-intervention arise in the presence of externalities or public goods or other market failures. In these instances, Pareto-efficiency itself calls for an appropriate tax/subsidy based on the production or consumption of the commodities concerned in the market area where the externality occurs.

The formation of global markets for goods has increased the efficiency of national economies by allowing them to specialise in the production of goods in which they have a comparative advantage. This is demonstrated formally in standard models of international trade that assume the factor endowments of countries are fixed. In such models international trade increases the aggregate value of the output and the aggregate value of consumption in every trading country, evaluating these aggregates at world prices.

The efficiency argument extends to international trade in capital goods and the international movement of labour. If the rate of return (marginal productivity) of capital or labour of some type is higher in one country than another aggregate world production is increased by moving the factor to the country with the higher rate of return (marginal productivity). International movement of capital plays a further role in diversifying capital across countries with different risks and in the transfer of technologies.

Note that the mechanism by which international trade in capital assets and the international movement of labour improves the efficiency of the world economy is different from that in markets for goods. By allowing the factors of production themselves to move to the location in which their marginal productivity is greatest, the global output is increased. Internationally mobile factors specialise according to absolute advantage, not comparative advantage (See Jones, 2000). With perfect factor mobility the world aggregate output would be maximized but the aggregate outputs of some individual factor-exporting countries might decline.

In the case of capital movements, this efficiency argument has been put by Stanley Fischer, the First Deputy Managing Director of the IMF, in the following terms:

> "Put abstractly, free capital movements facilitate an efficient global allocation of savings and help channel resources into their most productive uses. From the individual country's perspective, the benefits take the form of increases in the pool of investible funds and in the access of domestic residents to foreign capital markets. From the point of view of the international economy, open capital accounts support the

multilateral trading system by broadening the channels through which countries can finance trade and investment and attain higher levels of income. International capital flows expand the opportunities for portfolio diversification and thereby provide investors in both the industrial and developing countries with the potential to achieve higher risk-adjusted rates of return." (Fischer, 1998, pp. 2-23)

There is a strand of literature in the EU that argues that economic integration of markets may have a further effect on productivity and efficiency that is different from the allocative effects described above. The argument is that integration in product markets itself increases the degree of competition and this increased competition lowers costs and prices and increases product diversity in these markets (see Allen, Gasiorek and Smith, 2001 and European Commission, 2002).

2.3 Modalities of global integration

While we do not have comprehensive measures of the degree of integration of world markets, the general picture is clear.

For the world economy, the WTO is based on the principles of reducing discrimination but much discrimination by country remains in both goods and services trade. For goods trade, these principles are enshrined in Article I (Most Favoured Nation Treatment) and Article III (National Treatment) of GATT 1947. Article III is a wide-ranging principle that applies unconditionally to all trade in goods (but with some exemptions, as noted). The principle of National Treatment is also applied to trade in services under GATS but here it is conditional, applying only to those services for which the member has made the commitment.[4]

The progressive reduction of border barriers to trade in goods under the GATT/WTO regime has steadily reduced price differences among countries. However, there are still many restrictions on the movement of goods across national borders in almost all countries, especially agricultural goods and some manufactures such as clothing, textile and leather goods. National Treatment is assured to all goods entering the markets of all members of the WTO, with the exceptions of subsidies and government purchases noted above, though cases continue to come forward under the Dispute Settlement procedures of the WTO which allege breaches of National Treatment. There has been no development of common standards or common minimum standards for goods markets in the GATT or WTO. Thus, world markets for some goods are still a long way from complete integration.

Under the WTO, border barriers in some service markets have been reduced since GATS came into force in 1995. However, the commitments of WTO members are still far from free market access. Many countries have made only limited commitments to National Treatment in this area of service trade. Thus, world markets for services are further away from complete integration.

World markets for labour are much further still from complete integration as all countries control strictly the movement of people, for both short term and long term purposes, and there has been little movement towards National Treatment for mobile labour.

On the other hand, the world markets for capital have become much more integrated. The literature on financial market integration has long used differences among countries in the rates of return on classes of financial assets as a measure of integration. (See the papers in Eijffinger and Lemmen, 2003). This integration has occurred despite the lack of any multilateral body with binding laws regulating capital markets. With the minor exception of measures covered by TRIMS and some aspects of GATS for financial services, the WTO does not regulate capital markets. The integration of capital markets is, unlike the integration

[4] The definition of National Treatment in GATS differs from that in GATT 1994 for trade in goods.

of goods markets, the result of unilateral actions by national governments. It has been assisted by the IMF principle of capital account convertibility; pressed by the IMF, foreign exchange restrictions on capital movements have been removed in most countries. Yet, many border restrictions on capital movements remain in some countries, especially for foreign direct investments.

2.4 Modalities of regional integration

Until recently, the EU was the only major RTA that had formally adopted regional integration or a Single Market as a goal. CARICOM styles itself as a Single Market and some Latin American agreements have followed the spirit of the EU, but these areas are still a long way from a single market. The 2003 ASEAN Concord II adopted the goal of a single market. In January 2004 the Australian and New Zealand Prime Ministers expressed an intention of creating a “single economic market” (Prime Ministers Howard and Clark, 2004).

Outside the EU, only a few RTAs have achieved free trade in goods in the traditional sense of removing all border restrictions on goods trade. Some RTAs have progressed to removing some or all beyond-the-border measures that discriminate against foreigners. Some have progressed to liberalising trade in factors. This progress is reviewed in Section 4 below.

Nevertheless, since at least 2000, it is a safe conclusion that regional integration has been proceeding more rapidly than global integration, even though we lack measures of the extent of either regional or global integration. This is the result, primarily, of the explosion of RTAs and, secondarily, of the increasing extent of integration within RTAs. The latter has come about as the commodity coverage and the depth of tariff cuts and the achievement of National Treatment move closer to free trade in goods within RTAs, and also the inclusion of provisions relating to service trade, the movement of capital and labour in more of these agreements. (See Sections 4 and 5 below.) A few RTAs such as the EU, CER and NAFTA have addressed beyond-the-border measures on a substantial scale and are progressing rapidly towards complete regional integration. The latest agreements, such as the US-Singapore Agreements and the Australia-US Free Trade Agreement, contain provisions relating to even more areas. (For a discussion of new features in Latin American agreements, see Estevadeordal, 2002, and Salazar-Xirinachs, 2002. Productivity Commission, 2003, Table A.2 lists the main features of 18 major agreements and rates them according to an index of liberalisation.)

For goods trade, National Treatment coverage has been extended in RTAs. Early RTAs, such as the EEC, the 1960 European Free Trade Area (EFTA) and the 1983 Closer Economic Relations Agreement between Australia and New Zealand, did not contain provisions guaranteeing National Treatment for goods.[5] NAFTA, signed in 1993, does, however, contain the principle of National Treatment for goods (and for investment), in accordance with GATT Article III and its interpretation in the GATT. (The Canada-US Free Trade Area, signed in 1988, contained the same National Treatment provisions.) Post-NAFTA many RTAs have provided for National Treatment for goods (and in some cases for services and investments).

With regard to the harmonisation of standards across member countries, some of the earlier RTAs did contain provisions relating to technical barriers to trade or provisions recognising the possibilities of common or harmonised policies. At the regional level, the harmonisation of laws and regulations across member countries markets has been pursued mainly in terms of the harmonisation of non-border standards and regulations that discriminate against

[5] EFTA did have a provision relating to Internal Taxation that prevented the use of internal taxes for protective purposes.

foreign suppliers or service providers. Standard examples are the harmonisation of standards such as those relating to industrial products, food, and health and safety. However, any regulatory policies used in common by member countries are candidates for possible harmonisation. The list of regulations that are being subject to provisions in new RTAs continues to grow.

An example where harmonisation of laws and regulations is becoming more important is competition policy. A small number of RTAs have embarked on the harmonisation of competition polices. (Lloyd, Vautier and Crampton, 2004, review the meaning and difficulties of harmonisation of competition laws with emphasis on countries in the Asia-Pacific region.) The most notable are the EU and CER. In both cases, the harmonisation measures relate to competition law, which is a subset of competition policies.

Harmonisation of competition law is a particularly complex area because of the many elements of the law. In each of the countries, one must consider the objectives of the law, the scope of the laws with respect to enterprises or persons and their activities covered by the law, the methods of analysis, remedies, and the operation of the competition authority. Complete harmonisation of competition laws means the adoption of common standards, that is, commonality with respect to coverage of business activities, objectives, tests of market behaviour, penalties and other remedies, and other aspects of the law. No RTA has achieved this. The EU has a common law but it applies only to those business activities which have EU-wide implications. Activities that do not have EU-wide implications are subject to the national competition laws of the member countries. National laws differ among the countries, though they are increasingly incorporating elements and principles of EU law. There are special difficulties for harmonisation of competition law if one or more members of an RTA do not have a pre-existing competition law at the time of the formation of the RTA. In such cases, one of the provisions of an RTA may be that all members have or introduce basic competition law. This was the approach in NAFTA chapter 15 with regard to Mexico.

One of the problems of administering competition law in any country is the difficulty of enforcing a law relating to some anti-competitive business practice when the producer/seller resides in another country. For example, a foreign seller may be party to a cartel or market allocation arrangement. If the seller has no commercial presence in the country, it may be difficult for the authority to prosecute the seller successfully. Most countries follow the legal doctrine of territoriality under which a country may exercise its jurisdictions over all persons, whether local or foreign, within its territory but it has no authority to pursue persons outside the jurisdiction.[6] This limitation of legal action to persons within the jurisdiction might be regarded as a form of discrimination, albeit one which favours the foreign seller in this instance. The competition authority of the country in which the producer/seller resides may practice positive comity[7] towards the competition authority of the country wishing to take action; for example, it may prosecute the party in its home jurisdiction. Comity is designed to improve the prospects of prosecution in such instances. Essentially it makes foreign sellers in a domestic market subject to the same laws as domestic sellers.

Other areas of business law are being incorporated in the harmonisation of regional policies. These include securities law, corporation law, and intellectual property rights. In principle any area of business law is a candidate for harmonisation. Most of these areas relate to goods markets but some concern capital markets; for example, securities law. Labour market standards may also be harmonised.

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[6] Some countries, notably the US and the EU, follow a doctrine of extraterritoriality that enables them, in some circumstance, to pursue persons outside the home jurisdiction. However, there are major legal difficulties in seeking to prosecute persons residing outside the home jurisdiction.
[7] Positive comity refers to an agreement between countries allowing the government of one to appeal to the government or authorities of another country to investigate and, if necessary, to take action under the competition laws of that country against a person resident in the second country.

In contrast to the literature on economic integration, the literature on harmonisation tends to emphasis that harmonisation of any standards or policies should not be regarded as an end in itself. (See the papers in Bhagwati and Hudec, 1996. This was one of the first general discussions of the economics of harmonisation.) Harmonisation should be adopted only if it confers net benefits on the countries concerned. In fact, in the general literature on harmonisation, there are two opposing views, one favouring policy harmonisation and one favouring competition among jurisdictions; for example, the literature on tax competition versus the tax harmonisation (see, for example, Genser and Haufler, 1996 and Sykes, 2000). The strand of the literature which questions the economic benefits of harmonisation focuses on the difficult problem of determining the optimal standards. Differences in national circumstances and priorities may dictate differences in national standards. It is also difficult for members to agree on the single standard: should this be the standard of one of the members or new agreed standards?

These views are reflected in the many approaches to harmonisation. Harmonisation can mean common standards, that is, a single area-wide standard. But it can also mean minimum standards. The EU 1992 measures introduced another approach based on the mutual recognition of each other country's standards. The EU used this approach for some product standards and for labour market standards such as the recognition of labour market qualifications. Mutual recognition has the considerable advantages of allowing each nation to retain its own national standards and thereby avoiding negotiation of common or minimum standards, and requiring little bureaucracy and enforcement via courts. National Treatment is achieved by the mutual recognition of the distinct national standards.

With several approaches, harmonisation is best described as a convergence of standards rather than the establishment of single standards.

2.5 The long run effects of integration: convergence of prices and incomes

2.5.1 Convergence of prices

Integration of markets has a direct and short run effect on prices. As already noted, it tends to induce a convergence of prices for like products, or, to put it the other way around, a reduction in price dispersion. This holds for all markets, those for services and for factors as well as product markets.

There have been studies of *goods price* convergence in global goods markets. Some of these have been couched in terms of whether the Law of One Price holds.

Evidence for goods price convergence can also be got from cases of regional integration. For the EU, there have been attempts to measure the convergence of goods prices. Flam (1992, pp. 10-12) noted that there was still significant price dispersion among consumer goods in the EU countries. The European Commission (2001) found that there had been convergence in European prices since the formation of the EEC/EU and measures of price dispersion in the EU were now stable but not zero. Price dispersion in the EU was still considerably greater than it was in the US. Many European economists believe that the achievement of monetary union in the EU at the beginning of 2002 will result in a reduction in price dispersion, that is, in a convergence of prices. This may come about from increased transparency of prices for buyers, reduced transactions and search costs, and increased competition. Surprisingly, Engel and Rogers (2004) find no evidence of consumer price convergence in the period 2000 to 2003 after the adoption of the Euro, though they do find significant convergence in the decade of the 1990s.

McKinsey (2003, chapter 3) surveyed consumer prices for a sample of 70 food/beverage, personal care products and consumer electronic products that are representative of consumer expenditures in these areas in the ASEAN-5 countries in 2002. They found that price differences in ASEAN in 2002 were almost double those of the EU in 1985, before the Single European Market programme was introduced.

Integration of markets has a further indirect effect on prices that comes about because of the connections between *goods* prices on the one hand and *factor prices* on the other. Suppose there is a convergence of goods price throughout the world as a consequence of the liberalisation of international trade in goods but there is little or no liberalisation of international trade in labour and capital. The advantage of the notion of a general equilibrium for the world economy is that it enables us to trace the effects that convergence of goods price will have on factor prices since all prices are determined simultaneously in the equilibrium. With perfect competition, complete integration of product markets (the Law of One Price in all product markets) will lead to the complete equalisation of factor prices, even if all factors are completely immobile between countries. This is the factor price equalisation theorem. This result requires either an additional assumption of identical technologies in all countries or a condition that factor endowments are not too dissimilar between countries (see Blackorby, Schworm and Venables, 1993 for the necessary and sufficient conditions for factor price equalisation). If technologies or endowments are sufficiently dissimilar, factor prices may even diverge as goods trade is freed.

While the assumptions of identical technologies and similar endowments are unrealistic, this theorem is highly suggestive in indicating the strong connection between goods market prices and factor market prices. Under the conditions sufficient for factor price equalisation, if goods prices converge but are not equalised, there will generally be a convergence of factor prices if the differences between nations which cause international trade are in factor endowments rather than in technologies (see Falvey, 1999). These results suggest that the liberalisation of goods markets under the GATT/WTO, aided by regional and unilateral liberalisation, may have caused some convergence of the rates of return on capital and of wage rates in world markets but the overall picture is unclear because recent studies of the causes of comparative advantage have found substantial technology differences. In the case of capital markets and markets for some highly mobile professional labour, there will have been direct convergence in these global factor markets.

Over time whether factor prices converge or diverge will depend on changes in technology and other factors which determine factor productivities, as well as upon the degree of freedom of trade in goods and factors. If poorer countries have a greater increase in total factor productivity because of technological catch-up or other factors, this by itself will promote factor price convergence.

2.5.2 Convergence of incomes

Factor *price* convergence in a global or regional market may or may not lead to the convergence of individual or *household incomes* in the same market. Average income per capita in a country is the sum of per unit factor returns with each weighted by the average endowment of the factor. Thus, convergence of factor incomes across countries depends on the convergence/divergence of factor prices and of factor endowments. It is possible for factor prices to converge yet for average incomes to diverge if the average factor endowments diverge because the rate of capital accumulation is greater in richer countries than in poorer countries.

There is a voluminous literature on convergence of incomes across countries. (This literature is conveniently summarised by Islam, 2003). The first problem is that, with a large number of countries in the world, there are several distinct definitions of convergence of incomes across economies. One problem is how to measure convergence, given the group of countries; the convergence of one country can be measured against the richest country or any other country or against an average of all countries in the sample. Another is also a question of selecting the sample of countries; for example, there is unconditional convergence of the actual incomes and conditional convergence where the influence of various growth-inducing or growth-inhibiting factors is taken out, and there is global convergence or local or club convergence.

The consensus is that there has been some convergence of incomes globally. This effect is stronger among countries that are more open. In this context openness means lower border barriers with respect to trade in goods. There has been no testing of the extent of integration in goods markets in the broader sense of lowering both border and beyond-the-border policies that discriminate against foreign supplies as there are no measures of the extent of beyond-the-border liberalisation.

Of more interest for this study, is the evidence relating to the EU. This is the longest and deepest experiment in regional integration in the world. In this case, there has been complete liberalisation of both border and beyond-the-border measures for trade in goods, and considerable convergence of prices, as noted above. There has also been liberalisation of trade in services and of the movement of capital and labour.

There have been a number of studies testing whether the European regional integration has caused convergence of incomes. Park (2002) examines convergence of real per capita incomes in Western Europe countries alone over the period 1960 to 2000. Western Europe is taken to be the 15 members of the EU plus Switzerland, Norway and Iceland. The last three are members of the European Economic Area (EEA), along with the EU. EEA is an RTA that has adopted most of the EU rules and all commodity and factor markets are, therefore, well integrated. Convergence is defined as reduction in the measures of inequality in the sample of countries. The empirical results show clear and substantial convergence of incomes in the region. Poorer countries of the region grew significantly faster than the richer countries, resulting in a sharp decline in inter-country income inequality

Parikh and Shibata (2004) use panel data to test the hypothesis of convergence in 64 developing countries, including 14 Asian countries during the period 1970-99. The study concludes that liberalisation of trade in goods has accelerated convergence of real per capita incomes for developing countries in Asia and Latin America but not for developing countries in Africa. Convergence among the ASEAN economies is examined in Section 5.1.2.

2.5.3 Accelerating the rate of economic growth.

In addition to the effects on prices and incomes, integration may accelerate the rate of growth of real GDP and average incomes in individual economies. This is probably the most important outcome of integration as it persists through time.

There has been a vigorous controversy among economists about the effects of liberalising international trade in goods on the rates of economic growth. Here we do not have in mind the increases in productivity and incomes that result from specialisation according to comparative advantage. This is a once-for-all effect. Rather, in a number of ways, international goods trade liberalisation may assist the transfer and adoption of new technologies and the rates of growth of factor productivities.

Standard Neoclassical growth theory points to one relationship between opening international goods trade and the long run rate of economic growth (the annual increase in real GDP). This is the possibility that opening may increase the rate of saving and capital formation. In this model, with international trade in goods, opening may also lower the cost of capital goods used to increase the productive capacity of the country. New Growth Theory that developed in the 1980s and 1990s identifies a number of additional rate-of-growth effects. These include market expansion effects that lead to a greater variety of capital inputs and intermediate inputs and hence to greater factor productivity, more productive research and development, spillover effects associated with innovation and the avoidance of duplication of R & D costs. Taylor (1999) provides a survey of this literature.

The empirical literature is conveniently summarised by Lewer and Van den Berg (2003). The results of the empirical studies are remarkably consistent, not only in terms of finding a positive association between opening of economies and higher economic growth but even about the magnitude of the effect. Holding other growth-inducing factors constant, a one percentage point increase in the growth of exports is associated with a one fifth percentage point increase in the rate of growth of real GDP per capita. Thus, a country whose exports grow more rapidly by, say, 5 per cent per year as a result of opening up the goods trade sector can expect to have an increase in its annual growth of per capita output of 1 percentage point.

This literature is consistent with accepted explanations of the high rates of growth in the last 20 years or so in an increasing number of East Asian economies, including some in ASEAN. The fast-growing East Asian economies were early openers and this contributed to their high rates of economic growth. Some of this literature emphasises the complementary role of opening with respect to capital, especially the role of incoming FDI in assisting technology transfer and development of management skills. Fast-growing East Asian economies have generally had high rates of inflow of FDI relative to their GDP.

Regional freeing of trade in goods and in capital can play an analogous role at the regional level. In addition, there is one possible growth-inducing effect of regional integration that is not present in the world economy. This is the possibility that regional goods trade liberalisation may induce FDI diversion and thereby accelerate the rate of accumulation of fixed capital goods and the transfer of technologies. Unfortunately, there are few studies that link regional opening to growth performance.

3. NEW ISSUES ARISING FROM ECONOMIC INTEGRATION

Section 2 examined the issues of discrimination at the border and beyond-the-border and the harmonisation of measures across borders. These have become the standard subjects of economic integration. However, in recent years, new concerns have been voiced about tax issues and doing business across borders with foreign currencies. All of these add costs which restrict cross-border trade. These will be considered in this Section.

3.1 Taxes and fiscal unions

It was noted in Section 2.1.2 that a single market requires the equalisation of effective tax rates.

Consider first taxes on goods produced, that is, excise and sales taxes and value added or goods and services taxes. Differences in these tax rates among members of an RTA clearly violate the requirements of a single market. In the absence of equalisation of the tax rates on production and other provisions that determine tax liability among the members of an RTA, there will not be a single price in markets where these taxes are levied, even if all other conditions for a single market are satisfied.

One important area of fiscal harmonisation is that of subsidies based on production (as distinct from those based on exports or on domestic consumption/use or any other base)[8]. A subsidy based on production is simply a negative tax based on production. All that applies to taxes based on production applies to subsidies based on production.

GATT/WTO has done little to discipline the use of production subsidies. They are a permitted exception to the application of National Treatment, and there is little discipline of production-based subsidies outside the special rules which apply to agriculture, apart from the provisions in Article VI relating to countervailing duties that may be applied at the discretion of the importing country. Consequently, they could be an important potential area of harmonisation or discipline in RTAs. However, only two RTAs have taken action to reduce or eliminate production-based subsidies that distort intra-area trade, namely, the EU and the CER. Given the increasing relative importance of production-based subsidies as other forms of border protection are reduced, it is likely that other RTAs will address this area. The main difficulty at both the WTO and in regional policy formation is that subsidies are regarded as an important aspect of national policy and suggestions that they be reduced are widely considered to be an infringement of national sovereignty.

Similarly, a single market clearly requires the equalisation of tax rates for all taxes based on consumption of goods and services.

Equally, to achieve a single market, the harmonisation of tax rates should apply to all taxes on factors; that is, taxes on labour and capital. This includes taxes on income (which is the sum of incomes from the sale of labour, the ownership of capital and land). In the absence of equalisation of taxes on factor use or income, the return to factors will differ between members and production will be inefficient. If there is free movement of factors within an RTA but not equalisation of taxes on factors, factors will tend to move to the locations where the rate of return after taxes on their services is highest. But this is not the location in which the rate of return before taxes, the marginal product of the factor, is highest. Michael (1991) showed that capital or labour flows within a common market may be harmful if factor taxes are not harmonised. In this case, there is a further increase in real aggregate product if factor taxes are harmonised.

[8] Taxes that correct for pollution or some other market failure are non-distorting.

However, the step of harmonisation of the tax rates across member countries may not be feasible without the harmonisation of government expenditures. Taxes are raised to provide revenue for government expenditures (ignoring the decreasing role of servicing public debt). The only RTA which has made progress in fiscal harmonisation is the EU and even here the progress has been limited to some convergence of commodity tax rates; the VAT rate must be at least 15 per cent in all member countries and they have equalised the rates of taxation on fuel, tobacco and alcohol.

3.2 Foreign exchange markets and monetary unions

Almost all cross-border transactions are accompanied by foreign exchange transactions. The exceptions are barter and counter trade, or transactions between residents of countries that share a common currency.

As a result of the Asian Crisis, South East Asian countries are concerned about both the short term volatility of their exchange rates and the longer term levels of their rates. This applies particularly to the five countries that suffered substantial devaluations of their nominal and real exchange rates: Thailand, Malaysia, Indonesia and the Philippines among the ASEAN group, and Korea. This was shown in Figures 1.5. For each of these countries, this experience has raised a host of questions about the choice of exchange rate regime, capital convertibility, regulation of financial institutions and derivatives markets and macroeconomic policy choices.

These issues are much broader than the issues of economic integration but there are some more direct connections between concerns over exchange rate market behaviour on the one hand and the design of RTAs. A common currency or a monetary union may be considered by the members of an RTA for these macroeconomic reasons as well as because of the savings in transactions costs and exchange risks. Indeed, the original literature on optimal currency areas was driven by arguments about the response of national economies to macroeconomic shocks originating outside the areas.

