

Chapter 1

Introduction and Overview

1. Introduction

The decision to create an ASEAN Economic Community (AEC) by 2015 constitutes a milestone in the evolution of ASEAN economic integration. ASEAN was formed in 1967 with the Bangkok Declaration but significant steps toward deepening cooperation through a policy-led process only began to emerge with the ASEAN Free-trade Area (AFTA) in 1992. Since then, regional cooperation has been moving forward on many fronts, e.g., trade in services, trade facilitation, investment cooperation, intellectual property rights (IPRs), and even approaches to closing the “development gap” through the Integration for ASEAN Initiative. But it was the AEC, adopted at the 12th ASEAN Summit in Cebu in January 2007, that brought it all together by committing the region to a “single market and production base”, a “highly-competitive economic region fully integrated in the global economy”, as well as a “more equitable economic region”. The scope of the AEC is articulated in the AEC Blueprint, published in November 2007.

ASEAN economic cooperation in the 2000s is taking place at the same time that the region is becoming more integrated with its Asian neighbors and the world as a whole. It is dedicated to “open regionalism”, that is, regional integration as a means of becoming more globally competitive. More than any other economic block, ASEAN integration initiatives emphasize their outward-oriented nature and intentions. The overriding goal of the AEC is not the boosting of trade and investment shares per se but rather a reduction in the costs of doing business in the region, diffusion of best practices, and more extensive integration with global production chains, rather than merely Southeast Asian ones. As expressed in the AEC Blueprint:

The AEC is the realisation of the end goal of economic integration as espoused in the Vision 2020, which is based on

a convergence of interests of ASEAN Member Countries to deepen and broaden economic integration through existing and new initiatives with clear timelines. In establishing the AEC, ASEAN shall act in accordance to the principles of an open, outward-looking, inclusive, and market-driven economy consistent with multilateral rules as well as adherence to rules-based systems for effective compliance and implementation of economic commitments.

This study attempts to analyze ASEAN economic integration from a variety of perspectives: trade, development, investment, and finance, as well as its relationship with Dialogue Partners, e.g., in Asia, the EU, and the United States.

The bulk of this book deals with issues of economic integration. In this introductory chapter, we attempt to give some background information on the macroeconomic and microeconomic environment that characterizes the ASEAN Member Countries at present (Section 2), and we give a brief synopsis of the volume's chapters in Section 3.

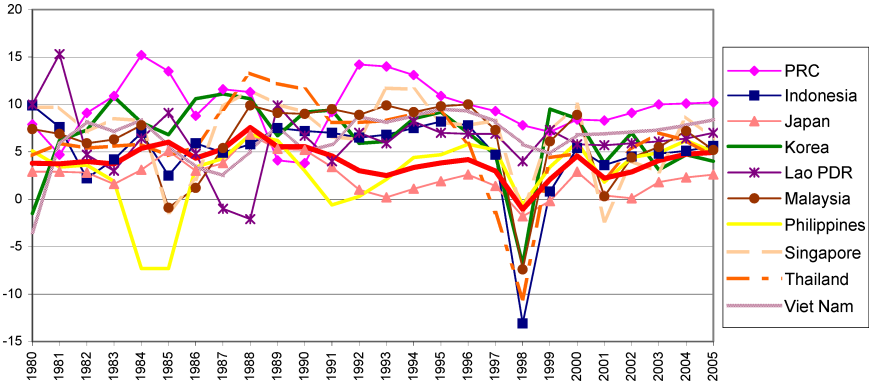
2. A Survey of the Business Environment in ASEAN

While ASEAN Member Countries are diverse in terms of investment and other measures affecting the private sector, all countries appear to be interested in liberalizing their respective policy structures in order to create a more business-friendly environment. Deeper economic cooperation and integration in ASEAN also constitute a general priority to lure Foreign Direct Investment (FDI); ASEAN's diversity in this sense is a strength rather than a weakness, as it would allow ASEAN- and non-ASEAN-based multinational corporations to take advantage of a vertical division of labor.

As an introduction to trends in the region facing the ASEAN private sector, we consider below the existing macroeconomic and microeconomic environments in ASEAN. This, hopefully, will help set the stage for the analysis of regional economic integration in subsequent chapters.