A single market is usually taken not to imply a common currency or a monetary union. Here a distinction is drawn between a common currency and a monetary union. A common currency is simply the use of one currency as the legal tender in two or more countries. A monetary union is a more comprehensive agreement than a common currency. It is an agreement among a group of countries to share a common currency and have a common central bank with powers to issue notes and determine monetary policies. A decision by an RTA to establish a monetary union is separate from the establishment of a Single Market. It involves primarily macroeconomic management. It also involves, secondarily, some microeconomic efficiency issues such as the avoidance of exchange transactions costs and exchange rate risk; a common currency avoids the costs for foreign suppliers of exchange market transactions.

There are a small number of monetary unions throughout the world – the European Monetary Union, the monetary union between Switzerland and Lichtenstein, the Eastern Caribbean Currency Union (ECCU) and the two groups that comprise the CFA Franc Zone, the West African Economic and Monetary Union and the Central African Economic and Monetary Union. The monetary union between Switzerland and Lichtenstein dates back to 1933 when it was created at the same time as the common market between these countries. The CFA Franc Zone was created in 1939 when the countries were colonies in the French Empire. The Eastern Caribbean Currency Union was created in 1983.

The common currency in a monetary union may be the currency of one member or a new area wide currency or that of another country. The monetary union between Switzerland and Lichtenstein is the sole example of the first modality. All of the other unions listed above have followed the second modality; the EU introduced the Euro, the Eastern Caribbean

Currency Union introduced the Eastern Caribbean Dollar (which is pegged to the US dollar), and the two CFA Franc Zone unions initially adopted the CFA Frank as their common currency and in 1999 switched to the Euro. In each of the cases, the common currency has been associated with a common central bank; in the case of the European Monetary Union it is the European Central Bank, and in the case of Eastern Caribbean Currency Union, it is the Eastern Caribbean Central Bank, and each of the two zones has a zone Central Bank.

Thus, there is only one case of an RTA in which all of the members of an RTA have adopted a common currency and a common central bank; that of Switzerland and Lichtenstein. In the case of the CFA Franc Zone unions, the zones are not part of an RTA. In the case of the EU, only 12 of the current 25 full members have joined the monetary union. In the case of the Eastern Caribbean Currency Union, only 7 of the 15 members of the RTA (the larger Caribbean Community and Common Market, known as CARICOM) have joined the monetary union, and ECCU is not formally a part of CARICOM. This illustrates the difficulty for the members of an RTA in achieving this step towards a single economy.

The adoption of a common currency is not an all or nothing possibility. Intermediate steps are possible in this dimension of integration. In the case of the EU (or the EEC before it), the members of the Union, or subsets of them, from 1969 adopted a number of different exchange rate mechanisms involving degrees of cooperation. For a period the members operated a system of joint floating, with the exchange rates of the participating members fluctuating within a fixed band. This was known as the “snake in the tunnel”. It was intended to give a high degree of certainty of exchange among members and flexibility *vis-a-vis* other currencies. This system failed. In 1979 the European Monetary System (EMS) was introduced. Officially, the EMS was an agreement among the central banks, not a part of the EEC/EU. This involved a number of cooperative elements, including the exchange rate mechanism (ERM) with realignment of currencies subject to common agreement, the pooling of reserves, swap facilities and a unit of account, the European Currency Unit (ECU). The ECU was used as a unit of account and a means of payment only among the central banks of the participating countries. The EMS lasted in various forms until it was replaced by the EMU in 1999.

There are a number of cases of countries which have adopted the currency of another country, mostly the US dollar and the Euro, either with the acquiescence of the country whose currency is adopted or unilaterally. Most of these are small islands and former colonies or dependencies or very small economies such as El Salvador and Panama. Thus, they are mostly very small economies that choose the currency of a very large country. In these cases, there is no common central bank across all of the countries using the common currency and hence there is no common monetary policy and no monetary union.

Other issues of financial architecture are mainly concerned with aspects of macroeconomic policy that go beyond economic integration. There is also a big question as to which group of countries should cooperate in the sphere of monetary and foreign exchange policy. For example, it is the ASEAN+3 (the 10 ASEAN countries plus Japan, the PRC and the Republic of Korea) group that has played a major role in developing the ASEAN+3 Surveillance Process (ASP) and extending swap arrangements among the central banks. In this regard, the experience of ASEAN is similar to that in other countries. We noted above that the most of the examples of monetary unions concern either a subset of the members of an RTA or go beyond the membership of the relevant RTA.

3.3 Empirical studies of non-traditional border restrictions; missing trade

Government-imposed border restrictions on goods trade – traditional tariffs and non-tariff barriers and, we should add, national standards and regulations – have been greatly reduced between almost all pairs of trading economies in the last twenty years or so. Consequently, one expects that, other things being equal, cross-border trade in goods would have increased. Indeed, it has done so, as discussed in Section 1. Yet, a number of economists have found that the level of cross-border trade is not as large as one might expect. This phenomenon has been dubbed “missing trade”. It is relevant to the discussion of RTAs as it identifies hidden influences of national borders on cross-border trade.

Some studies have compared the volume of bilateral trade between pairs of countries with that predicted by models of trade.[9] There are two types of models of trade in goods that have been used in these studies. One is the Heckscher-Ohlin model of trade that makes predictions of the direction and volume of trade on the basis of differences in national resource endowments and technologies (see Tefler, 1995). The other is the gravity model used to explain the volume of bilateral trade (see Anderson, 2000 and references therein). This model is particularly interesting in this context as it incorporates the trade-restricting effect of distance between markets in different countries, which is another potential explanator of bilateral trade volumes. Both have found missing trade.

Some especially interesting work has been done on trade flows between Canada and the United States. The pioneering study was that of McCallum (1995). McCallum compared bilateral trade between pairs of Canadian provinces on the one hand with that between pairs comprising one Canadian province and one US state. McCallum found that trade between two provinces is more than 20 times larger than trade between a province and a similar-sized state located the same distance away. In some way, this difference is related to national borders. This example is striking as the US and Canada share a common language, have common roots to their legal systems, have some common borders and both have strong legal systems giving security to international trade and convertible currencies with exchange risk cover widely available. Using a similar gravity model, Wen (2004) compares intra-country and inter-country trade among seven EU countries in 1996. She finds that an EU country trades about six times as much with itself as with a neighbouring EU country, after adjusting for distance and other factors.

Recent studies have added dummy variables measuring a language-in-common, common borders and joint membership of an RTA, all of which are expected to be trade increasing. Frankel, Stein and Wei (1997) find that a language-in-common increases trade by 60 per cent, common borders double trade, common membership in the EEC and Western hemisphere RTAs increase trade by 36 per cent and common membership in East Asian RTAs increases trade by a remarkable 733 per cent, other things equal in all cases. The dummies for common borders and common language reflect probably something about the security of legal arrangements and the availability of information.

What might explain these border effects? One factor is national product differentiation. According to Evans (2003) this explains around 46 per cent of the differences.

Now we need also to consider non-traditional trade-restricting transactions costs. Anderson (2000) suggests transactions costs associated with lack of information, imperfect contract enforcement, the added insecurity of international trade due to theft, piracy, extortion or graft, and undiversifiable country risks.

Another factor present in cross-border transactions between most pairs of destinations is the transactions costs and risks deriving from foreign exchange transactions, as noted in Section 3.2 above. In an important paper, Rose (2001) considers the effects on the bilateral volume of trade of two countries sharing a common currency. There are 92 such countries in his

[9] This phenomenon has been identified in other ways too. Some have argued that the ratio of export+import trade to GDP, while it has risen, is not as great as expected. Still others have shown that the relative price variability of consumer goods in different cities is much greater when the cities are in different countries. We concentrate on studies of the bilateral volume of trade as these are more relevant to the issues of border and regional trade policies.

sample, of which 36 are in the EMU and the other 4 monetary unions described below with the remainder countries that have adopted the currency of a major partner or former colonial metropolitan power. He uses a gravity model that controls for common membership in an RTA, common borders and a common language in the same way as Frankel, Stein and Wei (1997). The novelty is to add a dummy variable for the existence of a common currency or not. He finds that, after controlling for the other factors, countries sharing a common currency trade over three times as much with each other as countries not sharing a common currency. This effect is additional to and larger than the effect of common membership of an RTA. It is staggeringly large. However, a number of authors have argued that the econometric techniques used by Rose exaggerated the magnitude of the currency union effect (see, Persson, 2001; Christie, 2002 and Kenen, 2002).

We do not know what this currency effect is picking up. The effect is larger than the elimination of exchange rate volatility. It may be due to the transparency effect on buyers of a common currency. It may include in many cases the effects of common legal traditions and greater information or in a more general way the effects of close historical ties. Yet, it indicates the importance of aspects of commonness that go beyond a regional trading agreement or a common market. Given these estimates, we need to redefine a single market as one with a common currency among the member countries.

It is not possible to compute the welfare effect of a common currency from a reduced form gravity model. In a study of the European Monetary Union, Mendizábal (2002) computes the transactions cost savings derived from the Monetary Union for its member economies, though unfortunately he does not examine the bilateral volume of trade. His results imply an upper bound for the savings derived from reductions in transactions costs of approximately 0.69 per cent of Union GDP. For the smaller economies whose currencies are used less for international transactions, the gains are much larger, around 1 per cent of their GDP. (These estimates do not include the gains from the elimination of exchange rate uncertainty on intra-EMU trade nor the loss of gains from discouraged trade. They therefore underestimate the gains.)

These empirical studies point to large non-traditional transactions costs of doing business across national borders. All of these might be affected by measures adopted by RTAs.

3.4 Competitiveness in an integrated world economy

3.4.1 The meanings of competitiveness

Many studies examine “competitiveness” in terms of some aspect of the economic performance of nations. There is, however, no universally agreed definition of competitiveness. Depending upon the context of discussion, the term has several meanings.

In a much-cited piece, Krugman (1994) argues that the term is meaningless as nations do not compete and international trade is a positive sum game, benefiting all participants. While these points are correct and do raise a fundamental question about the use of the term, Wignaraja (2003) argues that the term is used in three distinct senses:

(1) A *macroeconomic* sense that focuses on the real exchange rate and management of the macro-economy.
(2) A *business strategy* sense that is concerned with competition among firms in global markets
(3) A *technology and innovation* sense that emphasises innovation and learning at the enterprise and national levels.

One can add two more recognisable uses:

(4) A *growth rate performance* sense that is concerned with the relative rates of growth of national output or of national exports.

(5) A *freedom of trade and investment* sense that focuses on the freedom of cross-border trade in goods and services and the attractiveness of the national policy environment to foreign direct investors.

Unfortunately, this categorisation reveals that the term “competitiveness” means whatever the user wants it to mean and that there is no general meaning of the term. Yet, there is much concern in many governments about “competitiveness”. The first sense raises important policy issues relating to the choice of exchange rate mechanism and the management of this mechanism; the second may raise a limited role for public policies that affect the ability of firms to compete on global markets; the third may raise a role for public policies that encourage innovation and technology development; the fourth raises the issues of freedom of cross-border trade in goods, services and capital and the degree of national treatment within the borders; the fifth raises policy issues that significantly affect the rate of growth of national output or exports. These five sets of policy issues are legitimate concerns.

Rather than seek a general definition, we shall examine these particular meanings of the term. The second and third senses raise important issues of management and skills training, technology and innovation policies as policy areas that may affect the long run rate of growth of an economy. The fourth sense looks at the relative growth performance itself of an economy over time and seeks policy measures which may accelerate this rate of growth. For example, the WEF produces a Growth Competitiveness Index. This is “… a set of institutions, market structures and economic policies supportive of higher productivity growth and increases in output”. While this is a legitimate concern of governments and the index is a useful ranking of these policies, the use of the term “competitiveness” illustrates again the adoption of this term as a catchy phrase rather than a useful descriptor of the content of the index. Thus three of the meanings of the term all relate to the growth performance of an economy over some time period. This sense of competitiveness in terms of growth performance is outside the scope of this study.

There are also studies that examine the performance of an economy in terms of the rate of growth of its aggregate *exports* of goods relative to the rates achieved by other countries. Two methods are frequently used to calculate this “export competitiveness”. One is constant market share analysis. This examines changes in a country’s share of world export markets over time relative to all other countries. It decomposes the growth rate over some interval of time into three components: country effects, commodity effects and the residual change in market share which is called “competitiveness”. (See Lloyd and Toguchi, 1996, and references therein). The last component is a measure of export performance, relative to other countries and after adjusting for country and commodity effects. The second method is shift-share analysis. This examines changes in a country’s share of world export markets (or sometimes the markets of some particular country or group of countries) over time relative to a selected reference country or group of countries. A positive/negative value of the differential, the “shift” effect, shows an improvement/deterioration in export performance relative to the reference group. The shift effect in turn is broken down into an industry mix effect and a “competitive effect” that measures the differential after adjusting for the mix effect. (See, for example, Wilson, 1999 and Voon and Yue, 2003). Export performance, as measured by either method, depends on many factors such as productivity growth, barriers to trade and exchange rate alignment or misalignment.

We shall, therefore, concentrate on the *macroeconomic* sense and the *freedom of trade and investment* sense as these two senses raise issues that bear on regional and global integration.

3.4.2 Competitiveness in the sense of the real effective exchange rate

The real effective exchange rate (REER) is the most common indicator of export competitiveness of goods. For a currency, the real effective exchange rate is derived from the nominal bilateral rates in three steps. First, the movements in a country's exchange rates against the individual major currencies are measured. By convention, an exchange rate is measured as the number of units of a foreign currency which exchange for a unit of the domestic currency. Consequently, a fall in the exchange rate against one other currency measured this way makes the country's traders more competitive in markets using this currency. Second, the nominal *effective* exchange rate is calculated as a suitably trade-weighted average of the movements of the currency vis-à-vis the individual currencies individual major currencies with which the country trades. Third, this average rate is adjusted for the rates of inflation in the country concerned and in its trading partners. This gives the *real effective* exchange rate for the country. A fall in the real effective exchange rate indicates a devaluation of the currency with respect to all trading partners of the exchange rate adjusted for price changes. The way the index is constructed, a fall in the index means an increase in the country's competitiveness. This stems from the convention of citing an exchange rate as the number of units of a foreign currency which exchange for a unit of the domestic currency. The resulting index is a measure of competitiveness of the countries traders.

Devaluation of the REER improves a country's export competitiveness by making that country's exports relatively less expensive in foreign markets. It also improves the competitiveness of domestically-produced goods sold on domestic markets that compete with imported supplies but the focus is usually on the competitiveness of exports. Such a devaluation may occur via devaluation of the nominal exchange rate or via a decline in the ratio of the domestic price level relative to foreign prices levels. In this sense, the movement of the REER is considered to be the mechanism by which the economy adjusts to changes in the balance of payments.

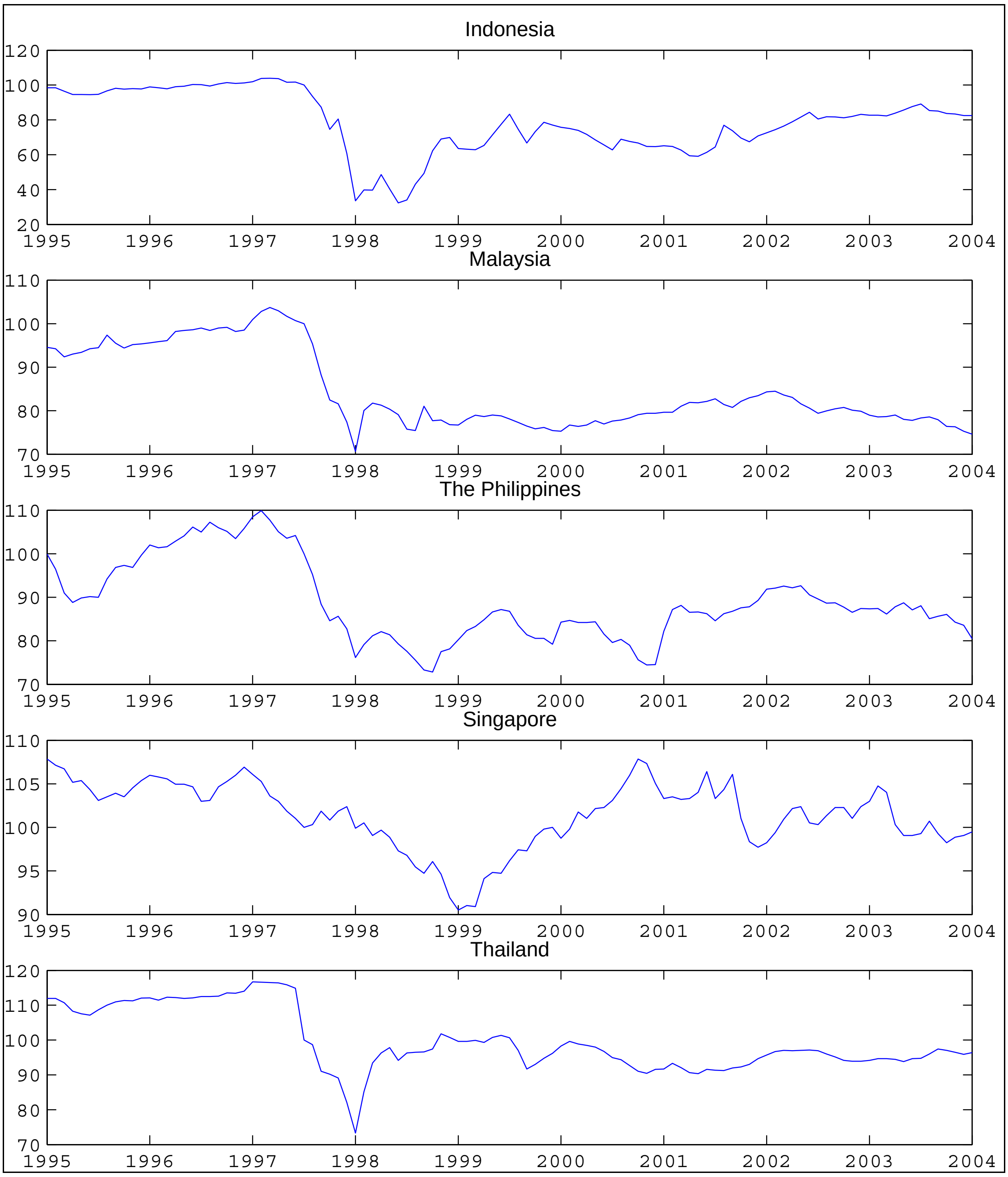
Series of REER for many countries are compiled by the IMF and the World Bank and for individual countries by many central banks. This index is calculated and graphed for the five ASEAN economies in Figure 3.1. These series were obtained from the International Monetary Fund's International Financial Statistics Data Base and expressed with a base in June 1997.

These figures of real effective exchange rates again show a clear break at the time of the Asian Crisis. However, for this series, the break is a little less dramatic than the earlier series for bilateral (nominal) rates. For Singapore, the real effective exchange rate has recovered to the pre-Crisis level. However, for the other four countries, the real effective exchange rate, like the nominal bilateral rate vis-à-vis the US dollar, remains below the levels prevailing before the Crisis.

There are several well documented problems with using the REER as a measure of competitiveness. First, variation in export prices or unit labour costs might reflect changes in the composition of the tradable sector rather than an improvement in competitiveness. Second, the REER does not reflect product quality or the reliability of contracts in a given country.

Third, the experience of the Asian Crisis indicates that the real effective exchange rate fails to capture a major element of export competitiveness. Despite the devaluation in real effective exchange rates of the ASEAN economies during the period 1997/98, the volume of trade in both goods and services decreased in these countries over this period and subsequently has failed to recover to post crisis levels. A REER is a useful indicator of general export competitiveness of an economy in the short-term only if there are no major shocks to the international trade sector. If, however, there is a major shock that substantially affects foreign buyers' and sellers' perceptions of the economy and its exchange rate risks, these effects may swamp the movements of the REER as a determinant of exports and imports of goods.

Figure 3.1 Real effective exchange rate indices (Jun 1997 = 100)



More fundamentally, in order to evaluate the real effective exchange rate as a measure of competitiveness, we need to consider what determines these rates. In the literature on international macroeconomics, competitiveness relates to how closely the level of the real exchange rate aligns with economic fundamentals. As discussed by Boltho (1996, p.2), the optimal level of competitiveness in this context is the level of the real exchange rate ensuring unemployment levels consistent with inflation (internal balance) and some optimal and sustainable current account level (external balance). By this definition, an economy producing at full employment levels might be said to be suffering from a lack of competitiveness if it is running a persistently large and unsustainable current account deficit, which would eventually require adjustment, either by a nominal currency depreciation, domestic inflation or some mix of the two. Some have argued that such an adjustment was at least partially responsible for the Asian financial crisis.

There are a number of reasons why exchange rates may be misaligned with long-run economic fundamentals. While markets will generally act as an equilibrating force in the long run, market forces can push exchange rates away from economic fundamentals in the short term at least, and possibly in the long term. Alternatively, government policies of pegging the exchange rate may fix the exchange rate deliberately at a high level, perhaps in a bid to control domestic inflation, or at a low level, possibly in a bid to increase international market share. The latter strategy of undervaluation is a form of “exchange rate protection” (Corden, 1981). This is a policy of setting an exchange rate at a level lower than it would be if determined by free market forces, in order to give its exporters and import-competing producers a competitive advantage. This might be done to favour the tradable sector relative to the non-tradable sector or in the belief that such an exchange rate is sustainable and will accelerate the rate of growth of aggregate real output in the economy.

Clearly, the costs of currency misalignments can be high. An exchange rate that remains overvalued for a long period of time can lead to a loss of international market share and unemployment in the sector of the economy producing tradable goods. On the other hand, an exchange rate which is persistently undervalued will generally only increase international market share in the short run as an undervalued currency will tend to raise price levels domestically offsetting any effect on the real exchange rate. Long run gains to competitiveness will generally occur only if the costs of the production of tradable goods in the home country decline relative to those produced abroad. Therefore any sustainable improvement in competitiveness in the long run must be associated with productivity growth.

An indicator of whether or not the real exchange rate is aligned with economic fundamentals is whether or not purchasing power parity (PPP) holds. PPP is an international variant of the Law of One Price. It is a belief or hypothesis that, adjusting for differing price levels and exchange rates and taking into account transport costs, the price of identical goods and services should be the same across countries. For the real exchange rate to be an estimate of the equilibrium real exchange rate, it must be the case that PPP holds.

The majority of empirical studies into PPP have not been able to reject the hypothesis that the real exchange rate behaves as a random walk. This essentially means that any shock to the real exchange rate will be permanent and the equilibrating forces of arbitrage will not come into play. That is, exchange rates are not determined by PPP even in the long term. However, tests for random walk behaviour are notoriously sensitive to sample size and structural change. (See, for example, Perron, 1989.)

The 12 month average of nominal effective exchange rate (NEER) is plotted against PPP exchange rates over the period 1990-2002 in Figure 3.2. The countries included are those for which nominal effective exchange rate data is available. These series were obtained from the International Monetary Fund’s International Financial Statistics Data Base. The PPP exchange rate is defined as the national currency per international dollar[10] and obtained from the World Bank’s World Development Indicators. Both the nominal effective exchange rates and the PPP exchange rates are normalized to 100 in 1990.

[10] An international dollar is defined to have the same purchasing power over GDP as a U.S. dollar has in the United States

Figure 3.2 Nominal Effective Exchange Rates Plotted against PPP Exchange Rates, 1990-2002 (1990=100)

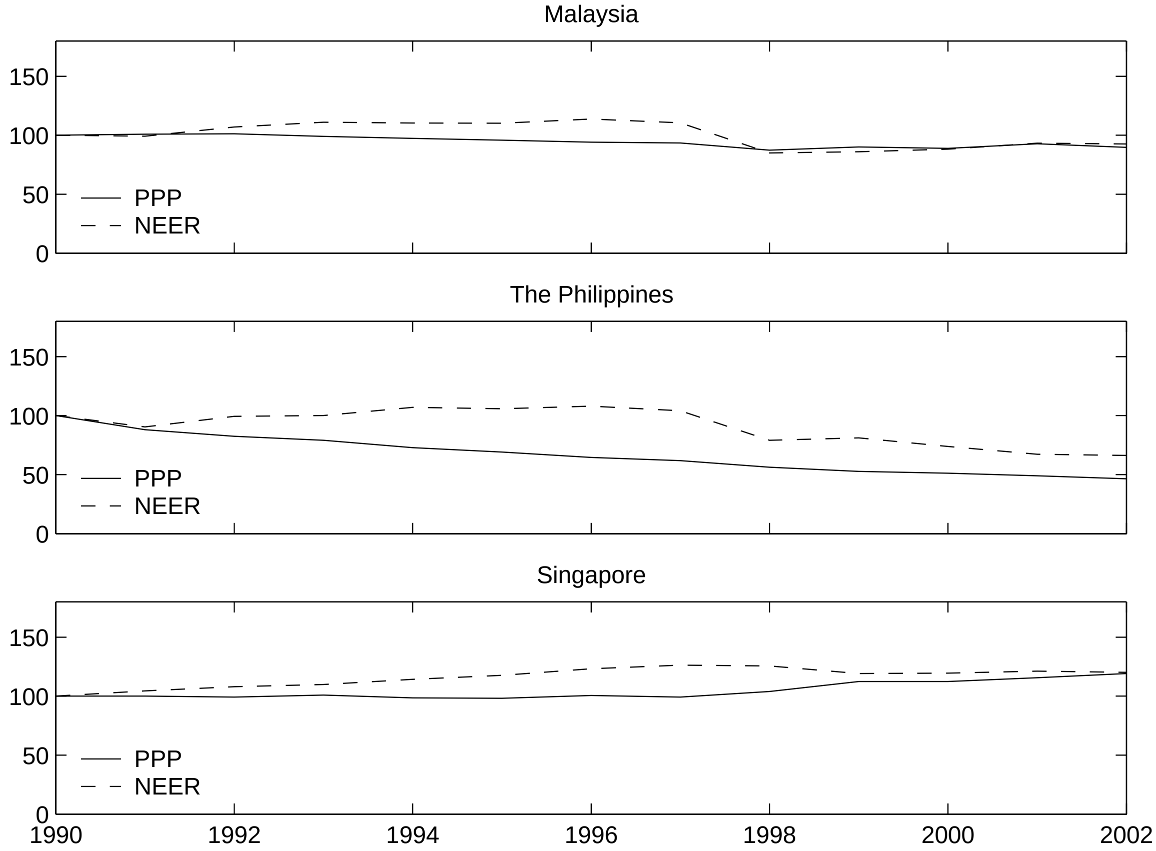


Figure 3.2 suggests that the nominal effective exchange rates of these countries do seem to adjust towards the PPP rates over the sample suggesting that PPP does hold in the long run. However, during the period 1991-1997 there was a divergence between PPP exchange rates and nominal effective rates. This supports the hypothesis that the nominal exchange rates were overvalued during this period.

A more formal test of whether or not PPP holds in the Asia-Pacific region was conducted by Basher and Mohsin (2004). This study aims to avoid the problem of small samples by pooling nominal exchange rate data and the aggregate consumer price index ratios of several Asian economies into a panel covering the period 1980-1999. Using new techniques for panel cointegration and panel unit root tests, these authors are still unable to find substantial evidence that PPP holds for any of the ASEAN-5 economies except Singapore. However, an alternative study by Wu, Tsai and Chen (2004) examines the theory of PPP when the possibility of structural changes, such as the Asian financial crisis or the Plaza Accord in 1985, is allowed for. Importantly they find that, when such structural changes are allowed for, there is evidence for PPP holding in the ASEAN economies. This finding implies the equilibrium real exchange rate is approximated by the real effective exchange rate.

3.4.3 Competitiveness in the sense of freedom of trade and investment

Several organisations produce indices of competitiveness annually for a large number of countries. These enable us to compare the performance of the individual ASEAN countries with other countries. The World Economic Forum (WEF) and the Institute of Management Development (IMD) rank countries according to their rival indices of “competitiveness” for 102 and 60 countries respectively in the latest reports. The Fraser Institute produces an Index of Economic Freedom for over 120 countries, derived in part from its annual "competitiveness" study. The journal *Foreign Policy* (FP) produces an index of globalisation for some 62 nations. While there are differences in the components of each of these indices, all are composite measures of the extent to which individual nations have removed border barriers to international trade in goods and factors and made it easier for multinational companies to operate within national borders. These indices relate to the level of barriers between the individual countries and the rest of the world rather than their RTA partners. In these indices, the higher the ranking the more competitive the country is considered to be.

Table 3.1 reports the rankings in these four indices for the latest year available in each case. To make the rankings comparable, the entries adjust for the number of countries in each sample; thus, an entry of 9/62 indicates that the country concerned ranked 9th out of 62 in the index reported.

Table 3.1 ASEAN Country Rankings in Indices of Global Competitiveness

Country	WEF Index	IMD Index	FP Index	Fraser Institute Index
Singapore	6/120	2/60	2/62	2/123
Malaysia	29/120	16/60	20/62	60/123
Thailand	32/120	29/60	48/62	44/123
Viet Nam	60/120	n.a.	n.a.	n.a.
The Philippines	66/120	52/60	33/62	51/123
Indonesia	72/120	58/60	59/62	91/123

n.a. = not available
Sources: WEF Index: www.weforum.org
IMD Index: www02.imd.ch/wcy
FP Index: www.foreignpolicy.com
Fraser Institute Index: www.fraserinstitute.ca/economicfreedom

Overall the results are remarkably consistent among the studies, despite the differences in the composition of the indices. The only difference in the rankings among the six is that Malaysia and Thailand change places in the Fraser Institute index. Singapore and Malaysia rank above the middle of the rankings in all four studies, and Thailand is ranked in the upper half in two out of four studies. In all four studies the top rankings are taken by a group of high income countries.

Singapore is a very open country with respect to border barriers for trade in goods and services *vis-à-vis* other countries, and the RTAs it has signed with other countries in recent years also score relatively highly in terms of the progress towards economic integration with these partner countries (see Table 4.1). Malaysia and Thailand score highly in the competitiveness rankings relative to other Developing Countries. The other ASEAN countries in the table have rankings typical of Developing Countries in general.

To see if there are any trends in these measures, Table 3.2 presents the results for each of these indices over recent years. The figures in the cells of the table are the raw rankings in each year. However, the number of countries in the sample has increased over the sample period. Therefore, it is necessary to adjust for this increase; otherwise a country might show a lower ranking simply because of the increase in the number of countries reported. The number of countries in each year of each index is reported in the final column. The raw figure can be adjusted by dividing by this number, as in Table 3.1 above. However, this has not been done in the table to avoid cluttering.

Again, the trend results, after adjustment, are remarkably consistent among the four measures of freedom of trade or "competitiveness". The adjustment for the number of countries reported makes the trends less pronounced but does not change them. For

Singapore there is no trend in any of the series except for the WEF Index which shows a trend towards higher competitiveness. For Malaysia, the WEF Index and the Fraser Institute Index also show a trend towards higher competitiveness while the IMD Index and the FP Index are trendless. For Thailand, three of the indices show a trend towards higher competitiveness while the FP Index is shows a trend towards lower competitiveness. For the Philippines and Indonesia all four indices show a trend towards lower competitiveness. For Myanmar and Viet Nam, the only one series available show a trend towards lower competitiveness. However, the period may be too short to reveal any lasting trends in these ASEAN economies.

There is a positive correlation between these indices on the one hand and both the average levels of GDP per capita and the rate of growth of GDP per capita on the other (see, in particular, Fraser Institute annual report on *Freedom of the World*). This is based on empirical analysis of the pattern for all of the countries in these surveys. This suggests that competitiveness in the sense of freedom of trade and investment has a positive effect on the rate of growth, though the causality could possibly go the other way.

Table 3.2 Historical Competitiveness Rankings for ASEAN Economies, 1996-2003

WEF Index								
	Indonesia	Malaysia	Myanmar	Philippines	Singapore	Thailand	Viet Nam	Possible Rank
1998	51	27	n.a	45	10	37	43	52
1999	53	27	n.a	44	12	39	50	59
2000	47	30	n.a	46	9	40	53	58
2001	55	37	n.a	53	9	38	62	75
2002	64	26	n.a	61	9	35	60	80
2003	60	26	n.a	64	8	31	50	102
IMD Index								
1997	39	17	n.a	31	2	29	n.a	46
1998	40	20	n.a	32	2	39	n.a	46
1999	46	27	n.a	32	2	34	n.a	47
2000	43	26	n.a	35	2	31	n.a	47
2001	46	28	n.a	39	3	34	n.a	49
2002	47	24	n.a	40	8	31	n.a	49
2003	57	21	n.a	49	4	30	n.a	60
2004	58	16	n.a	52	2	29	n.a	60
FP Index								
2001	38	20	n.a	34	1	30	n.a	50
2002	59	20	n.a	52	3	51	n.a	62
2003	58	18	n.a	52	4	47	n.a	62
2004	59	20	n.a	33	2	48	n.a	62
Fraser Institute Index								
1970	43	20	n.a	32	7	27	n.a	54
1975	47	15	n.a	43	7	24	n.a	72
1980	63	11	79	53	5	24	n.a	105
1985	29	12	91	65	4	29	n.a	111
1990	29	10	109	52	2	17	n.a	113
1995	42	17	121	26	2	26	n.a	123
2000	77	46	123	34	2	52	n.a	123
2001	91	60	123	51	2	44	n.a	123

Source: As in Table 3.1.

3.4.4 What should be done about competitiveness?

Are these measures of competitiveness a guide to regional public policy action? To answer this question, we must consider each of the senses separately. As explained above, we shall consider only the use of measures of "competitiveness" in the sense of real exchange rate management of the macro-economy and in the sense of a measure of freedom of trade and investment.

Competitiveness in the sense of real exchange rate management of the macro-economy is undoubtedly a vital concern of the managers of the macro-economy. It involves the choice of exchange rate mechanism and the management of the particular mechanism chosen by a country. Both of these have profound effects on all sectors of the economy. Yet, they are matters of macroeconomic management and they do not have a close relationship to issues of regional policy unless the RTA has progressed to a stage involving monetary cooperation between the governments or central banks of the countries in the region.

One way in which they might be related is in a monetary union. An argument for a monetary union among the members of an RTA may be based partly on the advantages to the macro-economy. This is the focus of the traditional "optimal currency area" debate. This debate concerns arguments about the extent to which shocks to the national economies of the members move together or move differently. These issues were discussed further in Section 3.2 above.

Competitiveness in the sense of a measure of freedom of trade and investment is also an important concern of governments and policymakers. It raises the issues of border trade policies and national treatment for traders in goods and services. These issues were discussed in Section 2 above. The implications for regional integration are discussed in Section 4 below. In the ASEAN economies, there is also widespread concern about being "competitive" in the particular sense of attracting more foreign direct investment. This raises issues about rights of establishment, national treatment for foreign investors, investment protection, incentives for foreign investors and other issues that affect the willingness of foreigner investors to invest in a particular economy. These are considered in Section 4 in so far as some RTAs contain provisions freeing up foreign direct investment. They may also be addressed by freeing up foreign investment inflows on a non-discriminatory basis.

4. STYLES OF REGIONAL ECONOMIC INTEGRATION

In terms of the definition of economic integration developed in Sections 2 and 3, there are distinct styles of economic integration. We first consider a general typology of integration. Then the EU and the NAFTA are used as the primary examples of styles as they have set the major precedents. We concentrate on differences in aspects of deep integration, including regulations concerning goods and factors. In this discussion, we consider the choice of modalities as well as the coverage. The styles of these two RTAs differ greatly in the extent and the modalities of deep integration.

4.1 A typology of RTAs based on integration

No two RTAs are identical in all of their features. In fact there is great variation among them in their features. These differences can be described in terms of the *scope* of the agreements with respect to the policies or measures that are included. RTAs also differ in terms of the *modalities* that have been chosen to implement these policies. We need some way to characterise these differences systematically.

Distinctions are frequently drawn between free trade areas and customs unions on the basis of whether the RTA has a common external tariff or not. While this distinction is important, the presence or otherwise of common external tariffs and other border policies is now only one of many features. References are also made to a common market or a single market, meaning an RTA that is following the lines of the European Common Market or the European Single Market respectively. There are recent surveys of the coverage of some RTAs; see, for example, Salazar-Xirinachs (2002) for the Americas and Productivity Commission (2003, Appendix A) for a broader selection of RTAs. These surveys construct a list of the features in each RTA.

However, it is much more meaningful to have a typology based on degrees of integration, following the development of this notion in Sections 2 and 3. Using the notion of a fully integrated regional market, we can distinguish several stages in the progression towards a fully integrated regional market. Of course progress along these stages is uneven in any RTA. Each of these stages can apply to the markets for goods, services, for capital and for labour. An RTA can at one time have achieved a stage with respect to, say, the markets for goods but with respect to another set of markets, say the markets for capital or labour, it may have made little or no progress at the same stage; for example CER has achieved complete freedom of movement across borders of goods and of labour, and almost all services, but not of investment. Hence, we need to consider the markets for goods, services, capital and labour separately. We require, therefore, a two-way classification. In addition, we need to classify features which apply to all markets. This group includes monetary and fiscal union measures and recognition of intellectual property rights.

Consider first the markets for *goods*. We may distinguish the following types of market organisation in terms of qualitative properties of these markets.

- an area in which there is free trade across national borders in goods markets
- an area in which there is free trade across national borders and full national treatment in goods markets
- an area in which there is a single market for all goods
- a single [regional] economy

Similar stages apply to the markets for services, capital and labour. In the case of services, we follow GATS in using the two-fold classification of Market Access and National Treatment. Trade in services, in the sense of GATS modes, is more complicated because it involves freedom of movement across national borders of consumers/buyers (Mode 2), trade in capital (Mode 3, Commercial Presence) and freedom of movement of persons (Mode 4, the Movement of Natural Persons) as well as the freedom of movement of services Across Borders (Mode 1). We have added the categories of Temporary Movement of Natural Persons and of Mutual Recognition of Labour Market Standards because agreements in these specific areas are an important milestone in establishing a single market for services. In the case of capital markets, the headings correspond to provisions found in a number of RTAs. There is some overlap in the provisions listed for the services markets on the one hand and the markets for capital and labour on the other because the Mode 3 (Commercial Presence) and Mode 4 (Movement of Natural Persons) for the delivery of services are associated with cross-border movements of capital and labour respectively.

The most restrictive form of agreement is one which achieves only free trade in goods markets or indeed partial freeing of trade in goods markets. There are still a number of RTAs that are confined to lowering border barriers to trade in goods, with no National Treatment and other liberalising provisions for goods markets and no provisions for services or factor markets. At the other end of the spectrum, the most complete form of agreement, short of a single economy, is one which achieves a single market covering all four sets of markets and including a monetary union and a fiscal union.

These types are pure constructs. In reality, for one set of markets and within each stage, the progress is uneven. For example, at the first stage, some goods markets may be free of border restrictions but others may not be. In almost all RTAs, there are exclusions to the free trade provision, most commonly in agricultural product markets. However, in general the exclusions lists are getting smaller and most new RTAs aim for free trade in all goods markets with limited exceptions. Further, almost all RTAs today contain some elements from two or more of these pure types.

4.2 Progress towards economic integration in RTAs

We now apply this typology to measure progress towards complete integration in RTAs. Table 4.1 sets out the results for a representative sample of RTAs. The EU and NAFTA had to be included because of their importance in international markets and the precedents they have set. MERCOSUR is one of the largest RTAs and serves as an example of Latin American regional trading arrangements. In the Asia-Pacific region, ASEAN and CER are older agreements. As a sample of “New Age” agreements, we have included the Agreement between Japan and Singapore and that between New Zealand and Singapore.

The measures reported in Table 4.1 distinguish between measures that apply to goods markets, services markets, capital markets and labour markets respectively. Within each set of markets, we also distinguish between measures that apply at borders, beyond-the-border and across-borders as appropriate. There is a final category titled “Single market measures” which apply to all markets or to two or more sets of markets. These include monetary unions and fiscal unions as they are a major step by themselves and mark further progress towards a single economy.

Within each market category, the choice of features reported in Table 4.1 is designed to measure key stages in the progress towards complete economic integration in these markets. Thus, in relation to goods trade, provisions that prohibit anti-dumping action against imports sourced from member countries, or prohibit export incentives affecting intra-region trade or grant mutual recognition of product standards are all milestones in this progress. Trade in agricultural goods is distinguished from trade in industrial goods because there is a clear division in the rates of progress in lowering border barriers to trade in these two categories of goods in many RTAs. The features listed do not cover all features included in RTAs. We have omitted some which are not related to the degree of integration of markets: for example, provisions in some agreements concerning state-to-state and investor–to-state dispute settlement procedures and e-commerce. There are fewer measures listed for services markets than for goods markets because service delivered by Mode 3, “Commercial Presence”, are also affected by the measures affecting FDI that are listed under the measures applying to capital markets.

We score each box by giving one of three scores – all, some or none. These are denoted by the symbols √, *, and × respectively. For example, with respect to industrial tariffs, all means that all industrial tariffs have been removed; that is, the commodity coverage is 100 per cent and the percentage cut is 100 per cent. If there are very minor exceptions only to a measure, the score will be taken to be “all”. Everything between all and none is “some”. Thus “some” indicates that some steps have been taken by the members towards the implementation of this measure but it is incomplete. For example, in the Singapore-New Zealand Closer Economic Partnership Agreement, for the line “Prohibition of anti-dumping action”, the agreement does not prohibit anti-dumping action against imports originating from the partner country but it introduces higher thresholds at which such action might be triggered and thereby reduces the likely incidence of such actions. As a second example, MERCOSUR has a National Treatment provision for goods but it is confined to taxes and charges only and does not include regulations. In one case, that of monetary union in the EU, the entry is scored “some” because not all of the members have adopted the measure.

These scores are based on the actual progress as at 2004; where an RTA has a long term goal for some border and beyond-the-border measure, we have endeavoured to assess the level of achievement at the present time. For example, in AFTA, for the line “Elimination of industrial tariffs”, the items of the Temporary Exclusion List of each country and the items on the Inclusion List which have tariffs above zero mean that intra-area trade in these items is not yet free. Hence the entry is rated “some”. In a number of cases for ASEAN (and for other agreements) discussions or negotiations on measures are in progress but these cannot be recognised as they have not yet been agreed and implemented; for example, there are discussions on mutual recognition of labour standards in service industries. The Agreement that took effect most recently, the Japan-Singapore Economic Partnership Agreement, has not had time to implement the commitments made in the initial agreement; the timetable for tariff reductions extends to 2010. In this case, we have accepted the timetable of tariff reductions as a commitment that will be implemented.

Unfortunately, there is no single source for the information giving these rankings in Table 4.1; the classification is based on an examination of the agreements and related documents for each of the RTAs. These have been checked against other sources such as Salazar-Xirinachs (2002) and Productivity Commission (2003).

In recording the achievements of each RTA, we have taken account of some agreements among the members of an RTA which are not part of and not an amendment to the agreement establishing the RTA. In a few cases, members have reached a separate agreement on particular aspects, either before or after the agreement establishing the RTA. For example, the European Monetary System was an agreement among the member countries’ central banks, not part of the EEC and, similarly, we have noted that the Eastern Caribbean Currency Union is not part of CARICOM. Many pairs of countries which are members of RTAs have double taxation agreements outside the agreements. As another example, Australia and New Zealand have an arrangement that allows free movement of persons in the CER area but it predates the CER Agreement and is not part of it. However, in such cases, what matters is the totality of commitments towards integrating the economies of the area. Consequently, all binding agreements have been recognised in compiling the table.

Table 4.1 Progress towards Economic Integration in Seven RTAs (Goods Markets)

Goods Markets

Border measures	EU	NAFTA	CER	MERCOSUR	ASEAN	Japan-Singapore	NZ-Singapore
Elimination of industrial tariffs	✓	✓	✓	✓	*	✓	✓
Elimination of Industrial NTBs	✓	✓	✓	✓	*	*	✓
Elimination of Agriculture trade-distorting measures	✓	*	✓	*	*	*	✓
Elimination of government procurement barriers	✓	✓	✓	✗	✗	*	✓
Prohibition of export incentives	✓	✗	✓	✗	✗	✗	✓
Prohibition of anti-dumping actions	✓	✗	✓	✗	✗	✗	*

Beyond-the-border measures	EU	NAFTA	CER	MERCOSUR	ASEAN	Japan-Singapore	NZ-Singapore
National treatment	✓	✓	*	*	✗	✓	*
Prohibition of trade-distorting production subsidies	*	✗	✓	✗	✗	✗	✓

Across-borders measures	EU	NAFTA	CER	MERCOSUR	ASEAN	Japan-Singapore	NZ-Singapore
Harmonisation of product standards – convergence of product standards	✓	✗	✓	✗	*	✗	*
– mutual recognition of product standards	✓	✗	✓	✗	*	✗	*

Table 4.1 Continued (Services Markets)

Services Markets

Border measures	EU	NAFTA	CER	MERCOSUR	ASEAN	Japan-Singapore	NZ-Singapore
Market access	✓	✓	✓	*	*	*	*
Temporary movements of business persons	✓	✓	✓	*	×	✓	✓

Beyond-the-border measures	EU	NAFTA	CER	MERCOSUR	ASEAN	Japan-Singapore	NZ-Singapore
National treatment	✓	✓	✓	✓	*	✓	✓

Across-border measures	EU	NAFTA	CER	MERCOSUR	ASEAN	Japan-Singapore	NZ-Singapore
Mutual recognition of labour standards	✓	×	✓	×	×	×	✓

Table 4.1 Continued (Capital Markets)

Capital Markets

Border measures	EU	NAFTA	CER	MERCOSUR	ASEAN	Japan-Singapore	NZ-Singapore
MFN Treatment	✓	✓	✓	✓	✓	✗	✓
Rights of establishment	✓	✗	✗	✓	*	✗	✗
Repatriation of capital and profits	✓	✓	✓	✓	✓	✓	✓

Beyond-the-border measures	EU	NAFTA	CER	MERCOSUR	ASEAN	Japan-Singapore	NZ-Singapore
National Treatment	✓	✓	✗	✓	✓	✓	✓
Prohibition of performance requirements	✓	✓	✓	✗	✗	✓	✗
Prohibition of incentives to foreign investors	✓	*	✗	✗	✗	✗	✗
Investor protection	✓	✓	✗	✓	✓	✓	✗

Across-border measures	EU	NAFTA	CER	MERCOSUR	ASEAN	Japan-Singapore	NZ-Singapore
Harmonisation of business laws	✓	✗	*	✗	✗	✗	✗
Taxes – double tax treaty/ bilateral investment treaty	✓	✓	✓	✓	✓	✓	✓
Taxes – harmonisation of taxes on business	*	✗	*	✗	✗	✗	✗

Table 4.1 Continued (Labour Markets)

Labour Markets

Border measures	EU	NAFTA	CER	MERCOSUR	ASEAN	Japan-Singapore	NZ-Singapore
Temporary movement of natural persons	✓	✓	✓	*	✗	✓	✓
Permanent movement of natural persons	✓	✗	✓	✗	✗	✗	✗

Across-borders measures	EU	NAFTA	CER	MERCOSUR	ASEAN	Japan-Singapore	NZ-Singapore
Mutual recognition of labour standards	✓	✗	✓	✗	✗	✗	✗

Table 4.1 Continued (Single Market Measures)

Single Market Measures

	EU	NAFTA	CER	MERCOSUR	ASEAN	Japan-Singapore	NZ-Singapore
Regional competition law – convergence of competition laws	✓	✗	✓	✓	✗	✗	✗
– bilateral cooperation agreement(s)	✓	✓	✓	✓	✗	*	*
Intellectual property	✓	✓	✗	✓	✓	✗	✗
Monetary union	✓	✗	✗	✗	✗	✗	✗
Fiscal union	*	✗	✗	✗	✗	✗	✗

Using this typology and scoring, we can compare the progress towards complete integration of the major RTAs. From Table 4.1, the EU is clearly the RTA that has progressed the furthest towards complete integration. It has completed the elimination of all border measures in all four markets and almost all the beyond-the border and across-border measures. The exceptions to beyond-the-border measures are a limited restriction of production subsidies and limited harmonisation of business taxes. With regard to the production subsidies, Article 92 of the original Treaty of Rome forbade “state aids” which distort trade between member states but in practice a number of EU countries give a variety of subsidies to ailing or to high-tech industries (see the discussion on State Aids in the annual report of the European Commission Directorate-General IV).