2.1. Macroeconomic Environment

While diversity in macroeconomic performance varies across ASEAN countries, in general the region has performed well relative to other developing regions. One aggregate indicator of robustness — and the most oft-cited — would be GDP growth performance which gives an aggregate impression of



Source: IMF, World Economic Outlook Database.

Fig. 1.1. GDP Growth (%) of ASEAN + 3 (1980 to 2005).

the business environment of a country. Obviously the business investment will depend on income growth (just as income growth will depend on business investment). As can be seen from Figure 1.1, economic growth in the ASEAN Member Countries has rebounded since the Asian Crisis to a pace that may be lower than the region's pre-Crisis trajectory but is enviable when compared to other regions. ASEAN average economic growth over the past decade has been lower than that of China, which is a key reason why China has been so successful in luring FDI flows. Interestingly, as noted in Chapter 7, growth rates of the ASEAN Member Countries have become increasingly correlated with each other and the ASEAN + 3 (ASEAN, China, South Korea and Japan). This is a manifestation of closer economic integration and interaction at a variety of levels, and in particular the rise in intra-industry trade.¹ In turn this intra-industry trade is a result of multinational activities in ASEAN, i.e., the "production fragmentation" process, discussed at length in Chapter 2.

In addition to a robust market, the private sector requires macroeconomic stability. After all, Latin America experienced very high growth rates in the 1960s and some of the 1970s, but irrational macroeconomic policies that led to high inflation, exchange rate instability, and burgeoning government debt ultimately condemned the region to economic crisis and stagnation in the 1980s. Moreover, economic growth does not necessarily mean development; economic growth in Botswana has been the highest in the world over the past three decades, but its growth has been based

¹Rana (2006).

on diamond production. Venezuela, Russia, and many of the Gulf States have been growing rapidly over the past few years, but this is a reflection of commodity prices, rather than a healthy across-the-board private-sector expansion.

One of the primary drivers of the “Asian economic miracle” has been the region’s conservative monetary and fiscal policies which have led to low rates of inflation and relative stability of other macroeconomic variables (World Bank 1993). Tables 1.1–1.3 give indicators of macro stability in the ASEAN countries in terms of inflation rates, interest rates, and fiscal balances, respectively, over time and compared to other major Asian economies. Inflation rates tend to be low by developing country standards for most ASEAN countries in recent years, with the exception of the Asian Crisis and other periods of economic turbulence. Since the Crisis, inflation and exchange rate volatility have been generally quite low. In addition, as in the case of GDP growth, these macroeconomic indicators appear to be increasingly correlated across ASEAN countries.

Regarding fiscal policy, ASEAN countries fare reasonably well. While problematic fiscal deficits tend to precede economic crises in Latin America, ASEAN Member Countries affected by the Crisis actually had budget *surpluses*. With the Crisis, these surpluses naturally turned into deficits, but fiscal balances have rebounded since, with all budgets improving over the last few years (and all deficits are less than five percent of GDP).

In sum, the macroeconomic environment in most ASEAN Member Countries, while not perfect, has generally been amenable to private sector

Table 1.1. Average Inflation Rates for the 1990s and for 2000–07. (Average Inflation).

Country	1990–99 (%)	2000–06 (%)	2007 Inflation (%)
Thailand	4.3	2.6	2.3
Singapore	1.5	0.6	2.1
Philippines	9.5	5.4	2.8
Malaysia	3.7	3.4	2.0
Indonesia	15.6	11.8	6.4
Cambodia		2.4	5.9
Vietnam		5.7	8.3
Myanmar	Double digit	Double digit	36.9
Korea	6.7	2	2.5
China	7.8	3.1	4.8
India	8.9	4	4.4

Source: IMF, International Financial Statistics; ADB, ADO 2008.

Table 1.2. Interest Rates. (Average Money Market Rate).