By comparison with the EU, all other agreements have made selective progress beyond the liberalisation of border measures. The items in which progress has been made vary greatly among the RTAs. CER and NAFTA rank after the EU in terms of general progress towards the integration of the economies of the member countries. The two "New Age" agreements are broadly similar in their pattern of progress and general level of integration. There are, however, some significant differences between the provisions which integrate the Singapore economy with that of Japan compared to those which integrate it with that of New Zealand. Although both have been put forward as model new style agreements, the measures they incorporate are in fact a long way from complete integration. ASEAN and MERCOSUR are the least integrated of these RTAs.

One feature of the rankings is that the RTAs involving countries with open economies *vis-à-vis* the rest of the world – that is, Singapore, the US, Canada, Australia, New Zealand and the EU countries[11] – all do well in their regional integration scores. Conversely, MERCOSUR and ASEAN member countries rank below those of the Developed Countries in terms of their openness and they also do less well in terms of the degree of integration of their RTAs. This suggests that countries with low MFN barriers to trade tend to form more open and integrated RTAs with their regional partners. However, the sample is much too small to draw any reliable conclusion.

The next Section looks at the styles of some RTAs in terms of general differences in the degree of integration and in modalities and institutions.

4.3 Styles of economic integration

The differences between RTAs are not just a matter of different rates of progress towards the freedom of trade in the markets for goods, services and factors. They are also a matter of style in terms of choice of modalities, institutions and other general features. The two most important RTAs -the EU and NAFTA- have very different styles. These are reviewed in the following sections. The other RTA which is examined from the point of view of style is CER. While this agreement is not important in terms of its share of world market, it provides an interesting contrast with the two dominant agreements.

4.3.1 The EU Style

The EU is the only RTA where progress has generally been even across all four sets of markets. This is because it has, from the time of the Treaty of Rome, adopted an equal view of all four market areas. The original 1957 Treaty of Rome adopted the far-sighted goal of a "Common Market" for all four sets of markets. This was termed the Four Freedoms policy. In the markets for labour and capital, it has achieved total elimination of all border barriers to the movement by applying the principle of non-discrimination according to nationality.

The EU has also pursued deep integration in a very wide variety of areas of government regulation. In the Common Market phase of the evolution of the EU, the attention to deep integration issues was limited to those measures that were traditionally regarded as indirect border protection, such as technical barriers to trade and those subject to the "common policies" such as competition law where a regional law dates back to the Treaty of Rome. A feature of the competition law is the existence of a supranational authority, Directorate-General IV, to administer the common EU-level competition law.

With the adoption of the EU '92 measures and later the Single European Act, the goal became one of a Single Market. The EU Single Market can be characterised as a genuine single market with the exception of only partial harmonisation of tax rates and the

[11] These countries rank highly in the indices of competitiveness and openness compiled by the World Economic Forum and other organisations (see Section 5.1).

persistence of national subsidies. Post-1992 it has adopted measures which ensure full national treatment in the markets for goods, services and factors. Some of the sectoral policies go beyond National Treatment in that they include policies for research and development and the development of sectors.

With regard to a fiscal union, there has been some progress towards tax harmonisation but it has been slow and limited. The EU has taken steps to approximate commodity taxes and some other taxes. (For a discussion of the extent of convergence of corporate tax rates and tax structures in the EU, see Devereux, Griffith and Klem, 2002.) In November 2003 France and Germany rejected the fiscal rules of the European Monetary Union relating to national deficits, the Stability and Growth Pact. With regard to a monetary union, as noted above, the European Monetary Union has been adopted by only 12 of the now 25 full members.

The EU is also quite distinctive in terms of the modalities it has adopted in the four market areas. It has pioneered a number of modalities that have been adopted by other RTAs, especially in the areas of deep integration.

As part of the Common Market, the Treaty of Rome provided for the “approximation” (or harmonisation) of national laws and regulations affecting businesses. This strategy was not successful, partly because of the requirement of unanimity in the European Council before approval and partly because “approximation” was originally interpreted as uniformity, that is a single set of EU-wide standards. The EU ’92 introduced the new strategy of mutual recognition in both goods and labour markets. This principle was first developed in the ruling by the European Court in 1979 know as the Cassis de Dijon case. According to this ruling, if health or safety objectives are “equivalent” between Member States, products from another State have to be (mutually) accepted, despite differences in the specifications of the relevant national laws. Thus, the principle obviated the need to design common standards, which had proven impossibly difficulty in most of the cases attempted. It has the advantages of simplicity and allowing each nation to have its own national standards. Mutual recognition has been adopted in some other RTAs; for example, ASEAN and CER. (Mutual Recognition Agreements have also taken place between countries which are not members of an RTA or between an RTA and another country but outside the framework of an RTA, such as the EU-US Mutual Recognition Agreement on Conformity Assessment and the 1998 EU-Australia Mutual Recognition Agreement on Conformity Assessment.)

In the capital markets, the Treaty of Rome provided for the creation of Community companies. This supplements the approximation of laws affecting businesses. Community law created EU-wide jurisdiction to incorporate firms as Community companies, as an alternative to the usual national incorporation laws and a means to ensure effective incorporation throughout the Community. This practice has not, however, been widely adopted.

The EU is also distinctive and pioneering in its institutions. Alongside the market access and regulation provisions of the Single Market are the institutions created by the Treaty of Rome. The European Commission is the administrative body. It is a large bureaucracy with extensive administrative powers. In some countries, notably, in the Netherlands and the UK, there is a growing questioning of the growth of the bureaucracy and regulation by the Commission. In the elections for the European parliament in 2004, the “Euro-sceptics” registered a strong protest vote that was widely interpreted as a rejection of the growing centralisation and bureaucratisation of policies in the EU.

In addition to an administrative body, which is found in a number of other RTAs, there is the European Parliament, the Court of Justice, the Council of Ministers, the European Council and a host of other courts, committees, banks and other institutions.

The EU is a new tier of government above that of the national governments of its member States. The Treaty of Rome and subsequent treaties contain elements of a constitution establishing this level of government and laying down its powers. In June 2003 The European Convention on the Future of Europe drafted a Constitution for Europe. This was approved by the European Council in June 2004 and is now awaiting ratification by the legislatures of the Member countries.

An important aspect of this multi-level government arises when law develops at both the national level and at the level of the European Union. It is then necessary to define the areas of these respective and potentially overlapping laws. This is determined by the principle of subsidiarity. (See European Commission, 2004). This principle was first laid down explicitly in the Treaty of Maastricht, though it has evolved during the whole history of the EEC/EU. Article 3B of the Maastricht Treaty declares:

> In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can, therefore, by reason of the scale or effect of the proposed action, be better achieved by the Community. Any action by the Community shall not go beyond what is necessary to achieve the objectives of the Treaty.

This principle does not lay down any pre-determined allocation of laws between the Community and the governments of member States. Rather, it allows their derivation according to this principle. It has been important in all areas where Community-wide laws have developed; for example in the area of common competition law. In support of this division of responsibilities, the EU has also evolved rules for the cooperation between the two levels.

These features show that the EU has progressed beyond the economic types of a Common Market and a Single Market into a political union with widespread powers in all areas of legislation, including, for example, foreign policy, citizenship, regional policy (which in this context means policies for the sub-regions within the EU) and social policy. The EEC established by the Treaty of Rome was much more than a regional trading arrangement and the extension of the powers in subsequent treaties has taken it further towards a regional government. The ultimate driving force of this persistent movement towards greater economic and political integration is the experience of two devastating wars and the determination to avoid national conflicts in the region.

4.3.2 NAFTA Style

While NAFTA is a comprehensive agreement in the markets for goods and for services, it has adopted a very cautious approach to the set of policies covered by the term “deep” integration, that is, beyond-the-border measures, and to the integration of factor markets.

For goods and services markets, NAFTA incorporates the traditional principle of National Treatment in the form established in the GATT but little deep integration beyond that. Chapter 9 is devoted to Technical Barriers to Trade. This is, however, directed at standards-related measures that affect trade in goods or services between the three countries in the manner of the WTO Agreement on Technical Barriers to Trade. It is concerned with the avoidance of unnecessary barriers to trade and MFN treatment in technical regulations and conformity assessment. As the basis for its standards, each country has to observe relevant international standards. There is no provision for the harmonisation of the substantive standards of the individual countries. Similarly, in relation to sanitary and phytosanitary standards, NAFTA Chapter 7 directs members to use “relevant international standards”. This observance of international standards is a very weak alternative to harmonisation.

In relation to competition law, Chapter 15 is limited to the obligation of each member to maintain and enforce a competition law and to cooperate with each other in the enforcement of these national laws. There are no common rules or even agreed scope of competition law and no supranational authority as in the EU. This North American style of cooperation arises chiefly from a concern over national sovereignty and a lesser willingness to harmonise or approximate national laws and regulations.

In the markets for capital and labour, there is very limited liberalization of across-the-border measures. Trade in capital (both FDI and financial capital) is covered by Chapter 11 of NAFTA ("Investments"). This chapter does not extend or guarantee the rights of establishment for foreign investors from member states. However, it lays down the general principle of National Treatment and MFN treatment for foreign direct investors, and abolishes specified performance requirements. It has strong provisions, however, with respect to investor protection; it prohibits expropriation, except for public purposes and on a non-discriminatory basis and after full compensation. The provisions in Chapter 16 relating to the movement of natural persons are limited. What they do is facilitate the temporary entry for business-related purposes on a reciprocal basis among the three countries. These provisions apply to four categories of business persons: business visitors, traders and investors, intra-company transferees and professionals.

During the negotiation of NAFTA, the Bush Administration insisted that Mexico sign the so-called side agreements, the North American Agreement on Environmental Cooperation and the North American Agreement on Labor Cooperation, as a condition of entry into NAFTA. The former lays down the objectives of protecting the environment and establishes general commitments to monitor and protect the environment. The latter lays down general commitments, establishes core labour principles (such as the rights to organise, bargain collectively and to strike, non-discrimination, abolition of forced labour and protection for children and young workers) and promotes cooperation among members.

NAFTA has strong provision for the protection of intellectual property. It was also the first RTA to provide for the resolution of investment disputes through investor-to-state arbitration.

NAFTA has a Secretariat, with a Canadian Section and a Mexican Section and a US Section in the respective capital cities. However, its functions are limited to administration of the dispute settlement provisions of the Agreement. All of the provisions relating to trade in goods and services are overseen by the Commission on Free Trade. The North American Agreement on Labor Cooperation and the North American Agreement on Environmental Cooperation agreements are overseen by a Commission for Labor Cooperation and a Commission for Environmental Cooperation.

Two general themes run through NAFTA and largely account for its style. One is a strong underlying belief in private capitalism and the associated rights of enterprises to have access to markets and protection from arbitrary state intervention. The second is the importance of national sovereignty. The US Government has carefully protected what it sees as its sovereign rights in areas of industry regulation and taxation and has, consequently, avoided forms of cooperation or harmonisation that limit the ability of Congress to determine national laws and regulations. This is in sharp contrast to the EU development of laws and courts in these areas that are binding on the governments and citizens of its Member States.

4.3.3 CER

CER is an interesting case as it is distinctive in style, innovative in its modalities and has in a few directions progressed a long way towards complete economic integration.

With regard to goods markets, all border barriers were eliminated by June 1990, that is, only seven years after the agreement came into effect and five years ahead of schedule. This included the removal of all non-tariff barriers and all export incentives which distorted regional trade; and a prohibition on the use of anti-dumping actions against imports originating in the other member country[12].

This bold approach has been extended to the harmonisation of some standards. In addition to the harmonisation of customs procedures and other border trade regulations, beyond-the-border measures have been subject to harmonisation in selected areas of business law, in product standards, food standards and food inspection, and conformity assessment.

In the area of product standards, there is no formal National Treatment provision in the Agreement. However, the 1988 Memorandum of Understanding on Technical Barriers to Trade and a subsequent Exchange of Letters in 1992 has committed the governments to standards harmonisation and mutual acceptance of certification and accreditation.

In the area of competition law, there has been legislative convergence of competition law in the area of the abuse or misuse of market power, takeover law and consumer protection law. Some of the definitions and tests of anti-competitive practices were harmonised. In addition, in relation to the area of the misuse or abuse of market power, the law is applied on an area-wide basis. The so-called "trans-Tasman competition provisions" introduced in 1990 were an extraterritorial extension of the pre-existing provisions in each country which prohibited the use of a substantial degree of market power for the purpose of restricting/preventing entry or for anti-competitive conduct. The market in these provisions was defined as the trans-Tasman market rather than the national market. As part of these provisions the two governments prohibited the use of anti-dumping actions against imports originating in the other country. Thus, competition law remedies were substituted for anti-dumping actions under trade laws.

The 1990 competition law amendments also introduced important ancillary enforcement measures. The rules of evidence were altered to allow the gathering of evidence by a court in one CER country from the other CER country. A court of one country can issue subpoenas to be served on persons in the other country. If appropriate, a court can conduct its proceedings in the other country. These changes to the rules of evidence have no precedent in any other RTA. Complementary to the inter-governmental harmonisation of competition law, the competition authorities of the two countries in 1994 concluded an arrangement for coordination and cooperation of the activities of the two authorities. This includes provision for positive comity. Work is being done on possible integration of competition law in areas outside the misuse of market power.

In other areas of business law, work is proceeding in the areas of electronic transactions law, disclosure regimes and cross-border insolvency.

The harmonisation that has occurred has varied widely in terms of the modalities. The 1983 agreement envisaged harmonisation in the loose sense of the convergence of standards rather than the uniformity of standards. It stated explicitly in Article 8 that "both governments recognise that effective harmonisation does not require replication of laws, although that may be appropriate in some cases." The 2000 Memorandum of Understanding on the Coordination of Business Law elaborated on this theme:

> "An array of approaches exists to achieve the goal of increased coordination in business law. Both Governments recognise that one single approach would not be suitable for every area, that coordination is multi-faceted and does not necessarily mean the adoption of identical laws, but rather finding a way to deal with any differences so that they do not create barriers to trade and investment. In working towards greater coordination, the efforts of both Governments will focus on reducing

[12] Quarantine regulations, particularly in Australia, are regarded by some as an unjustifiable barrier to trade.

transaction costs, lessening compliance costs and uncertainty, and increasing competition."

This has been the model for business law.

However, the food standards harmonisation produced a single set of uniform (or common) standards in the two countries administered by a single bi-national independent authority (Food Standards Australia New Zealand or FSANZ). This modality of a single set of standards administered by a bi-national authority is being followed in the current negotiations relating to therapeutic goods standards.

The 1998 Trans-Tasman Mutual Recognition Arrangement introduced the different modality of mutual recognition for both goods and labour market standards.

With regard to services markets, trans-Tasman trade in services is covered by the Protocol on Services which was added in 1988. Trade in services is now completely free except for services inscribed in an Annex. Most of the inscriptions have been removed, the only substantial exception to free trade in services remaining being coastal shipping.

With regard to factor markets, the CER area is unique and peculiar in that it has free movement of labour supported by mutual recognition of labour market qualifications but no formal provision at all for investment flows. The free movement of persons for temporary and permanent purposes is guaranteed to all residents of the countries under the Trans-Tasman Travel Arrangements. These pre-date the CER Agreement by some 50 years. The Australian Government has resisted the addition of investment provisions in the RTA. However, both countries have modified their investment screening regimes with respect to investments from the other country so that a large majority of investment proposals do not require approval from the investment authority of the country concerned. Only one investment proposal has been rejected in the last ten years and this involved difficult matters relating to the future of national airlines and civil aviation in the two countries. There is a double tax treaty and both governments are addressing tax provisions which discriminate against corporations from the other country.

There are no specific dispute settlement procedures. The view of both governments is that the close relations between the countries mean that any issues of grievance or concern by governments or corporations can be addressed through discussion between the two governments.

One notable feature of the CER style is the sparsity of institutions to support the liberalisation of trade and incipient integration of the two economies. The only two institutions created are the authority FSANZ which is required to administer the common foods standards and Secretariat of the Joint Accreditation System of Australia and New Zealand. There is no CER secretariat and no website. All aspects of administration are handled by government departments.

The rather distinctive style that has evolved since the inception of the regional trade agreement is explicable in terms of the very close economic and political relations historically between the two countries. Both were English-speaking former colonies of the British Empire and are now members of the British Commonwealth. This explains both the willingness to undertake some far-reaching integration measures such as the harmonisation of business laws and food standards and the abolition of trade-distorting subsidies, and the lack of action in areas such as national treatment, foreign investment and intellectual property. In these latter areas, trade in goods and services and foreign investment is very close to being completely free, despite any formal commitment under the RTA.

In the CER region, Australian and New Zealand Prime Ministers and Ministers have in the past described the CER approach as "pragmatic". They avoided the use of terms such as "integration" or "single market". However, in January 2004 the Australian and New Zealand Prime Ministers expressed an intention of creating a "single economic market" (Howard and Clark, 2004). They have in mind the measures adopted by the EU, though it is doubtful they have a precise idea of the extent of these measures.

4.4 Competition between styles

There is a vigorous, though little acknowledged, competition between the EU on the one hand and the NAFTA countries on the other in terms of the provisions which are included in the RTAs they have signed.[13] With the proliferation of arrangements around the EU and NAFTA countries, the precedents set in the EU and NAFTA are gaining much greater geographic coverage. Experience shows that when these groups of countries engage in their second or third or subsequent regional agreements, they have tended to follow the precedents set in the first regional agreement.

Thus, the EU has incorporated many of the features of the Treaty of Rome and subsequent EU Treaties in its regional agreements with the former EFTA states (The European Economic Area), the Europe Agreements with Central European countries, the Europe-Mediterranean Agreements and the most recent Europe-MERCOSUR Agreement. The EU has made it plain that all countries aspiring to full membership of the EU must accept the rules of the EU as they have developed (called the "acquis communautaire", that is, the accumulated community rules) and it has tended to force the same pattern on other trading partners.

Moreover, some other RTAs that have developed independently of the EU in Latin America and the Caribbean have styled themselves closely after the EU. The Central American Common Market formed in 1961 followed the general style of the then EEC but with a lesser commitment to freeing trade in the four markets. MERCOSUR, the Southern Common Market, too was styled closely after the European Common Market. In the Caribbean, the Caribbean Community and Common Market was established in 1973. By a revision of the treaty, its title was changed to the Caribbean Community (CARICOM). As part of the Caribbean Community, there is a CARICOM Single Market and Economy (CSME), styled after the EU Single Market.

A similar pattern is emerging with the NAFTA countries, though in this case the US, Canada and Mexico have each negotiated independently with new trading partners because NAFTA as a group has eschewed negotiating agreements with other countries. In its post-NAFTA negotiations with new trading partners, the US has insisted that the provisions follow closely those of NAFTA. This is true of both the provisions pursuing liberalisation of border measures and those pursuing aspects of deep integration; such as those concerned with competition standards, industrial standards and intellectual property. In regard to harmonisation of standards, the US has confined the measures in new agreements to the NAFTA style of abiding by international standards plus cooperation among the regulatory authorities of the member countries, and eschewed any measures leading to the convergence of standards. This pattern is also true of the provisions relating to capital and labour markets. It is also true of the side agreements on the environment and labour standards. However, the recently-negotiated US-Australia Free Trade Agreement does not have side agreements on the environment or labour standards as these were deemed not necessary.

[13] This competition also applies in other bilateral agreements outside RTAs. For example, there is a distinct "European model" and a "North American model" in the design of Bilateral Investment Treaties (known as BITs) (see OECD, 2004, para 2.1).

Similarly, Canada and Mexico have incorporated many of the features of NAFTA in other subsequent regional agreements to which one is party. As one example, following the precedent of the NAFTA side agreements, the 1997 Canada-Chile Agreement and the 2001 Canada-Costa Rica Agreement both have two side agreements, an Agreement on Labor Cooperation and an Agreement on Environmental Cooperation. These side agreements are designed to force developing member countries with weaker systems of law to achieve minimum standards in areas that impinge on intra-area trade.

As with the EU, countries in the Americas other than the three NAFTA partners have also adopted many of the features of NAFTA. Many recent RTAs in the Americas have chapters in their agreements modelled after the NAFTA chapter on “Investment”, “Competition”, etc. These similarities are documented by Salazar-Xirinachs (2002, especially Table 2) for 9 RTAs in the Americas other than NAFTA.

As a consequence of the deliberate replication by NAFTA countries of the features of NAFTA and of the imitation of the NAFTA style by other countries in Latin America in particular, the NAFTA style, like the EU style, has now spread far beyond the borders of the original area. The papers in Sampson and Woolcock (2003) draw out the similarities and differences across RTAs with respect to six areas: technical barriers to trade, food safety, environmental labelling, public procurement, services and investment. They detect a clear pattern of “regulatory regionalism” in these areas.

This NAFTA pattern will spread dramatically if the current negotiations by the 33 countries in the Americas on the Free Trade of the Americas Agreement are concluded this year. The draft of this agreement follows the lines of NAFTA.

Why has this bipolar pattern emerged? Part of the explanation no doubt is the somewhat different view of state regulation and intervention in markets prevailing in the EU and in the US, which was noted above. The US has a stronger notion of national sovereignty and a lesser disposition to cede powers to multilateral and regional organisations.

Another part of the explanation is that many of the new features of RTAs are WTO-plus, that is, they go beyond the rules of the regulation of multilateral trade in the WTO. In the current multilateral negotiations there were many proposals to extend the rules of the WTO to new areas such as the Singapore issues of “trade and competition” and “trade and investment”. These proposals are very contentious. In the earlier stages of the Doha Round negotiations and discussions relating to these new areas, the US and the EU positions reflected closely the features they have developed in their own regional agreements and subsequent hub-and-spoke agreements. (Hub-and-spoke arrangements are discussed in Section 5.2.2 below.) There is thus a major interaction between the precedents of RTAs and the rules which may be developed in the Doha Development Round relating to deep integration and the new issues. This parallels the interaction between regional and multilateral liberalisation of market access for goods and services.

In fact, there is a new kind of competition between the EU and the US as centres of regionalisation. The EU and the US are locking those countries with which they have formed recent bilateral or plurilateral spokes into their style in terms of the extent of deep integration features and the choice of modalities. In the long run, this may have a profound influence on the kind of international trade rules that emerge at both the regional and multilateral levels.

5. SOME SPECIFIC FORECASTS

5.1 Economic growth rates

5.1.1 Growth rates of per capita incomes in the ASEAN economies

There are two standard formal statistical approaches to producing forecasts of growth rates. One is a simple time series model in which forecasts are made on the basis of previously observed patterns and cycles in the growth rates of real per capita GDP growth. The other is a growth regression that predicts economic growth on the basis of several variables that are believed to be predictors of economic growth in standard growth theory. Such variables usually include investment, population growth and trade openness.

Monokroussos and Kraay (1999) examine the ability of these two alternative formal methods of forecasting to make reliable forecasts of real GDP per capita in developing economies at several time horizons. They find that the simple univariate time series model produces forecasts of similar accuracy to the more complicated growth regression. The principle of parsimony dictates that we prefer simpler models with the same explanatory and predictive power. We adopt the univariate time series approach to forecasting economic growth in this report.

For each country, it is assumed that the growth rate in real GDP per capita for a given year may be modelled as dependent upon three factors: a trend term capturing the average secular growth rate, a proportion of the previous year's per capita growth rate capturing recent events and a random error term. The model accounts for unusual observations, such as the very deep recession associated with the Asian financial crisis, in order to prevent them from impacting unduly on the average secular trend in GDP per capita. The method allows us to determine which periods constitute anomalous observations.[14] The possibility that average growth rates have been permanently reduced since 1997 is allowed for, but not imposed.

Real per capita GDP data in constant $US is available for the ten ASEAN economies from the IMF World Economic Outlook database. For Brunei data was available from 1984 only, for Cambodia from 1986 only. To make forecasts comparable across countries, we use the same sample period (1985-2002) to estimate the forecasting equation described in the footnote.

Realized (2000-2002) rates and forecasts (2003-2020) of real per capita GDP growth rates are presented in Table 5.1. No data was available for per capita growth rates of real GDP per capita in 2003 at time of writing.

These forecasts predict a recovery in GDP per capita for all ASEAN economies other than Brunei, with growth rates gradually increasing over the next few years. Particularly strong growth is forecast for Singapore and Thailand and the transition economies of Cambodia and Viet Nam. More moderate growth is forecast for other ASEAN economies.

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[14] More formally, let y_t be the growth rates in real GDP per capita for a given year, m be the trend term capturing the average secular growth rate, r the proportion of the previous year's per capita growth rate capturing recent events, and e_t a random error term. The forecasting equation is
$y_t = m + r\, y_{t-1} + e_t.$
The dummy variable follows a Markov switching process as in Hamilton (1989). Regime switching models of this type are usually employed to capture the features of the business cycle. However, as the data in this study is only available at an annual frequency these models capture outliers and trend breaks as determined by the data. Therefore, only parameter estimates from the dominant states were used to obtain forecasts.

Table 5.1 Realized and Forecast Real Per Capita GDP Growth Rates 2000-2020 (%)

Univariate Time Series Forecasts								
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006-10**	**2011-20**
Brunei	0.4	1.2	1.1	0.7	0.9	1.0	1.5	2.4
Cambodia	4.6	3.5	3.5	4.4	4.5	4.7	4.9	5.2
Indonesia	3.5	2.1	2.3	2.3	2.6	1.9	3.5	3.6
Lao PDR	3.3	3.2	2.6	3.6	3.5	3.6	3.6	3.6
Malaysia	5.7	-2.0	1.9	3.5	3.8	4.0	4.2	4.3
Myanmar	11.5	8.7	4.1	4.8	5.0	5.0	5.1	5.0
The Philippines	3.5	0.7	2.3	2.3	2.4	2.5	2.6	2.7
Singapore	7.3	-5.2	1.4	4.1	4.5	4.7	4.9	5.1
Thailand	3.9	1.4	4.6	5.0	5.1	5.2	5.2	5.3
Viet Nam	5.3	5.4	5.6	5.4	5.3	5.2	5.2	5.2
ASEAN average	**4.9**	**1.9**	**2.9**	**3.6**	**3.8**	**3.8**	**4.1**	**4.2**

5.1.2 The development gap

These forecasts can be used to consider changes to the development gap in the ASEAN economies. Standard models of economic growth regard economic growth as being dependent upon the accumulation of factors of production such as labour and capital as well as technological progress. An increase in each of these factors has a positive effect upon economic growth, but their effects are diminishing. For this reason, these theories of growth imply that the growth rates of countries which have been industrialized for longer time periods will be lower than newly industrialized or industrializing economies. The implication is that incomes in economies with similar basic endowments and characteristics will eventually converge.

For the ASEAN economies, forecast growth rates in GDP per capita presented in Table 5.1 were used to predict real GDP per capita in each of the countries for the years from 2003 to 2015. Figure 5.1 plots the logarithms of observed (before the vertical line) and predicted levels (after the vertical line) of GDP per capita for the countries listed in Table 5.1. The log of GDP per capita is trending upwards for all countries during the observed sample period, and this trend in predicted to continue into the future.

The income gap between Singapore and Brunei on the one hand and the other ASEAN economies on the other remains rather large over the entire period. Forecast differences are recorded from 2003 as distinguished by the vertical line. Over the historical sample period, it is apparent that only the economies of Cambodia, Viet Nam and Thailand narrowed the income gap with Singapore, while the income gap between Singapore and the other ASEAN economies actually increased over the period.

To see which economies, if any, are closing the income gap with Singapore, the *difference* between the log of real per capita GDP in Singapore and the other economies of Figure 5.1 were calculated and are plotted in Figure 5.2. In this figure, for one of the ASEAN economies, a negative slope over some period indicates that it is converging on Singapore and a positive slope indicates it is diverging.

Figure 5.1 Logarithms of Real GDP Per Capita 1985-2015

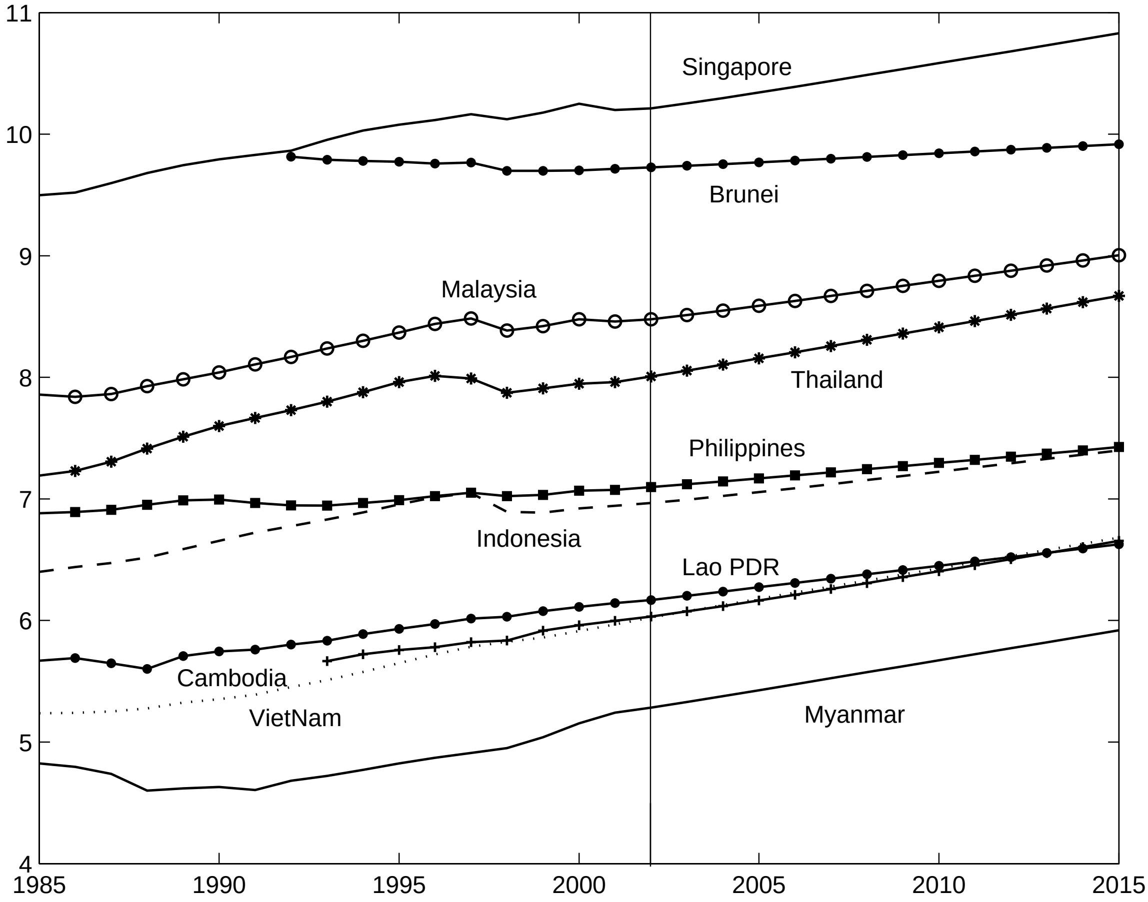


Figure 5.2 Differences in the Log of Real GDP Per Capita between Singapore and other ASEAN Economies, 1985-2015

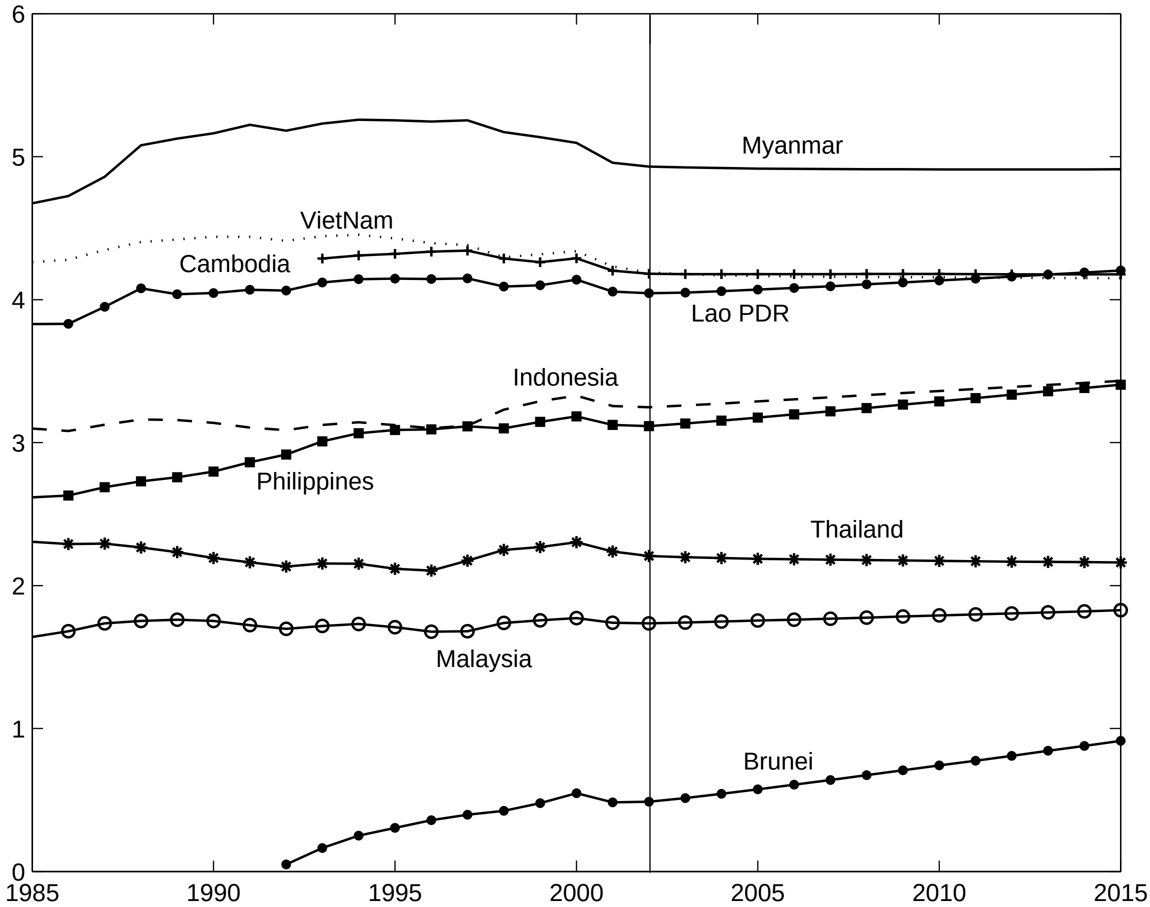
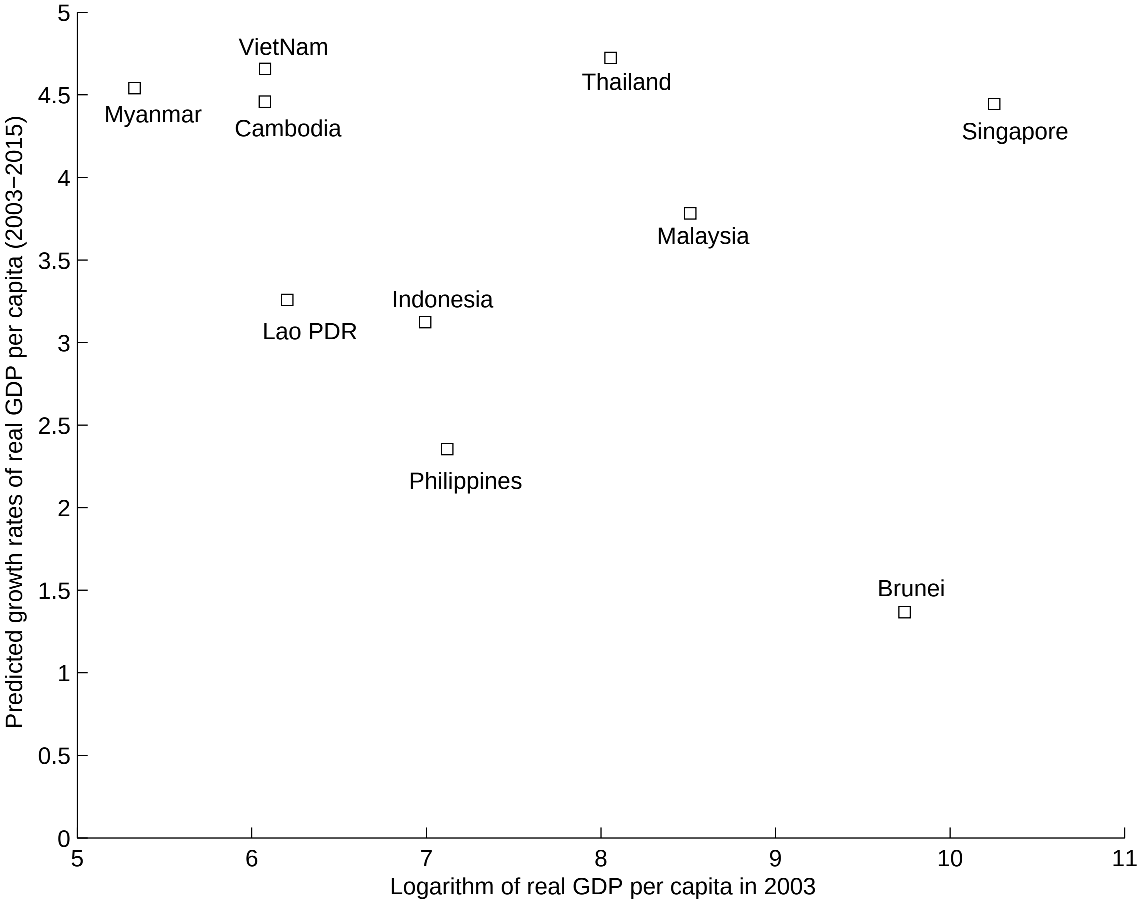


Figure 5.2 shows that, with the Singapore economy as the point of comparison, the Brunei economy is expected to diverge quite rapidly from that of Singapore and the economies of Indonesia, Lao PDR, Malaysia and the Philippines less rapidly. All of the other ASEAN countries will converge slowly on the Singapore economy.

Figure 5.3 presents a scatter plot of the logarithm of real GDP per capita in 2003 against the predicted growth rate of real GDP per capita between 2003 and 2015. For each country in this figure, those to the right of it on the horizontal axis have a higher per capita income. If, for this country, the predicted rate of growth on the vertical axis is higher than that of a country to the right, the poorer country's income will converge to that of the richer country over the period. This device is the easiest way to see whether a country is converging or diverging from those with higher per capita income. If all countries were converging to those above them in the ranking, the observations would all lie around a line sloping downwards.

We see that Myanmar, the poorest economy, is expected to converge on most of those economies but not on Viet Nam or Thailand. Viet Nam is expected to converge to all countries above it, except Thailand. Lao PDR is expected to converge on Indonesia, the Philippines and Brunei but to diverge from Thailand, Malaysia and Singapore. Cambodia is expected to converge on all of those above it but Thailand. The Philippines and Indonesia are expected to diverge from all those above them in per capita income except Brunei. Thailand will converge on Brunei, Malaysia and Singapore. The economy of Brunei is expected to diverge from Singapore.

Figure 5.3 Forecast Per Capita Growth Rates (2003-2015) Plotted against Initial Real GDP Per Capita (2003)



Overall, there will be little convergence among the ASEAN economies. The poorest countries, Myanmar and Viet Nam, will converge very little on all countries above them in per capita income and Lao PDR and Cambodia will not converge at all. All CLMV countries therefore will remain by the end of 2010 much poorer than all other older members. Singapore and Brunei will remain much richer than the other economies. Malaysia and Thailand will remain much richer than the other 6 countries currently below them in terms of per capita incomes.

This pattern is clear. More convergence would require a major departure from recent trends and one which favoured the poorer countries.

There is a fundamental problem in ASEAN arising from the very success of countries in the region. Convergence will always be very difficult if higher income countries maintain rapid rates of growth, as the six older members have continued to do. High rates of growth in these six countries are very desirable. But if they continue, it will require extraordinarily high rates of growth in the four CMLV countries to narrow the gap substantially in the time frame of the Vision Plan.

These forecasts have not incorporated the effects of ASEAN integration explicitly. It was argued in Section 2.5.3 that regional integration promotes convergence of incomes across countries in the region. This effect has been significant in the EU but the pace of integration in ASEAN may have been too slow in the past for this effect to show. Movement towards a single market in ASEAN in the future will be a factor promoting convergence but the integration will have to be far-reaching for it to have a substantial effect.

5.2 Changes in the global trade environment

Changes in the global trade environment arise because of changes in market access and national treatment. In this section, we focus on the changes in market access. Changes in market access result from changes in the trade policies of nations at three levels; the multilateral, regional and unilateral levels. We ignore changes at the unilateral level here because they are less important than the other two sources of change and have diminished in relative importance in recent years.

5.2.1 WTO and multilateral liberalisation

The GATT/WTO has played the major role in improving market access across national borders for more than 50 years. The main source of improved market access is by the reductions in tariff rates and non-tariff barriers to trade across national borders in the periodic rounds of multilateral trade negotiations held under the auspices of the GATT and now the WTO.

The GATT/WTO system has also contributed in another way. One significant and under-appreciated contribution is the commitments made by new members as a result of the accession negotiations. With a steady annual stream of new members since the end of the Uruguay Round, including one very large trader in the Peoples' Republic of China, and the increasingly strict conditions of entry for new members, accession commitments have been an important source of improved market access. This is likely to continue for a few years as a number of countries complete their current accession negotiations, including some important trading nations such as Russia and Saudi Arabia. However, the number of new members will decline markedly when the current backlog is processed. Within a few years, the rounds of negotiations will be the sole source of major MFN reductions in barriers to international trade.[15]

In the current round, the Doha Development Round as it is called, the mid-term Ministerial Conference in September 2003 in Cancún ended with no agreement on a text for the future course of the negotiations. This round is the first to be held under the auspices of the WTO. Some of the Ministerial Conferences of the GATT had similar breakdowns. However, the Cancún failure comes soon after the failure of the third Ministerial Conference of the WTO in Seattle in 1999 which had sought to establish the framework for these negotiations. This WTO record raises a question as to whether the new organisation has features that make negotiations more difficult than under its predecessor.

Several reasons have been given for the failure at Cancún. There were many more countries and many more issues on the table than in previous GATT Rounds. There were basic differences between groups of countries on issues such as subsidies on agricultural trade, industrial tariffs, TRIPS, WTO rules, S & D and the Singapore issues (trade and investment, trade and competition, transparency in government procurement and trade facilitation). But there were always differences among countries in earlier GATT rounds and in these rounds too coalitions of countries pushed the agendas of country groups. The Single Undertaking agreed to in the Uruguay Round meant that members no longer had the option of opting out of some of the agreements.

[15] Another largely-unacknowledged source of improved access over the last twenty years has been the removal of restrictions on access to foreign exchange for importers with the end of exchange controls in many countries, chiefly Developing Countries. Current account convertibility is a requirement of all members of the IMF.

There are two deep-rooted differences between the WTO and the GATT which appear to have played a major part. The first is the growth of anti-globalisation sentiment in a number of countries and among many NGOs since the conclusion of the Uruguay Round. In the arena of international trade negotiations, widespread anti-globalisation sentiment was first exhibited at the Seattle Ministerial Conference of the WTO. Many groups now question the merits of trade liberalisation whereas there had been growing acceptance of the benefits of trade liberalisation during the 1970s and 1980s. This scepticism was reflected in the stance of some countries at Cancún, for example, India, Brazil and South Africa. The second factor is the demand by some countries for expanding the scope of the rules of the WTO to new areas such as the Singapore issues.

These two factors are related. They both stem from the growing integration of the world economy. Integration of the world economy is continually posing new challenges in the rules of the world trading system.

In July 2004, the General Council reached agreement on a package that will allow the resumption of negotiations. Our best-endeavour scenario is that the Round will conclude though the negotiations may take another two or more years. For agricultural goods, it will include the elimination of export subsidies but only limited reductions in other support measures and tariffs. It will include improvements in industrial market access, but the reduction formula has still to be decided. The Singapore issues have been dropped, with the exception of trade facilitation. The changes in WTO rules will be minimal. In goods and services, the Developing Countries will have a longer implementation timetable and lower reduction coefficients than Developed Countries. It is likely that the achievements of the Doha Development Round will be modest compared to the Uruguay Round and perhaps also the preceding Tokyo Round.

Despite the probable modest outcome of the current round of multilateral trade negotiations in terms of improved market access, the successful conclusion of the Round will allow the continuation of the world trading system in its current form after it was seriously threatened in the lead up to Cancún and during the Cancún negotiations. Even so, this halting progress in multilateral negotiations affects the prospects for regional trading agreements.

5.2.2 Regional trading agreements

The formation of RTAs has exhibited clear trends in recent years. First, there has been an acceleration in the number of new agreements since the conclusion of the Uruguay Round. Second, the membership of RTAs increasingly overlaps, giving rise to “hubs-and-spokes” patterns of multi-layered discrimination. Third, the scope of these agreements is widening, including many new areas of beyond-the-border measures and other new issues such as e-commerce, investor protection, dispute settlement procedures and intellectual property rights protection.

The first of these trends is well documented by the WTO itself as it has conducted a series of “mapping” exercises that set out the growth in the number of RTAs notified to the WTO and their principal features; the latest of these is WTO (2003a). (A running list of notified agreements and much other information is available on the WTO website, www. wto.org/regional agreements).

The second trend is much-discussed and becoming better understood. Wonnacott (1996) introduced the terminology of “hubs” and “spokes”. A hub exists when one country (customs territory) is a member of two distinct RTAs. The spokes are the other countries which are members of one of the same RTAs as the hub country. One country may be both a hub with its own spokes and, with respect to another hub, a spoke. A hub or a spoke may also be a multi-country RTA itself; for example, the EU (an RTA) has regional trading agreements with many countries and is, therefore, a hub. Indeed, both a hub and a spoke may be RTAs rather than individual countries; as an example, the EU has regional trading agreements with EFTA states and with MERCOSUR, both RTAs. In this example, the EU is the hub and EFTA and MERCOSUR are among its spokes. The patterns are becoming very complex. One country with a large number of hubs may be called a super-hub. There a number of super-hubs with many spokes; such as the EU, EFTA States and Mexico. (For further discussion, see WTO, 2003a and Lloyd and MacLaren, 2003. The latter reference also presents a list of hub-and-spoke countries in the Asia-Pacific region.)

The economic importance of hub-and-spoke arrangements is that they create multi-layered discrimination. Spokes have less market access than the hub as the hub enjoys preferential access to all spokes but a spoke has preferential access to the hub only and, conversely, for import trade, a hub gets imports on better preferential terms from all spokes whereas each spoke gets preferential imports on preferential terms from only its spoke.

The third trend of increased coverage of measures has been discussed at some length in Sections 2, 3 and 4 above. One of the implications of this trend is that some of the features of some recent RTAs are WTO-plus, that is, they involve agreements on measures and regulations of the member governments that are not currently covered by WTO rules and not, therefore, subject to any discipline by the WTO. This applies, for example, to almost all of the provisions relating to investment, labour, competition and the environment. It also applies to many of the provisions for which there are rules in the WTO because the WTO rules relating to RTAs under Article XXIV, the Enabling Clause of GATT 1994 and under Article V of GATS, are limited to aspects of market access and national treatment and do not say anything about other aspects of trade in goods and services, for example, intellectual property and dispute settlement procedures.

These trends together herald a great increase in the importance of RTAs in the world trading system. One consequence of the formation of regional trading agreements is that the volume of goods trade among members of an RTA increases. This is a direct consequence of improved market access to each other's markets which results from the exchange of tariff preferences in an RTA while holding constant MFN rates for a tariff item (or the average MFN rate if the RTA is a customs union rather than a free trade area). This effect is somewhat weakened if, at the same time as the introduction of the preferences, some or all of the members lower their MFN tariff rates unilaterally. Empirical studies of the volume of trade between pairs of countries using gravity models with proxy variable for whether the two countries are members of the same RTA, show consistently that RTAs increase intra-area trade (see, for example, the survey of these models in Productivity Commission, 2003).

With regard to market access for industrial and agricultural goods, the growing importance of RTAs implies that regional lowering of border barriers has become much more important relative to multilateral lowering of barriers. There are, unfortunately and surprisingly, no precise statistics of this trend. We know from an examination of the individual agreements themselves that most recent RTAs have greater commodity coverage, in both the goods and services sectors, and that the depth of tariff cuts (that is, the difference between MFN rates applying to tariff items and the lower preferential rates) is typically greater than in earlier agreements. Both of these features make the new agreements more liberalising for goods and services trade than earlier agreements. But there are no global statistics of these aspects. (An excellent analysis of these features for RTAs in the Americas is provided by Estevadeordal, 2002).