Country	2000–06 (%)	2006 (%)
Thailand	2.2	4.6
Singapore	1.9	3.5
Philippines	8.1	7.8
Malaysia	2.8	3.4
Indonesia	9.7	9.1
Vietnam, Cambodia, and Myanmar	N/A	N/A
Korea	4.2	4.2
China	N/A	N/A
India (for comparison)	N/A	N/A

Sources: IMF, International Financial Statistics; ADB Key Indicators and OECD Statistics Database; Data refer to the general government sector, which is a consolidation of accounts for the central, state and local governments plus social security.

Table 1.3. Average Fiscal Balance/GDP Ratio for Asian Countries (%).

Country	1990–99	2000–06	2007
Thailand	1.26	-0.72	-1.7
Singapore	11.01	5.69	12.2
Philippines	-1.20	-3.67	-0.2
Malaysia	-0.42	-4.80	-2.8
Indonesia	-0.27	-1.45	-1.2
Cambodia	-3.98	-2.39	-3.2
Vietnam	-2.22	-2.81	-4.9
Myanmar	-1.75	0.71	n/a
Korea	-0.90	1.21	-2.3
China	-2.59	-2.15	0.7
India	-5.91	-5.06	-5.5

Sources: 1988–2005: http://www.adb.org/Documents/Books/Key_Indicators/2006/default.asp, with country data in each Excel file. 2006: http://www.adb.org/Documents/Books/Key_Indicators/2007/default.asp, with country data in each Excel file; Pre-1988 data has only government finance data instead of government finance ratio of GDP so pre- and post-data will not be consistent; IMF, International Financial Statistics Database, and CEIC Database.

growth and development and, given strong growth and responsible macroeconomic policies, attractive to multinational corporations. Moreover, the correlation of these variables across ASEAN countries has been rising over time; this would suggest that what happens in one country will affect other

countries (that is, there is a clear “policy externality”), which increases the case for closer economic cooperation.

2.2. Internalizing Policy Externalities: Learning from the Asian Crisis

This last point deserves elaboration. The Asian Financial Crisis that began in July 1997 sent shockwaves through policy circles of affected East Asian economies. There was a clear “contagion” effect of this Crisis, in which the financial crisis in Thailand spread quickly to its ASEAN neighbors (and subsequently Hong Kong and South Korea). The transmission mechanisms through which contagion spreads are many, including: (1) “real contagion”, in which investors believe that the shock to one country will affect other countries that are major trading partners and/or compete with it in third markets; (2) “financial contagion”, in which multinational banks when exposed to increased risk in one market are forced to reduce exposure in other regional economies; and (3) “herd behavior” of banks, in which a crisis in one market leads to panic among financial institutions, who follow each other out of the market. In general, all three types of contagion existed during the Asian Crisis. As ASEAN becomes more integrated, it will likely be the case that investors will increasingly perceive the region as being interdependent and, as such, the potential for contagion will rise. Hence, as economic (real, financial, policy) integration proceeds apace, what happens in one ASEAN country will affect other Member Countries as well. This is what is meant by “policy externality”: macroeconomic policy in one ASEAN Member Country will increasingly have a bearing on macroeconomics in others.

As is the case with all externalities, the market will fail to be efficient unless this policy externality is “internalized”, which in this sense relates to macroeconomic monitoring and “peer pressure” with respect to pursuing prudent macroeconomic policies. After the Asian Crisis, together with the Asian Development Bank-ASEAN Member Countries established a monitoring system that has worked well to date. This sort of approach will be increasingly important as intra-regional trade and investment rise over time, and the AEC is put into place. The EU, for example, saw that it had to formalize such policies at higher levels of integration which have come to be enshrined in the “Maastricht Criteria” and the “Stability and Growth Pact”. From Tables 1.1–1.3, we see that the ASEAN countries are relatively close to meeting the Maastricht Criteria, were it applied in the context of

ASEAN integration. It is yet to be seen if this will keep up throughout the on-going global economic crisis.

2.3. *Microeconomic Environment*

As noted above, it is often difficult to compare investment-related measures and policies across countries. In ASEAN, each country has a unique history of microeconomic policy formation and hence, even policies that appear to be the same may well be different in practice. Moreover, capturing empirically the effects that various policies have had on the private sector is complicated, especially since so many factors influence domestic investment and FDI. For example, in the early 1980s, reforms in Sri Lanka made it one of the most liberal countries in the developing world. However, the civil war that began at that time nullified the expected private-sector response to these initiatives.