Failing these statistics of commodity coverage and depth of preference margins, we would like to know what percentage of world trade in goods enters the importing countries at preferential rates that are lower than the non-preferential MFN rates. But this information too is not available. All the WTO can tell us is that, as of January 2003, 43.2 per cent of total world trade in goods involved a source and destination country that were both members of an RTA (WTO, 2003b, Table 1B.10). (This does not include trade under non-reciprocal preference terms, as under GSP and other preferences to Developing Countries, and agreements of partial scope in terms of sectoral coverage.) However, not all of this intra-RTA trade was conducted on preferential terms for several reasons; most agreements exclude some commodity groups from preferential access, many applied MFN rates are zero (and therefore no preference is possible on these items), some traders do not use preferential access because they are excluded by stringent rules of origin (ROOs) or the costs of complying with ROOS are too high. The WTO (2003b, p. 48) also forecasts that, if all RTAs that were under negotiation are successfully concluded within the next three years, the percentage will rise to 51.2 per cent by 2005. This is an underestimate as many RTA negotiations have begun since the report was written.

It is possible that, since the WTO came into operation in 1995, the lowering of trade barriers to goods and services on a discriminatory basis within RTAs has improved market access around the world more, in the aggregate, than the combined effects of multilateral and unilateral MFN reductions.

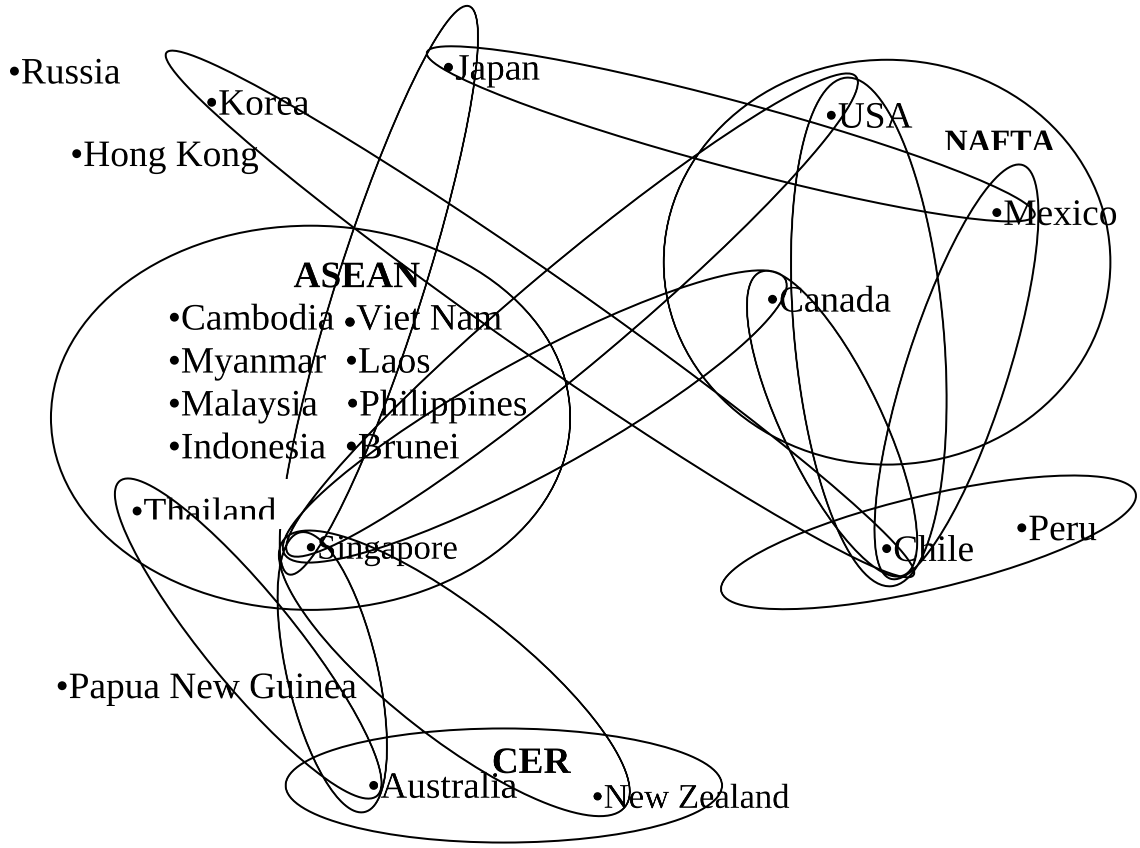
All of these trends are certain to continue. There are, in fact, a large number of new RTAs under negotiation at the present time. In its *2003 World Trade Report* (WTO, 2003b, p. 46), the WTO estimated that about 70 were then under negotiation and the number must be considerably greater now.
These trends are likely to be accentuated in the East Asian region. East Asia, apart from ASEAN, is a latecomer to the movement towards regionalism. Until the last few years a number of East Asian countries had eschewed regional trade agreements as they favoured MFN liberalisation; this was true of Japan, China, Korea, Hong Kong, Taiwan and Mongolia. As at November 2003, Mongolia was the only one of all 146 members of the WTO that was not a member of an RTA or involved in current negotiations for one! (WTO, 2003b, para 1).

Figure 5.4 provides a diagram[16] of RTAs in force in the Asia-Pacific area as defined by the APEC countries. (This is an updated version of the figure in Lloyd, 2002. Estevadeordal, 2002 provides a similar diagram for the Americas.) To avoid being too cluttered, it does not include the RTAs involving an Asia-Pacific country or countries on the one hand and a country or countries outside the Asia-Pacific on the other, the so-called cross-regionals. This diagram easily locates hubs-and-spokes and gives a sense of the direction of the discriminatory trade flows. Among the ASEAN countries, Singapore and Thailand have become members of more than one agreement, that is, they are hubs. In the East Asian region, Japan and Korea are also hubs.

One other important consideration in predicting the future path of regionalism in the world economy is the possibility of changes to the WTO rules relating to RTAs. Any new rules might affect both the rate of formation of new RTAs and the features included in these RTAs.

[16] This diagram is called a Venn diagram. Each loop contains the set of countries in an RTA. The intersections of these sets show the hub countries.

Figure 5.4 RTA's in Force in the APEC Area, 2004



WTO members are permitted to enter regional trade arrangements under three sets of rules: Article XXIV of GATT 1947 (as clarified in the Understanding on the Interpretation of Article XXIV concluded in the Uruguay Round and included in GATT 1994) provides for the formation of customs unions and free trade areas covering trade in goods; the 1979 Enabling Clause provides for the formation of preferential trade arrangements in trade in goods among Developing Countries only; Article V of GATS governs the terms of RTAs in the area of trade in services, for both Developed and Developing Countries. There are some differences between the rules in each of these areas (see WTO, 1995).

These rules are all very limited in the discipline they impose on members. With respect to trade in goods, most agreements have been notified to the GATT or WTO under Article XXIV. Article XXIV does require that, for those tariff items covered by the agreement, duties and other regulations of commerce be eliminated between members (that is, a 100 per cent depth of cut) but the only limitation on the extent of the commodity coverage is the weak requirement in Article XXIV that they cover "substantially all trade". Amazingly, the rules do not cover rules of origin for free trade areas and there are, therefore, no binding rules relating to preferential rules of origin in the WTO. They do not cover National Treatment, presumably because at the time they were written, in 1947, it was believed that the National Treatment Article III would suffice for preferential trade as well as MFN trade. Hence, they deal with border trade rules only, not beyond-the-border rules.

The only provision that really restricts the freedom of members to form customs unions or free trade areas among themselves is the requirement that "…duties and other regulations of commerce …shall not on the whole be higher or more restrictive…than prior to the formation of the customs union/free trade area". This was intended to prevent loss of trade for outside countries. It has generally prevented MFN trade barriers being raised against outside countries but it has not protected the interests of outside countries. The preferences themselves represent a worsening in market access for outside countries, even if MFN rates do not change. For outside countries to be no worse off as a result of the trade discrimination inherent in RTAs would require a *lowering* of MFN barriers, not just a stand still provision.

The rules under the Enabling Clause are somewhat weaker. No specific criteria are set out for the elimination or even the reduction of tariffs and non-tariff barriers. For services, Article V of GATS has conditions which are similar to those of Article XXIV, including a "substantially all trade" requirement. Both the Enabling Clause and Article V of GATS provide, in language similar to but not identical to that of Article XXIV, that the agreement not raise barriers to outside countries.

Moreover, these WTO rules have not been enforced; to date, the Committee on Regional Trading Agreements has reached a conclusion on only one of the RTAS notified to it and the GATT record was no better (see WTO, 1995, chapter V and annual reports of the WTO Committee on Regional Trading Agreements). As a consequence, many agreements do not satisfy the WTO requirements, weak though they are. For example, many would fail any reasonable interpretation of the "substantially all trade" provision and many have not eliminated the tariff rates for which preferences have been applied. Many have a timetable stretching well beyond the 10 year limit imposed by the Understanding on the Interpretation of Article XXIV.

In short, the rules of GATT/WTO have allowed members to do almost what they want in respect of forming new regional agreements, apart from raising the levels of tariffs and other restrictions against non-members.

There is general agreement that the rules are too permissive, particularly with respect to the effects on members outside the agreement (see, for example, WTO, 1995 and Schiff and Winters, 2003, chapter 8). Outside the GATT/WTO a number of more radical suggestions for reform of the WTO rules have been made. These include proposals to mandate lowering of MFN barriers, mandating 100 per cent commodity coverage (as well as the 100 per cent preference margins), harmonising and liberalising rules of origin, making accession of new members more liberal and putting a time limit on regional preferences, which after all violate the fundamental GATT/WTO principle of non-discrimination (see WTO, 1995, chapter V, Schiff and Winters, 2003, chapter 8 and Panagariya, 1999).

The Ministerial Declaration made at the end of the Ministerial Conference in Doha in November 2001 set out the work programme for the current negotiations. The section relevant to RTAs is that covering "WTO rules". It declares

> "We also agree to negotiations aimed at clarifying and improving disciplines and procedures under the existing WTO provisions applying to regional trade agreements. These negotiations shall take into account the developmental aspects of regional trade agreements."

This would allow a major revision of the rules. However, the discussions to date have been limited to transparency and clarifying the existing provisions relating to “substantially all trade” and “the not on the whole more restrictive” rules, and the procedures of notification and approval (see the compendium of issues produced by the WTO as background to the negotiations on RTA rules ; WTO, 2002).

There is little hope of a major change in rules relating to RTAs. The EU and the US have in the past opposed any major reform of these rules. New rules would have to permit the current RTAs as they are under a grandfather clause. The rules of origin are being discussed separately; there is enormous variation among RTAs in the pattern of rules of origin and there is no sign of any convergence on these rules. The almost certain outcome of the negotiations is that they will leave the WTO rules concerning RTAs much as they are.

Given this outcome, the future progress of RTAs will depend on other factors. Chief among these are the likelihood of new multilateral reductions in trade barriers and the emerging pattern of RTAs. The first of these was discussed in the preceding section.

The formation of new RTAs itself creates a new incentive for other outside countries to form further RTAs or for the enlargement of existing RTAs. As noted, if the MFN barriers remain unaltered when an RTA is formed, the accesses of outside countries to the markets for their export commodities are worsened. This effect is especially strong when the expansion of regionalism takes the form of the creation of new RTAs with many members. A country which trades with, say, the EU member countries or the US on MFN terms is put at a major competitive disadvantage if these countries are important destinations of major export commodities. The latest enlargement of the EU and the possible completion at the end of 2004 of the negotiations for the FTAA in relation to America’s markets explains why an increasing number of countries are seeking to protect their interests in these markets by pursuing bilateral or plurilateral agreements to put them back on an even playing field with major competitors in the EU and the US. This has led to the suggestion of “domino regionalism”. (For some discussion of the literature on the dynamics of RTAs, see Lloyd, 2002.) It is this incentive principally which explains why countries such as Japan and China have abandoned their stance against participating in RTAs.

One positive outcome of the likelihood of little change to the rules is that, from the point of view of individual RTA member countries, they can choose the design of an RTA without any restrictions from the WTO (apart from the levels of restrictions applying to MFN trade).

Another outcome of these projections is that ASEAN countries individually and collectively will have more to gain from pursuing new regional agreements in the future than they did in the past, and more to lose from abstaining.

5.2.3 Monetary unions

In a world with exchange rate flexibility, there are risks of exchange rate volatility in the future and even of crises for some countries. There are various forecasts of exchange rate movements but only for a few quarters. There are also some leading indicators of volatility or crises in the short term. To our knowledge, no one is forecasting exchange rate movements beyond the short term and no one is making forecasts for the global economy.

Monetary unions are one strategy for reducing exchange rate risk. Section 3.2 above reviewed the role of monetary union in the context of economic integration among the partners of a regional agreement. It was noted that there are a small number of monetary unions throughout the world. The only major example is the European Monetary Union and this is confined to only 12 of the now 25 members of the EU.

Yet, there has been discussion in recent years of the possibility of a monetary union or a common currency in several RTAs. For some years authors have discussed the possibility of a monetary union in the Southeast Asian or East Asian region (see, for example, Eichengreen and Bayoumi, 1999; Ng, 2002; Mundell, 2002). There has been considerable discussion in Canada of a monetary union with the United States or a monetary union involving all three NAFTA partners (for example, Grubel, 1999). The possibility of a monetary union has been debated in the Canadian Parliament. This discussion has been outside the NAFTA framework. There has been little interest in the US, the bigger trading partner. The US Government has made it plain that it is not interested in ceding any sovereignty over US monetary policy to Canada. Nor is it interested in sharing the seigniorage with Canada, or any other country that might want to adopt the US dollar as their national currency. (Seigniorage is the revenue received by the central bank which issues currency.) Similarly, there has been a discussion of the advantages of a monetary union in the CER area, taking the form of either a new area wide currency (the ANZAC dollar) or New Zealand adopting the currency of the larger partner, namely, Australia (see Grimes and Holmes, 2000 and Haug, 2001). This discussion has been outside the CER framework. In 2004 a poll of business executives in New Zealand found that more than 50 per cent favoured a common currency or monetary union but neither possibility has found support among politicians in New Zealand, while Australian politicians and policymakers have paid little attention to the debate in New Zealand.

Most of this discussion in these three regions has focussed on the macroeconomic issue of stabilising the national economy and has drawn upon the literature on the “optimal currency union.” In this literature, the dominant concern is over the pattern of co-movements of shocks to the economies of potential members of a monetary union, based on Mundell (1961). A country joining a monetary union loses one instrument of macroeconomic stabilisation, namely, an independent monetary policy. In theory, if the country has a flexible exchange rate, the central bank can design a monetary policy that responds to shocks to its macro economy, operating a loose monetary policy when the macro economy dips down and a tight monetary policy in an expansionary phase. On the other hand, by linking to the second country, it will gain if the pattern of shocks in the two countries is not too dissimilar. The case for a monetary union also requires a high degree of factor mobility within the region.

There is a second aspect of monetary union, namely the possible microeconomic benefits in commodity markets from the elimination of exchange rate risk and exchange transactions costs in intra-monetary-union area trade. These benefits were discussed in Section 3.2.

The balance of benefits between macroeconomic and microeconomic effects seems to be shifting towards the latter. From the macroeconomic view, some economists believe that the traditional advantages of monetary policy as a stabiliser have diminished. Calvo and Reinhart (2001) argue that many central banks in supposedly flexible exchange rate systems have not in fact been able to carry out countercyclical policies, much less the optimal ones. This is mainly due to a “fear of floating”. Reinforcing this view, more countries are using monetary policy to achieve an inflation target, rather than macro economy stabilisation. There is now a widespread belief that monetary authorities should focus on providing a stable framework with low inflation. From the microeconomic view, there is increasing evidence of the benefits of operating a common currency (see Rose and van Wincoop, 2001). In future, it is likely that more attention will be paid to these benefits.

Another concern is the choice of countries with which to link in a monetary union. As the examples of monetary union to date have shown, country membership of a monetary union need not and probably will not coincide with that of the RTA; in some cases membership in the monetary union has gone beyond membership of the RTA and in others only a subset of the members of an RTA have agreed to form a monetary union. A high degree of intra-union factor mobility is required. Hence, monetary unions may work best in areas that are already well integrated. This choice of area is compounded if the money markets vary greatly in sophistication among the members of an RTA, as they do certainly in the case of ASEAN. Another important consideration will be the credibility of the monetary authority of the union. Some small countries want to link to a larger country with more sophisticated monetary markets and more credible monetary policy.

The experience to date shows the difficulties of forming a monetary union. It is still too early to assess the gains from monetary union in the EU countries. It is likely that progress towards monetary union around the world will be slow, at least until there is a consensus on the European case.

5.3 Emerging risks in the 21st century

The management of risk to a nation has always been important. However, recent terrorist attacks and outbreaks of communicable diseases such as sudden acute respiratory syndrome have demonstrated how events that may once have been localized in their impact can now quickly spread across international borders. This is another effect of globalisation as these risks are associated with the movement of goods or people. The result has been a heightened international awareness of the importance of international co-operation in perceiving and mitigating potential risks. This section briefly considers potential new threats to the region.

5.3.1 Terrorism

Nitsch and Schumacher (2004) find evidence that countries that are the targets of a larger number of terrorist attacks trade significantly less than similar countries that do not have such problems. The mechanisms through which this can occur may be divided into three broad groups. The first is that terrorism, in increasing insecurity and uncertainty, also acts to increase transaction costs associated with trade, thereby lowering the incentives to do so. Secondly, terrorist attacks often lead to tightened security arrangements that can make trade more expensive. Thirdly there is the risk that traded goods will be destroyed or stolen.

Member states of ASEAN are highly dependent upon seaborne trade. Therefore the issue of maritime security is of particular importance to the region. Approximately half of the world shipping trade and one half of its oil are transported through the Straits of Malacca and Singapore. According to Richardson (2004, p.39), recent terrorist activity and land bombings in Indonesia have led to concerns that radical groups in the region may become interested in targeting shipping lanes in the region. The intention of such an attack would be to paralyse trade in the region, with disastrous implications for the regional and world economy.

While a major terrorist attack on shipping in the area may be catastrophic, the likelihood of a successful attack may be overstated. It would be difficult, for example, to sink a ship in an exact location. In May 2004 a large freighter took several hours to sink in the Straits of Singapore, by which time Singaporean authorities had towed the vessel out of shipping lanes (*The Economist Magazine*, 2004, pp.29-30). Furthermore, following a successful campaign by security authorities from the United Sates, tighter international security measures have been adopted by the International Maritime Organization and enter into force in July 2004. The security measures focus on improving security on board ships and at ship/port interface areas.

5.3.2 Oil Prices and Energy Policy

There is some concern about any impact the recent inflation of oil prices may have on economic growth in the region. The high degree of dependence of several ASEAN economies on oil imports raises the concern that recent increases in oil prices to over US

$40 a barrel, if continued, could dampen, or even reverse economic recovery in net oil consuming economies. However, it is unlikely that recent increase in oil prices will be as large or match the impacts of previous oil shocks, with the real price of oil still substantially lower than was the case with the 1970s oil price shocks.

In a recent report to the Asian Development Bank, Park (2004) investigates the impact higher oil prices may have on Asian economies. While the economic environment in most of the ASEAN economies is currently favourable, Park argues that a reconsideration of external policies may be required if increased oil prices create an adverse shock to the terms of trade. In particular Park argues that a nominal appreciation in exchange rates may be required to mitigate such effects. For countries with managed floats Park recommends that more flexibility in exchange rates should be allowed to mitigate the vulnerability of the economy to external shocks and decrease the cost of holding foreign reserves. On the other hand countries with pegged exchange rates should continue market oriented reforms in good and labour markets to increase flexibility in domestic prices and wages. In the long term Park recommends that ASEAN economies which are net oil importers should prioritize policies aimed at encouraging decreased oil dependency and improved energy efficiency.

5.3.3 Natural and Technological Disasters

While concern over terrorist activity is currently receiving attention from policy makers as well as the public at large, a new report by the OECD *Emerging Risks in the 21st Century* highlights the fact that the number of natural disasters reported in the world, including floods storms and droughts has been gradually increasing over the last fifty years. Progress in technology as well as heath and emergency services has reduced the human cost of such disasters but the financial burden, particularly insurance costs, has been steadily increasing world wide.

In line with the increased reported incidence of natural disasters, the incidence of technological disaster has also been steadily increasing. Such disasters include explosions, fires and transportation accidents. Example of such disasters include the 1987 ferry collision in the Philippines which affected 4375 victims, and the Chernobyl nuclear reactor meltdown, which reportedly affected over 135,000 people and resulted in $2.8 billion in economic losses (OECD, 2002). Policies aimed at ensuring adequate industrial safety standards and emergency responses are therefore important in order to moderate costs associated with such disasters when they occur as well as to suppress insurance costs.

5.3.4 Issues of Public Health

5.3.4.1 Communicable Diseases

Despite great improvements in epidemiological surveillance systems in the South-East Asian region since the outbreak of sudden acute respiratory syndrome and concern over the avian flu, such systems remain at various stages of development. Epidemiological surveillance systems are vital to the early detection and prevention of out-breaks of life-threatening diseases. They become increasingly important as developing countries near eradication of target diseases such as polio or leprosy in order to prevent new outbreaks or re-introduction. While the monitoring of new diseases such as sudden acute respiratory syndrome is important, it is worth noting that according to the World Health Organization (2004), certain communicable diseases, such as HIV/AIDS, malaria and tuberculosis will remain as major problems of public health in the region and that priority needs to be given to their surveillance and control.

5.3.4.2 Non Communicable Diseases

Associated with the rapid progress of economic development in the region has been a gradual increase in life expectancies. Non-Communicable diseases have therefore become more important in the South East Asian region. This potentially places new burdens on the health care systems of South-East Asian countries. While all countries in the region have official public health policies, the World Health Organization (2004) argues that the quantity, quality and accessibility of information on non-communicable diseases in the region largely remain inadequate.

6. POLICY IMPLICATIONS AND RECOMMENDATIONS FOR THE VIENTIANE ACTION PROGRAMME

6.1 The global context – globalisation and regionalisation

This section summarises the lines of argument and the conclusions of previous sections, and considers their policy implications for the ASEAN Economic Community. It concludes with specific recommendations for the Vientiane Action Programme.

The world trading environment has been changing rapidly for the last two decades and continues to change rapidly. Two trends are apparent – globalisation and regionalisation.

Globalisation is the process of forming global markets for goods, services and factors. As barriers to the cross-border movement of goods have been reduced, there has been a steady and almost uninterrupted expansion of world trade in goods over the last two decades (see Figure 1.1). Similar trends have been shown in the markets for services and for factors (see Figures 1.1 and 1.2). The rate of growth of FDI flows exceeded the rate of growth of trade in goods worldwide until the year 2000 but there has been a downturn since then. These trends have been the result principally of lowering barriers to cross-border trade in these markets.

Regionalisation is the process of forming more closely linked regional markets for goods, services and factors. The mechanism which has brought this about is the formation of regional trading agreements (RTAs).

At both the global and regional level, reductions in the barriers to trade are broken down into two components. These are called *border* barriers and *beyond-the-border* barriers. For goods trade, border barriers are the traditional tariff and non-tariff measures such as quotas or prohibitions or licensing. Beyond-the-border barriers are the measures that apply after goods have passed the border. These include technical barriers due to industrial, environmental and other standards, other regulations which discriminate against foreign goods and differences in tax treatment. The same distinction is made for barriers that restrict flows of services and of capital and labour across national borders.

The ASEAN countries have participated in the trend towards globalisation. Annual data of trade, measured in real terms, are available for 5 ASEAN countries. For these countries, the rate of growth of ASEAN goods trade and ASEAN services trade exceeded that for the world as a whole over the period 1981 to 2002. These growth rates, however, have slowed markedly since the 1997 Asian currency crisis. The difference is less marked for trade in services. Consequently, in the ASEAN countries, unlike the rest of the world, the rate of growth of services trade has not been faster than the rate of growth of goods trade. Inflows of FDI into ASEAN countries during the decade of the 1980s and that of the 1990s until the Asian Crisis were well above world rates. These inflows slumped after the Crisis, but there are signs of a recovery in 2003 and 2004.

The process of globalisation has had profound effects on the ASEAN economies. Without the environment of continually expanding overseas markets, especially in North America and Europe, the ASEAN countries would not have been able to achieve the high rates of growth of real GDP and GDP per capita they experienced. These growth rates were well above the world average and the envy of many countries in other regions of the world. Greater linking to world markets, however, brings risks of macroeconomic fluctuations and currency crises. Since the Asian Crisis, the volatility of exchange rate movements has continued to be much higher than it was before the Crisis (see Figure 1.5).

The regional linking of markets by the formation of regional trading agreements poses special opportunities and challenges. Freeing of trade in commodities and factors yields benefits from improved efficiency. These improvements give higher real incomes and greater choice of goods and services for residents of the regional area. This is the primary benefit of regionalisation. In addition, the regional linking of markets may assist the exchange of goods and services with countries outside the region. It may make ASEAN exporters more competitive in world markets, or make them competitive in new markets as these economies become exporters of new higher quality goods and services.

East Asia has participated in the trend to regionalisation too. However, apart from ASEAN, it was a latecomer to the movement towards regionalism. The trend towards regionalisation is likely to be accentuated in the East Asian region in the future. Until the last few years a number of East Asian countries had eschewed regional trade agreements as they favoured MFN liberalisation; this was true of Japan, China, Korea, Hong Kong, Taiwan and Mongolia. That has ended. In addition, Singapore and Thailand have become members of more than one agreement, that is, they are hubs.

These processes of globalisation and regionalisation pose a general challenge for the ASEAN economies and for the ASEAN area collectively.

One challenge is the possibility of ASEAN as an entity forming new regional links with countries or groups of countries outside the area, as the EU, EFTA, MERCOSUR and some other RTAs have done. This is an important consideration. Any such possibility will require careful consideration by the ASEAN members. Currently ASEAN has Framework Agreements with China, Japan and India under which the ASEAN countries are exploring possible modes of economic cooperation with these countries.

An agreement between ASEAN on the one hand and another country or group of countries on the other has advantages over agreements between individual ASEAN member countries and another outside country or group of countries. First, an ASEAN agreement is likely to lead to more trade liberalisation. An agreement between ASEAN and one individual country is equivalent to 10 agreements between the individual ASEAN member countries and the outside country. Second, with one agreement that has ASEAN as a party, the coverage of the agreement and the terms will be uniform for all trade between the 11 countries whereas multiple agreements by individual ASEAN members are likely to lead to a patchwork of agreements with different terms. In areas such as rules of origin, a single uniform set of rules is a distinct advantage. Third, multiple agreements introduce a new layer of discrimination among the ASEAN countries. When Singapore or Thailand signed an agreement with an outside country, one ASEAN country gained access to the markets of this country under the terms of the agreement on terms which are better than those of the other 9 ASEAN countries. Conversely, the outside country gained access to the markets of the one ASEAN country on preferential terms. These terms may be equal to those of other ASEAN countries under the terms of AFTA. The market access of the outside country to the markets of the one ASEAN country may even be better than that of the other nine ASEAN countries for some commodities with non-zero tariffs or non-tariff barriers and less stringent rules of origin. On the other hand, a single ASEAN agreement has the disadvantage that the negotiations among 11 or more countries may be difficult.

By the same token, there are advantages to the negotiation of a single agreement between ASEAN and the three North Asian countries of the Peoples' Republic of China, Japan and the Republic of Korea. There is also the same disadvantage that a negotiation between ASEAN and three countries may be more difficult than negotiation between ASEAN and one of these countries. One particular difficulty is that exceptions or limitations on the scope of the agreement because of the objections of one of the three may be applied to all three, thereby limiting the scope of the agreement among the 13 countries.

Economic integration goes further than the liberalisation of border trade. It is the process of lowering border and beyond-the-border measures and harmonisation across national borders of laws and regulations that restrict trade in commodities and factors. The limit of the process of economic integration is a single market. A single market is an area in which there is no discrimination in the markets for commodities and for factors against foreign goods, services or capital and labour. Consequently, the markets are completely integrated. Countries can choose the extent to which they approach a single market.

With respect to the evolution of ASEAN itself, the challenge is how far and how fast should the linking of the ASEAN economies proceed? Should their economies become more integrated by lowering the beyond-the-border barriers as well as the border barriers to intra-ASEAN trade and specialisation? Should the countries harmonise laws and regulations across the member countries? To consider these questions, we begin with the objectives of the ASEAN Economic Community.

6.2 ASEAN current objectives

The statement of objectives is central to the development of a regional trading agreement. The objectives should be clear and simple and should give direction to the policies.

The Bangkok Declaration of 1967 set the general form of the ASEAN area. It declared seven "aims and purposes" of the Association. These include "economic growth", but they also include the promotion of regional peace and stability, social progress, cultural development, and scientific and technical collaboration. ASEAN has continued to evolve on all of these fronts. The Declaration of ASEAN Concord II at Bali 2003 declared the establishment of an ASEAN Community "…comprising three pillars, namely political and security cooperation, economic cooperation, and socio-cultural cooperation". To implement this Community, the Declaration set up an ASEAN Security Community, an ASEAN Economic Community, and an ASEAN Socio-cultural Community. Plainly the Association is much more than a regional trading agreement.

In the area of economic cooperation, Concord I at Bali in 1967 declared that, in order to promote development and growth in the area, the members "…shall cooperate in the field of trade". The 1977 Agreement on ASEAN Preferential Trading Arrangements (PTA) initiated a programme of liberalisation of goods trade on a preferential basis. The declared objective for goods trade was "trade liberalisation" rather than free trade.

A major step was taken in 1992 with the launching of the ASEAN Free Trade Area, AFTA. This established a Common Effective Preferential Tariff (CEPT) Scheme. The product coverage of the scheme was taken to be "All manufactured products, including capital goods, processed agricultural products falling outside the definition of agricultural products, as set out in this Agreement." Thus the product coverage of the goods trade provisions was wide but not complete. There were temporary and permanent exclusions lists and a general exceptions list. A 15-year timetable was set for tariff reductions on the items covered. At the Third ASEAN Informal Summit in 1999, the ASEAN Leaders agreed to eliminate all import duties by 2010 for the six original members and by 2015 for the new members. This was an important step in the evolution of the free trade area.

Provision was also made in the CEPT, in respect of products under the Scheme, to eliminate immediately all quantitative restrictions and to eliminate within a period of five years other non-tariff barriers upon enjoyment of the CEPT concessions. Article 5 also provided for "….further measures on border and non-border areas of cooperation to supplement and complement the liberalisation of trade".

Trade in services was not covered until the introduction of the ASEAN Framework Agreement on Services (AFAS) of 1995. This provides for preferential intra-ASEAN trade in services by means of the members making commitments which are inscribed on a schedule. AFAS states the goal of the agreement as "… to eliminate substantially restrictions to trade in services among members…within a reasonable time-frame." Seven priority areas were nominated. This is the positive lists approach. There is provision for subsequent negotiations. The Agreement also provides for the mutual recognition of education achievements, licensing and certification of service suppliers.

Cooperation in the area of investment began with the 1998 Framework Agreement on ASEAN Investment Area (AIA). With regard to intra-area investment, the objective set out in Article 3 is

> "… to progressively reduce or eliminate investment regulations and conditions which may impede investment flows and the operation of investment projects in ASEAN, and to ensure that the realisation of the above objective would contribute towards free flow of investments by 2020".

The Agreement provided for open access and national treatment for all "ASEAN investors" in manufacturing and manufacturing services, and other privileges (minimum 30 per cent corporate investment allowance, duty free imports of capital goods). Exceptions were listed on a Temporary Exclusion List, a Sensitive List and a General Exceptions List, following the modality of CEPT. Provision of intra-area preferences is unusual in RTAs. However, national treatment and privileges are to be extended to all non-ASEAN investors by 2020.

The Agreement contains other objectives relating to increasing the flow of investments into ASEAN from non-ASEAN sources as well as ASEAN sources and promoting ASEAN as the most attractive investment area. This is another unusual feature of the AIA by comparison with investment provisions in other RTAs.

There are no general provisions relating to the freedom of movement of labour within the ASEAN area. The Hanoi Plan of Action set out a programme to promote human resource development in the area. This included a plan to establish networks of professional accreditation bodies to promote regional mobility and mutual recognition of technical and professional credentials and skills standards, beginning in 1999. The ASEAN Labour Ministers meet annually. In May 2000 they adopted an ASEAN Labour Ministers Vision and Mission Statement. The focus is on regional cooperation in human resource development.

In the first three decades of ASEAN there was no mention of economic integration. The landmark ASEAN Vision 2020 statement, made in 1997, declared that "we commit ourselves to moving towards closer cohesion and economic integration". It announced a number of measures to pursue this new goal. The First Plan of Action, the Hanoi Plan of Action, the following year reaffirmed the goal of "closer economic integration". Significantly, it expanded on this goal by declaring an intention

> "To create a stable, prosperous and highly competitive ASEAN Economic Region in which there is <u>a free flow of goods, services and investments, a freer flow of capital,</u> [our underlining] equitable economic development and reduced poverty and socio-economic disparities".

The 2003 Declaration of ASEAN Concord II went further. In the section on the ASEAN Economic Community, it reiterated the "end-goal of economic integration as outlined in the ASEAN Vision". It then declared

> "The ASEAN Economic Community shall establish ASEAN as a single market and production base."

Thus, ASEAN has now progressed to the most far-reaching goal, that of a single market. The meaning of the term "single market" requires careful examination.

6.3 What the goal of a single market implies

The term derives from the Single European Act of the EU but it has achieved widespread usage in recent years. The goal of a single market is much more far-reaching than commonly believed.

In terms of market coverage, a single market is normally taken to cover the markets for all goods, services, capital and labour. That is, all the markets in an economy. In terms of the measures applying to these markets, the term “single” is taken to mean that there shall be no discrimination according to source throughout the region as defined by the RTA.

The establishment of a single market is much more demanding than the establishment of a common market. The latter term is, following EU terminology again, generally taken to mean free movement across borders in all markets, though the European Common Market contained elements of common policies in addition to free trade.

Economists have given greater precision to the term “single market”. They regard a single market as one in which the Law of One Price holds for all markets. That is, after adjusting for transport and other unavoidable costs of moving goods (or services or assets), the price of a tradable commodity should be the same throughout the single market area. This one price test provides a standard to measure progress towards a single market.

The Law also provides a means of determining what measures are required to ensure there is a single market. The conditions necessary to have only a single price in the market area are very demanding.

First and obviously, a single market requires the elimination of all border measures which inhibit the movement across national borders. In goods markets, this is the removal of tariffs and other non-tariff border measures, including foreign exchange restrictions. In service markets where the delivery is by the mode of Commercial Presence, it requires the unrestricted right of establishment and the absence of foreign exchange controls on transactions. Likewise, in FDI markets, it requires the unrestricted right of establishment and the absence of foreign exchange controls on transactions. In markets for portfolio capital and other capital assets, it requires the right to buy and sell across borders without restrictions.

Second, after a commodity or factor crosses the border, a single market requires full national treatment with respect to taxes and other state charges and regulations. The notion of national treatment is not normally applied to labour markets but in labour markets it encompasses such labour market issues as the recognition of labour market qualifications and experience on an equal footing with domestic labour. In capital markets, it requires full national treatment with respect to taxes and business regulations. It implies the absence of such measures as performance requirements that apply to foreign-owned enterprises but not like domestic enterprises. All of these are sometimes called “beyond-the-border” measures.

Third, it requires the harmonisation of standards, laws and regulations across nations that prevent a single price from ruling across countries. In goods markets, these include standards for industrial products, health and safety of persons, and the environment, policies relating to particular sectors such as industry or transport, and business laws that differentiate between foreign and domestic supplies. In goods, investment and service markets, they include business laws.

Fourth, a single market requires equal taxes, that is, equal tax rates and other tax provisions throughout the area.

Fifth, less obviously, economists have come to the realisation that a single market requires a common currency. Transactions costs and exchange rate risk accompanying the use of foreign exchange markets to effect transactions imply real costs and lead to price differences.

In total, this list of conditions is very demanding.

There is one general issue that arises when a single market spans more than one country. This is the issue of subsidiarity. Subsidiarity is the principle that determines what level of government should carry out decision-making. It applies when there are two or more levels of government. It applies in a Federation to allocate powers between the Federal and the State/Province levels of government. It applies in an RTA when powers are divided between the RTA and national levels of governance. This principle does not lay down any pre-determined allocation of laws between the Community and the governments of member States. Rather, it allows their derivation according to a principle.

Among RTAs, the principle of subsidiarity was first laid down in the EU but it has been recognised as applying generally when there are both RTA-wide and national laws or regulations applying at the same time (see, for example, Guerin, 2002 and Sauvé, 2003 and references therein.) It involves allocating roles between levels of government, coordinating the implementation of decisions and managing accountability and participation. In the EU, it has been important in all areas where Community-wide laws have developed; for example, in the area of common competition law. It will be applicable in ASEAN if and when common standards or laws or regulations are adopted.

6.4 Advancing the ASEAN Economic Community towards a single market

6.4.1 ASEAN progress towards a single market to date

With the definitions of a single market in Section 6.3, we can consider how far ASEAN has progressed towards this goal in terms of the measures it has actually adopted. We shall first consider the broad picture of border measures and then beyond-the-border measures and harmonisation across nations of standards and other laws and regulations.

How far is ASEAN from a free trade area, that is, an area in which there are no *border* measures restricting intra-area trade? We interpret this term now in the European sense of an area with free trade in goods, services, capital and labour.

With regard to goods trade, considerable progress has been made towards the elimination of border tariffs and non-tariff measures restricting or distorting intra-ASEAN trade. The tariff timetable has been accelerated several times. The Fifth ASEAN Summit held in Bangkok in 1995 accelerated the timetable from the original 15-year timeframe to a 10-year timeframe. The 1998 Hanoi Plan of Action accelerated the implementation of tariff reductions further. There have been a few set backs in implementing the timetable. In 2000, in the period of the aftermath to the Asian Crisis, some ASEAN members deferred their tariff reduction commitments under CEPT.

At the time of writing, the six original members of ASEAN are well down the path of eliminating intra-area tariffs. For the six members, the 17th Meeting of the AFTA Council in September 2003 stated 99.5 per cent of the products traded in the area were on the Inclusions List and of these products in the CEPT Inclusion List 99.6 per cent are now within the 0-5 per cent range (ASEAN, 2003b). The new members (CLMV) are also keeping pace with their CEPT commitments. Their Inclusion Lists now comprise 72.2 per cent of their total tariff lines (ASEAN, 2003b). (The items on the General Exceptions List are legitimate WTO-consistent permanent exclusions of products that are harmful or endanger national security, human or animal or plant life and health or are of artistic, historic or archaeological value.) The details are in the ASEAN Tariff Database and the frequency distributions of tariff rates available on the ASEAN Secretariat website. There are still products on the exclusion lists.

Overall, for some product groups, border tariffs still substantially restrict intra-area trade among the old members; these include automobiles and automobile intermediate materials, some other manufactures and a number of agricultural products.

However, McKinsey (2003, p. 39) report that, in a survey of imports in 2000, less than 5 per cent of intra-ASEAN trade entered under CEPT preferential rates. Even allowing for items on which the MFN rates are zero, this implies a very low preferential tariff utilisation rate. The rules of origin do not appear strict. ASEAN uses a regional value content rule and the required domestic content of 40 per cent is relatively low among RTAs that use this criterion. The rules allow the use of a direct or indirect method of calculation. A recent comparison of features of rules of origin systems among 18 RTAs by the Australian Productivity Commission (2004, Figure 4.1) rated the CEPT rules as among the least restrictive. Yet, the very low utilisation rate suggests considerable administrative difficulties on the part of exporters and importers in meeting the rules of origin requirements.

With respect to the non-tariff measures, however, the AFTA Council expressed its “serious concern over the slow progress” of these measures. There are still quotas, import licensing and other product-specific NTBs.

ASEAN has no provision relating to export incentives. There are no data on export incentives distorting intra-ASEAN goods trade. There is no provision for liberalising government procurement. AFTA has no provision for the prohibition or mitigation of anti-dumping actions taken by one ASEAN member country on imports sourced from another ASEAN member country, as there is in some RTAs. However, few, if any, anti-dumping actions have been taken on imports from fellow ASEAN member countries.

Under the provision in CEPT on areas of cooperation to complement trade liberalisation, several measures have been started. These include the simplification of customs clearance procedures, mutual recognition of conformity assessment requirements, and harmonisation of sanitary and phytosanitary standards. The ASEAN Transport Ministers have also taken a number of steps to facilitate the movement of goods between ASEAN countries by road, sea and air. This is an important accompaniment to measures that lower barriers to the movement of the goods.

With regard to services trade, the ASEAN positive list approach and the absence of clear targets (other than the ultimate target of free trade in services by 2020) has limited the commitments to those sectors where the member countries have been willing to make them. The initial commitments have been extended by two subsequent rounds of negotiations with a third round in progress. The current commitments are set out in the Member Countries’ schedules but there is no summary of these commitments similar to the distributions of tariff rates for tariffs on goods. The third round is currently in progress. For this round, the ASEAN Economic Ministers adopted two new modalities, the modified common sub-sector approach and the ASEAN-X formula. These modalities represent a sectoral approach to extending the coverage of the Agreement.

With respect to capital, the 1987 Agreement and the 1996 amending Protocol applied to investments in manufacturing and the primary industries (agriculture, fishery, forestry and mining and quarrying). The Agreement provides for countries to grant greater access to ASEAN countries for investment purposes and the AIA has ensured national treatment for investors. Exceptions were permitted in AIA via a Temporary Exclusion List, a Sensitive list and a General Exceptions List. Malaysia and Singapore have no Temporary Exclusion List. In 2003 the Temporary Exclusion List was phased out by five other countries. While services are not covered, the 1998 Framework Agreement on the AIA and its Protocol extended the coverage of direct investments to include services incidental to manufacturing, though there are no commitments by the national governments in this area yet. All transfers of capital and profits and other remittances are guaranteed and there is full protection from expropriation and nationalisation. There is, however, no general provision for other measures affecting capital such as a prohibition of performance requirements or the harmonisation of business laws or taxes. The ASEAN Secretariat maintains a Compendium of Investment Policies and Measures in ASEAN Countries.

One feature that warrants attention is incentives to ASEAN and third country investors to invest in ASEAN economies; that is, financial incentives as distinct from more general policies to make the area more attractive to investors. A variety of tax exemptions and allowance and other incentives are offered to foreign investors in all ASEAN economies. The Compendium lists these incentives. Such incentives distort investment in favour of the eligible foreign investors *vis-à-vis* domestic investors. They lower the percentage of the value added that is retained by the host country government and factor suppliers and thereby reduce the benefits of FDI. Surveys of the attractiveness of countries for FDI have generally shown that foreign investors do not usually choose to invest in a particular country because of foreign investment incentives; rather the security of investments, availability of key infrastructure services and skilled labour and other features of the general investment environment are more important.

With respect to labour, there has been no action in promoting cross-border movement of labour. There are various schemes for human development. The 2003 ASEAN Concord II highlighted the link between ASEAN's economic and social agendas, by committing to ensure that ASEAN's work force shall be prepared for, and benefit from, economic integration by investing in human resource development. Mutual recognition to facilitate the flow of professional services was mandated by the 7th ASEAN Summit in November 2003. The coordinating Committee on Services has identified four MRA areas to be developed and has started drafting MRA for two of these, Architecture and Engineering.

The progress in the *beyond-the-border* measures and harmonisation of standards and other laws and regulations affecting goods trade is limited. Under this provision in CEPT regarding measures on non-border areas of cooperation to complement trade liberalisation, harmonisation of standards is progressing. In addition, ASEAN adopted in 1998 the Framework Agreement on Mutual Recognition Arrangements. Under this scheme, the sectoral MRA for Electrical and Electronic Equipment is in operation and the MRA for Cosmetics has been signed. MRAs are being developed for the Pharmaceuticals, Prepared Foods, Telecommunications, Equipment and Automotive sectors. The progress in the beyond-the-border measures affecting services trade to the individual national commitments are listed in their national schedules.

At the Eighth ASEAN Summit in November 2002 a Roadmap for Integration of ASEAN was prepared (ASEAN, 2002). This contains detailed plans for all markets other than labour markets but these plans are not binding on members. Members are encouraged to work towards achieving the targets.

6.4.2 Closing the development gaps in ASEAN

An additional issue in ASEAN, as in other RTAs that have members with widely different levels of development and incomes, is the possibility of developing area-wide policies to assist lower income member countries or lower income sub-regions. This issue has become much more important since the admission of the CLMV countries in the 1990s.

As background to this issue, we draw upon the forecasts of per capita income of the ASEAN member countries in Section 5.1 above. The central issue in the analysis of growth rates is convergence of per capita incomes. For this to occur, it is necessary that the lower per capita income countries have rates of growth of per capita income that are faster than those of the richer member countries.

Using the time series of historical growth performance and allowing for a structural break in the series at the time of the Asian Crisis, we have forecast future growth in per capita incomes to 2010 and 2020 for the ASEAN-10. This is the period of the ASEAN Vision. For this period, there will be little convergence among the eight ASEAN economies. Singapore and Brunei will remain much richer than the other economies. Malaysia and Thailand will remain much richer than the six countries below them and, in fact, their incomes will diverge from those of The Philippines and Indonesia. The economies of all four CLMV countries will converge a little on all countries above them in per capita income but by the end of 2010 will remain much poorer than the other six members. This pattern is clear. More convergence would require a major departure from recent trends and one which favoured the poorer countries.

In the light of historical experience and forecasts till 2020, the development gap will remain a major problem. Consequently, attention must be paid to the possibility of ASEAN-based schemes that might accelerate the growth rates of the poorer members.

ASEAN has in fact developed initiatives designed to accelerate the growth in the poorer member countries. In November 2000, the ASEAN Leaders agreed to launch an Initiative for ASEAN Integration (IAI), which gives direction to collective ASEAN efforts to narrow the development gap between its older and newer members. There is a six-year IAI work plan covering July 2002 to June 2008. The four designated priority areas are infrastructure, human resource development, information and communications technology and promoting regional economic integration. The last is assistance to enable the CLMV countries to implement other ASEAN Economic Community plans. The projects are partly funded from outside development assistance sources. These initiatives are very commendable and should be expanded.

Another possibility is an arrangement that spans more than one country. The 1992 Framework Agreement on Enhancing Economic Cooperation contained an article, Article 4 that provides for “sub-regional economic arrangements” as a complementary form of economic cooperation. These arrangements quickly became known as sub-regional economic zones (SREZs for short) or Growth Triangles although they are now known officially as “growth areas”. They are a unique feature of ASEAN; no other RTA has a similar arrangement.

Growth areas are designed to narrow the gap in the development levels among member countries and to reduce poverty and socio-economic disparities in the sub-region. The constituent areas are underdeveloped compared to the other areas of the countries and to other countries in ASEAN. The measures employed are the facilitation of investment and the provision of infrastructure. For example, BIMP-EAGA was formed in 1994, spanning selected parts of Brunei, Indonesia, Malaysia and the Philippines. It is an agreement that seeks to attract private capital from other parts of Indonesia, Malaysia and the Philippines as well as from outside the countries to the trade and industry sectors.

Undoubtedly measures to promote development in these poorer sub-regions are desirable. They should be directed both at poor regions in old members and the new members.

A variety of mechanisms are possible. One mechanism is the facilitation type measures of growth areas. This raises the choice as to government action to facilitate investment on a national scale or a sub-regional scale. (A similar choice arises with the liberalisation and facilitation of trade by means of Free Trade Zones. This choice is discussed in the next sub-Section.) The removal of unnecessary government bureaucracy is desirable everywhere.

Another possibility is the type of regional policies that have been developed in the EU. The EU has had a set of regional policies since its inception. (For information on these, see the EU website www.europa.eu.int/regionalpolicies.) The EU has put in place a number of measures that are designed to assist regions where GDP is less than 75 per cent of the EU average. There are four structural funds. Moreover, the accession this year of 10 new states that are all poorer than the average income in "old" members of the EU raises the same issues as the admission of the CLMV states to ASEAN. The EU has created tailor-made financial programmes for the period 2000-2006 to help the new members adjust to membership and to start narrowing the development gap between old and new members. This EU programme suggests a more general programme of this type could be introduced in ASEAN. It could be aimed at low income regions in both the new and the old members. A level of income could be used to determine the regions, as in the EU. However, the EU regional policy dispenses subsidies, funded principally by trade taxes that go to the EU rather than the national governments. ASEAN does not have its own funds available for this purpose.

Yet, all of these possibilities combined will not narrow the development gap in ASEAN rapidly, if at all. There is a fundamental problem in ASEAN arising from the very success of countries in the region. Convergence will always be very difficult if higher income countries maintain rapid rates of growth, as the six older members have continued to do. High rates of growth in these six countries are very desirable. But if they continue, it will require extraordinarily high rates of growth in the four CLMV countries to narrow the gap substantially in the time frame of the Vision Plan.

Although convergence will be slow, a second possible strategy is special assistance to any economy, especially a CLMV economy, which diverges from the richer economies. This will require the continuous monitoring of the growth performance of all ASEAN economies.

The higher income members of ASEAN should also consider expanding programmes for labour training at primary, secondary and tertiary levels and additional special programmes for selected groups such as public sector employees who are to administer an expanding set of single market policies and business executives who are to trade and invest across borders.

6.4.3 The Recommendations of the High-Level Task Force

Since the initiation of the first of the action plans, the Hanoi Action Plan, ASEAN has been reviewing intensively its plans for trade liberalisation and economic integration. ASEAN has received two concept papers as a background to the development of plans for the single market; ISEAS (2003) and ISIS (2003). It also received a study on economic integration in the area from McKinsey (2003). In preparation for the Ninth ASEAN Summit 2003 and as part of the preparation for the Vientiane Action Programme, a High-Level Task Force reviewed these studies and made a number of recommendations on ASEAN economic integration (ASEAN, 2003a). This is an important statement of the possible future direction of economic integration in the ASEAN economies.

The High-Level Task Force (HLTF) focused on liberalisation and facilitation measures in the areas of trade in goods, services and investment. It adopted the end-goal of economic integration as outlined in the ASEAN Vision 2020 and as characterised as a single market and production base in ASEAN Concord II.

With respect to goods markets, there were several recommendations concerning border measures affecting trade in goods. They recommended improvements to the CEPT Scheme Rules of Origin to make them more transparent and predictable and the introduction of an alternative criterion for conferring origin. They recommended measures to ensure transparency of NTMs and to set a clear and definitive work programme for the removal of these barriers by 2005. They recommended further improvements to customs procedures. On beyond-the-border measures, they recommended acceleration of Mutual Recognition Arrangements in the five identified sectors and setting specific targets for the harmonisation of standards and regulations for other sectors with significant trade value, and the development of ASEAN technical regulations, where possible.

With respect to services markets, the recommendations were comprehensive, reflecting the more limited progress in this area to date. They recommended clear targets and schedules of service liberalisation be set for each service sector, and an acceleration of service sector liberalisation in specific sectors through the application of the ASEAN-X formula. Importantly, they recommended the end date to achieve free trade in this area be earlier than 2020 but did not recommend a specific date. They recommended that MRAs be completed for qualifications in major professional services by 2008 to facilitate free movement of professional and skilled labour in the ASEAN area. This is another important development. They also recommended harmonising procedures for issuing visas to tourists by 2004.

With respect to investment, they made a number of recommendations. They recommended the speeding up the opening of sectors currently in the sensitive list, using the ASEAN-X modality, beginning in 2004, and a mechanism to monitor the specific activities and timelines undertaken by each country. They recommended a network of ASEAN free trade zones (FTZs) so that companies could structure their manufacturing processes across the ASEAN economies to take advantage of their comparative strengths. They recommended implementation of the Roadmap for Integration of ASEAN in finance.

With respect to intellectual property rights, they recommended cooperation beyond trademarks and patents by including cooperation in copyrights information exchange and enforcement by 2004.

Apart from harmonisation of some product standards and mutual recognition of qualifications in major professional services, all of the measures related to border regulations. They recommended new initiatives for 11 priority integration sectors in six individual countries to encourage intra-ASEAN investment and trade in materials in these sectors. The initiatives included liberalisation of trade in products of these sectors and the integration of services in these sectors.

With respect to labour markets, they recommended measures to facilitate mobility of business people through visa exemptions. This is the first concrete measure to liberalise cross-border movement of labour in ASEAN.

There were a number of other recommendations to strengthen the institutions, aimed at ensuring the implementation of all agreements and resolutions.

We support all of these measures relating to current economic cooperation initiatives, with the exception of the establishment of a network of free trade zones which we question.

A free trade zone is a local area within an ASEAN economy. It can offer improved market access for goods and services and FDI, investment incentives, subsidised infrastructure services and other measures that are not available within the ASEAN economy but outside the zone. FTZs would introduce a new layer of discrimination within the ASEAN area. In some countries in different parts of the world, they were an important alternative to liberalisation of border measures for the whole economy in the early stages of liberalisation when countries were not willing to make the same commitments on a national basis. Free trade zones are redundant if measures are taken to provide the same market access and trade facilitation on the basis of the whole ASEAN area. That is, the whole of ASEAN should be a free trade zone. This should be the priority. By comparison, FTZs would be limited to the area designated in the zones. They may be useful as temporary measures for the CLMV transition economies but these countries and ASEAN should explore the alternative of introducing the same measures on a regional or national scale, thereby avoiding discrimination against producers and consumers in the areas outside the zones.

The HLTF also supported the move in Special informal AEM in July 2003 to accelerate 11 priority sectors for integration. This is another example of the sectoral modality. This modality is discussed in the Section 6.4.4.

In general, HLTF recommendations were made on the premise that the goal of the ASEAN Economic Community is economic integration as outlined in the ASEAN Vision 2020. This is the goal of progress towards economic integration rather than a goal of complete economic integration. While the terminology of a single market was introduced in ASEAN Concord II last year and the Roadmap sets out plans for many measures, the implications of this term have not been explored thoroughly. The HLTF recommendations were also based on existing modalities. The next section considers further possibilities for economic integration, including those that would be required if the goal of a single market is pursued.

6.4.4 Further possibilities for economic integration

The progress towards economic integration in any RTA depends on three factors

- the objective or objectives of the RTA
- the timetable or timetables for the achievement of the objective(s)
- the choice of modalities to implement the integration

The most basic of these is the choice of objective. ASEAN has adopted an end-goal of a "single market" but the sense in which this term is intended is ambiguous. The Hanoi Plan of Action set the end-goal as "a free flow of goods, services and investments, a freer flow of capital". This is short of a single market in the sense of a completely integrated area in several respects. It relates only to border measures. The commitment to free flow of capital extends only to investments (presumably FDI) and there is no commitment to free flow of labour. ASEAN has made some progress, as outlined above, with respect to beyond-the-border measures in goods, services and capital markets but this progress is spotty.

The ASEAN Economic Community needs to make a clear choice of the objective for the Community in coming years. There are several choices. As the most complete definition of a single market, it could adopt the European style definition, meaning a single market for every good, service, capital asset and type of labour with complete equality of access to all ASEAN economies in the sense of no border restrictions, full national treatment within borders and harmonisation of regulations and laws across nations. This would be an extremely ambitious choice. A less ambitious, and perhaps achievable, choice would be a single market for every good, service and capital asset in this sense but not including labour markets. A still less ambitious, and more achievable, choice would be a single market in every good and capital market. (ISIS, 2003 recommends a focus on goods and capital markets.) Another still more limited choice is the removal of all border measures which restrict the cross-border flow of goods, service and capital assets plus specified beyond-the-border measures.

Our preference is for the choice of a single market covering goods, services and capital markets. The benefits of integrating goods and direct capital markets have been recognised in ASEAN. The exclusion of services would omit major possibilities of improved efficiency in these markets. Moreover, the integration of all three market areas is interrelated. Foreign direct investment is, as noted above, closely related to both goods trade and to services trade. To get the maximum benefit from the integration of goods markets requires the integration of direct capital markets and access to technology, management and know-how, and *vice versa* the benefits of the integration of capital are maximised if goods markets are also integrated. Similarly, services are essential inputs in the production of all goods and, consequently, the liberalisation of trade in services improves productivity and competitiveness in goods markets. Moreover, the integration of all capital markets would involve a substantial integration of services because of the importance of Mode 3 delivery, while the omission of liberalisation of capital markets affecting services distorts the allocation of capital.

The capital market provisions could perhaps be limited to direct capital. Portfolio and other non-FDI forms of capital are more liquid and pose added questions of volatility. However, the exclusion of other forms of capital creates its own problems. If cross-border flows of FDI are liberalised, it is desirable to also permit flows of portfolio capital in public companies. In general the integration of ASEAN capital markets will assist the raising of capital, especially venture capital, and the development of deeper capital markets with more sophisticated forms of risk sharing and hedging.

The adoption of an objective of a single market is a large step in the evolution of ASEAN. If ASEAN chooses a single market for any set of markets, it will require the adoption of policies and measures beyond those already adopted in ASEAN. It will include full national treatment in all markets. It will also include, among others, harmonisation of standards in many new areas of product standards and environmental standards and other standards, common competition policies and intellectual property laws, and common business laws. The adoption of a goal of a single market, in, say, the markets for goods and capital and services, as recommended above, should only be made in the full recognition of the changes that will be required to border and beyond-the-border measures in all markets.

The adoption of the objective of a single market will also require a fundamental change in thinking. The objective of a free trade area with limited commitments to removing beyond-the-border measures that inhibit cross-border trade is a much more limited goal with no definite end-point in terms of the coverage of measures. This objective can be pursued through modalities based on consensus. However, the objective of a single market is quite definite in terms of the ultimate coverage of measures, namely, all measures required to ensure the establishment of single markets and the attainment of a single price in all markets covered. Consequently, means must be found in the statement of the objective or in subsequent negotiations to include all of the measures required and to achieve this for all of the member countries.

The focus of discussions and negotiations should be on measures that affect intra-ASEAN trade in the markets for goods, services, capital and labour. A distinguishing feature of the ASEAN Economic Community is the relatively large attention paid to improving the competitiveness of goods production for sale in the markets outside ASEAN and to attracting FDI from outside the region in the AIA. Attracting FDI from non-ASEAN sources is desirable and important but it is primarily a matter of improving the overall economic environment of the area. Similarly, competitiveness, in its various senses, is an important set of considerations but they are best addressed through measures to improve factor productivity and competition. The achievement of integration among ASEAN economies is itself an important contributor to both the economic environment of the area and the growth of factor productivity and competition.

One strategy is an investigation of all the measures which currently prevent either the free movement across national borders or the full national treatment or different regulations and laws that inhibit trade. This was the strategy adopted by the EU (or the EEC as it then was) before the adoption of the EU ’92 measures. They published a White Paper on *Completing the Internal Market* (Commission of the European Communities, 1985) which listed several hundred measures that needed to be adopted before an “internal market” (as it was then called) could be achieved.

For all of those border and beyond-the-border measures which are to be eliminated and all of those regulations and laws that are to be harmonised, definite starting dates and end dates and timetables should be set for all countries.

One issue to be resolved here is the possibility of differential dates for the CLMV countries. These countries definitely do have problems adjusting to ASEAN-initiated changes in policies as well as their own reforms and other changes to meet WTO commitments. Yet, throughout the world, there are now more than 20 RTAs that have both Developed and Developing countries among their members, and some of the Developing Countries are Least Developed Countries or transition economies (Bilal, 2003). The experience with RTAs in the EU, NAFTA, Latin America, CER and elsewhere is that lower income countries gain more from regional trade liberalisation and economic integration. Unfortunately, we know of no empirical study of this aspect of integration but the literature on growth convergence in the EU that was discussed in Section 2.5.2. above, indicated that economic integration in Europe had promoted convergence of the real per capita incomes of European countries.

A related issue is flexibility. The HLTF recommended "...that flexibility be allowed in its [the deadline's] implementation to enable those member countries that are ready to proceed first". This introduces the possibility of postponement and backsliding on target dates and indefinite timetables. In this respect, the experience of the WTO negotiations is instructive. The WTO General Council in July 2004 reached a package of agreements that will enable the multilateral negotiations to continue. In terms of commitments, the special interests of Developing Country members are accommodated by allowing them longer implementation periods and, in some areas of negotiations, lower reduction coefficients, in the language of the WTO. The latter device is not feasible in the case of a single market. All member countries must make the commitment to the same end-goal.

When it is recognised that some countries need more time to achieve a policy change, it is better to fix a longer implementation period and a more attenuated timetable for such countries but to then stick to that time table. Lower income countries gain access to the richer and generally larger markets of the higher income members of the RTA. Integration with other more developed neighbours with higher levels of technology, a more skilled labour force and deeper capital markets should itself assist the CLMV countries. This would certainly be the case in ASEAN. In goods markets, safeguard provisions that permit the temporary suspension of obligations provide a way of meeting exceptional unanticipated circumstances. Similar provisions might be introduced in other markets. Safeguard provisions should not be open-ended. As in the WTO, they should be applied sparingly and only under pre-specified conditions.

With respect to the choice of modalities, this is a matter to be worked out in each set of markets. The experience of RTAs around the world and in the GATT/WTO shows there is wide choice. One guiding principle can be stated. The choice of modality is closely related to the objective and, in particular, to the commodity coverage of a measure.

In goods markets, three measures warrant priority, apart from the existing efforts to reduce border and beyond-the-border measures that inhibit trade. First, the achievement of a single market requires that all tariff items be on the Inclusion List. The sole exceptions that should be allowed are those under GATT Article XX, which are confined to measures necessary to protect public morals, human or animal or plant life and health and other narrowly defined classes of goods that are universally regarded as very special exceptions.

Second, the rules of origin need to be reconsidered. The very low preference utilisation rate suggests considerable difficulties on the part of exporters and importers in meeting the rules of origin requirements, despite the apparent liberality of the rules. The problem may lie in the administration of the rules. Administration should be made easier for importers. Because of the complexity of the operation of rules of origin, there should be a detailed prior examination of these rules. The last meeting of the AFTA Council (ASEAN, 2003b) instructed the Taskforce on CEPT Rules of Origin to commence work to put in place a general alternative rule based on the change-of-tariff classification criterion rather than the regional-value-added criterion. However, the experience with multiple criterion rules of origin in other RTAs is that they are more complex and trade-restricting. Another possibility is the type of waiver of rules of origin requirements recommended by the Australian Productivity Commission in its recent enquiry into CER rules of origin where there were complaints about the administrative difficulties of meeting ROOs (Productivity Commission, 2004). They recommended that, when the difference between the Australian and the New Zealand MFN tariff rate is 5 percentage points or less, the rules be waived. This measure alone would provide automatic entry at the preferential rate for imports in almost 50 per cent of the total number of tariff items in this case. In ASEAN, a similar rule would compare the substantive tariff rates in the exporting and the importing country.

Third, there has been recent discussion of a common external tariff. A significant problem with differences in tariff rates in a free trade area is that producers of some product in an ASEAN country may be able to obtain from countries outside ASEAN raw materials and other intermediate and capital goods required for its product more cheaply than producers in another. (If the inputs are sourced from a country inside ASEAN, the tariffs on inputs are currently zero or low and converging to zero as ASEAN proceeds to a free trade area.) This is inconsistent with a single market and a single production base. While a common external tariff would immediately resolve this problem (and that of the rules of origin), there is an obstacle in that Singapore and Brunei are duty-free markets and would not agree to raise tariffs on intermediates and capital goods. There are alternative solutions to this problem involving the selective reduction of the substantive tariff rates on intermediate and capital inputs to zero in countries where they are not zero or an administrative provision that lowers them to zero when the imports are used as inputs in some process that is competitive with some other ASEAN country.

Similarly, in services markets, if the objective is one of free trade in all services, then there is a strong case for a negative list approach rather than a positive list approach; that is, all service sectors are covered unless specifically exempted on the list. Given the complexities of negotiations in service sectors with the four modes of supply, a small positive list can lead to protracted negotiations and a slow pace of liberalisation. A negative list also has the advantage that the restrictions on trade in services are more transparent as they are listed explicitly in the list (see Stephenson and Prieto, 2002). A negative list should be small and the exemptions must be regarded as temporary only; otherwise, it has the same problems as a positive list in lengthening negotiations and exempting many services for a long period or permanently. NAFTA and those in the Americas that have followed the NAFTA style, and CER have successfully used a negative list in this way.

A general issue is the use of sector-based modalities. ASEAN has used this type of modality in measures affecting all four sets of markets - goods markets, service markets, investment and labour markets. Moreover, the Priority Integration Sector strategy introduced in 2003 may combine measures applying to goods, services and labour markets in these sectors. This is a sectoral view of the interaction among these markets. Thus, a sectoral approach is now a major part of ASEAN modalities in all market areas.

As a general rule, sector-based modalities are useful when there is a clear difference between sectors that requires different treatment of measures across sectors. This is the case, for example, in product standards. The early EEC experience in trying to develop common standards made little headway. A better approach, the Europeans found, was to develop common standards for different product groups only for those product groups which were not difficult and to develop the alternative modality of mutual recognition elsewhere. In the case of goods and services, there are differences in circumstances in every industry but there are no inherent differences between sectors that necessitate a sectoral approach.

When there is not a clear difference between sectors, it is better to rely upon modalities that apply to all sectors. For example, mutual recognition of product standards can be developed in a straightforward way for all product standards together, as some other RTAS have done. The same applies to service sectors.

The use of a sectoral approach in these areas makes negotiations more complex. This is an important consideration. The ASEAN Economic Community is already a very complex agreement by comparison with any other RTA except the EU. There are distinct sets of rules in all of the market areas, unlike the EU or NAFTA for example, each subject to separate agreements, and in all areas there is a sequence of protocols, concords, declarations, statements and other agreements.

The WTO experience is informative. Sectoral approaches to negotiations of tariffs and non-tariff barriers were tried in the Kennedy, Tokyo and Uruguay Rounds for the reduction of border barriers to goods trade without much success. Similarly, GATT/WTO separate negotiations in service sectors such as Basic Telecommunications, Financial Services proved difficult and limited and applied only on a plurilateral basis. A major difficulty with the sectoral modality in both areas is to achieve reciprocity in sectoral negotiations that rule out across-sector or broad area exchanges (see Winters, 1987).

In goods and services markets, a sectoral modality may play a useful role as a supplement to the primary non-sectoral modalities. In the Uruguay Round, the use of the “zero for zero” tariff cuts in selected sectors led to the elimination of tariffs in these sectors but this strategy was a supplement to the primary formula approach. In the Doha Round, the July package agreed by the General Council has agreed upon a non-linear formula as the primary modality for reducing tariffs on non-agricultural goods items but it also agreed to explore supplementary sector-based modalities such as zero-for-zero sector tariff elimination or sectorial harmonisation (WTO, 2004, Annex B).

If a sectoral modality is used for the primary modality, as in services, or for the sole modality, as in the Priority Integration Sectors, it is essential to find a way of quickly extending the coverage to all other sectors. There should be a progression mechanism; otherwise, the sectoral coverage will remain highly selective. This is not consistent with the objective of a single market in these areas.

Steps to strengthen institutions in order to ensure achievement of timelines are desirable, as recommended by the HLTF. These should include the monitoring of progress in all areas. As an example, the Organization of American States does an excellent job in monitoring the process of tariff liberalisation and market access in all Hemisphere RTAs (see Estevadeordal, 2002).

There needs to be an ongoing review of possibilities of new areas of integration and new modalities, as the experience of the EEC/EU has shown. New possibilities emerge as old problems are solved.

One such possibility is a monetary union. However, the experience has shown that this step is difficult and probably premature for ASEAN as a whole at the present time. A monetary union may be feasible only if done on an ASEAN-X basis or even on a small group or bilateral basis. This is precisely because of the large differences among the ASEAN economies in terms of the structure of their macro economies, the extent of bilateral trade, the sophistication of their financial sectors and other relevant features. If considered by a subgroup of ASEAN economies, the benefits and costs will require a careful assessment before a decision is taken.

One possible initial step toward unifying the fiscal systems could be taken by unifying fiscal measures applying to multinational corporations investing in ASEAN economies. In particular, the treatment of double taxation and withholding taxes on the incomes of multinational corporations could be harmonised. This would be a useful supplement to measures integrating the capital and goods markets.

Similarly, NAFTA-style provisions for the temporary movement of business persons and possibly selected professional groups would be a useful supplement to measures integrating the capital and goods markets. This would be best done as a stand-alone agreement rather than attempting it as part of service sector Mode 3 negotiations within AFAS. The former has the advantage that it could be done speedily and for all sectors in the economy. (Nielson, 2003 surveys labour movement provisions in RTAs. See also the other papers in Mattoo and Carzaniga, 2003).

Some of these measures will involve a loss of national sovereignty in that countries agree to forgo the use of some instruments of government policy or to harmonise them at levels agreed in concert with other ASEAN economies. The loss of sovereignty involved is, however, a continuation of that already agreed to in many areas of rules in the ASEAN Economic Community and it is not great.

6.5 Recommendations

We recommend that

1. ASEAN state a precise objective as a basis of the Vientiane Action Programme. The choices include
    a. a single market covering all goods, services, capital and labour markets;
    b. a single market for goods, services and capital;
    c. a single market for goods and capital;
    d. a free trade area with the removal of all border restrictions on the intra-ASEAN flow of goods, services and capital plus specified beyond-the-border measures.

   Of these options, the choice of a single market covering goods, services and direct capital markets is preferred. These three market areas are closely linked and the full benefits of integration in one area require integration in the other two market areas.

   The chosen objective of a single market in the market for some commodities or assets will give strong guidance as to the desirable measures that need to be eliminated or harmonised and the best modalities. In particular, the choice of a single market requires an equal commitment by all member countries to the achievement of a single market throughout the area.

   To be implemented, this objective must have the full support of all ASEAN Leaders.

2. Definite starting and end dates and timetables be set for all border, beyond-the-border and across-border measures covered by the choice of objective.

3. There be an investigation of all the measures which currently prevent the free movement of goods, services and capital between member economies. This investigation should include business laws and other laws and regulations affecting corporate activities, as the achievement of a single market for goods, services and direct capital will require the harmonisation of a range of business laws that affect trade in these markets. This was the strategy adopted by the EU (or the EEC as it then was) before the adoption of the EU ’92 measures.

   Such an investigation will provide guidance to the choice of measures and modalities.

4. In goods markets, the achievement of a single market requires that all tariff items be on the Inclusion List, other than GATT Article XX exceptions. All non-tariff barriers must be eliminated. There should be a detailed examination of rules of origin prior to

any reform of these rules. One possible reform is a waiver of rules of origin requirements when the tariff rates in the exporting and the importing country are similar.

5. In services markets, there be a negative list approach rather than a positive list approach and those services on the negative list be reviewed with the object of removing them. If a positive list approach is continued, a mechanism should be introduced to transfer all sectors onto the positive list.

6. Sector-based modalities be used primarily where it is not possible to design rules that are uniform across sectors. Where it is possible to design uniform rules, the primary modality should apply uniformly to all sectors but sector-based modalities can be used as a supplement to the primary non-sectoral modalities, provided there is a mechanism to ensure progression of all sectors not initially included.

7. The treatments of double taxation and withholding taxes on the incomes of MNCs be harmonised across ASEAN economies. This would be a useful supplement to measures integrating the capital, goods and services markets.

8. NAFTA-style provisions for the temporary movement of business persons, and possibly selected professional groups, should be introduced as another useful supplement to measures integrating the capital, goods and services markets.

9. The difficulties of the CLMV countries in adjusting to the single market measures be accommodated by more distant end dates and more attenuated timetables for this group of countries. Once set, these timetables should be adhered to, apart from limited safeguard actions under pre-specified conditions.

   Measures to promote development in the poorer sub-regions should be expanded. They should be directed both at poor regions in old members and the new members. The selection of eligible areas might be based on a level of average incomes, as in the EU. Special assistance might be granted to any economy, especially a CLMV economy, which diverges from the richer economies. This will require monitoring of growth performances.

   The higher income members of ASEAN should expand programmes for labour training at primary, secondary and tertiary levels and additional special programmes for selected groups such as public sector employees who are to administer an expanding set of single market policies and business executives who are to make business decisions in a single market.

10. A monetary union be considered at a later date when the ASEAN economies are more integrated. A monetary union may then be feasible only if done on an ASEAN-X basis or even on a small group or bilateral basis. This is because of the large differences among the ASEAN economies in terms of the structure of their macro economies, the extent of bilateral trade, the sophistication of their financial sectors and other relevant features.

11. Steps be taken to strengthen institutions. These should include the monitoring of progress for all measures in all market areas, and means to ensure that all countries keep to their timetables.

12. There be an ongoing review of possibilities of new areas of integration and new modalities.

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APPENDIX 1: ABOUT THE AUTHORS

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