One way to get around the problems associated with such estimates of the real implications of various investment measures and policies would be merely to focus on the *results* of these policies. If a country seems to have fairly liberal investment measures in most areas but *de facto* the private sector struggles, a problem obviously exists. We would then be able to focus on where the shortcomings exist and chart out means to rectify them.

Annually the World Bank attempts to do just this. In its *Doing Business* database, it seeks to gauge as objectively as possible business regulations and their enforcement in practice. Included in its survey are 175 different countries, including all ASEAN Member Countries save Brunei Darussalam and Myanmar. Such a survey suits our purposes well, as it provides: (1) a general idea of how liberal and open the region's economies are in various crucial areas of business regulations and enforcement; (2) a global comparison of the policy environment existing in the ASEAN Member Countries, suggesting which countries come closest to global "best practices"; and (3) a good indication of how diverse ASEAN is at the microeconomic policy level.

In Table 1.4, we summarize the results of *Doing Business 2007* for ASEAN Member Countries. Global rankings of each are given in relation to an overall indicator of "ease of doing business" and 10 additional areas: (1) starting a business; (2) protecting investors; (3) dealing with licenses; (4) paying taxes; (5) employing workers; (6) trading across borders; (7) registering property; (8) enforcing contracts; (9) getting credit; and (10) closing a business. Under each of these general areas, there are

Table 1.4. Policy Diversity Towards Business in ASEAN: Global Rankings of Private-Sector Efficiency.

Measure	Country							
	Camb	Indo	Laos	Malaysia	Phil	Sing	Thai	Vietnam
Ease of doing business (overall rank)	143	135	159	25	126	1	18	104
Starting a business	159	161	73	71	108	11	28	97
Protecting investors	60	60	170	4	151	2	33	170
Dealing with licenses	159	131	130	137	113	8	3	25
Paying taxes	16	133	36	49	106	8	57	120
Employing workers	124	140	71	38	118	3	46	104
Trading across borders	114	60	161	46	63	4	103	75
Registering property	100	120	148	66	98	12	18	34
Enforcing contracts	118	145	146	81	59	23	44	94
Getting credit	174	83	173	3	101	7	33	83
Closing a business	151	136	151	51	147	2	38	116

Note: No data available for Myanmar and Brunei Darussalam.

Source: World Bank, *Doing Business 2007*. (www.worldbank.org)

subcategories with separate rankings for additional questions. For example, under “starting a business”, the survey includes rankings for “procedures” (number), “time” (days), “cost” (as a percentage of per capita income), and “minimum capital requirements” (as a percentage of per capita income). While interesting, we mainly limit ourselves to the general areas in Table 1.4; the interested reader can get additional information from www.worldbank.org.

Beginning with “ease of doing business”, it is clear that ASEAN Member Countries run the entire spectrum of liberal and restrictive policies. For example, Singapore ranks number 1 globally, whereas the transitional ASEAN economies, the Philippines, and Indonesia all rank above 100. Thailand and Malaysia each have a favorable environment, ranking 18 and 25 respectively, better than a number of OECD countries.

This diversity across ASEAN Member Countries obviously reflects great differences in investment measures and the regulatory environment that exists in the region. Reducing disparities has been an important goal of ASEAN investment cooperation (see Chapter 4); creating a more integrated and harmonious region characterized by minimal transaction costs associated with production chains would be attractive to multinational corporations. Hence, harmonization of relevant measures and policies necessary for regional integration, as in the case of the EU, could result in not only

a significant increase in FDI flows to the region but, more importantly, a more attractive business environment for *domestic* investment. In this sense, the fact that ASEAN has among its Member Countries highly-competitive regimes could serve as examples for other countries to follow. In particular, some of the original ASEAN economies have a great deal of experience that they can share with the transitional economies, something that is encouraged (even mandated) by the Initiative for ASEAN Integration (IAI). In its *Doing Business 2005* survey, the World Bank showed a clear positive correlation between ease of doing business and the UNDP human development index.

The EU experience testifies as to how an established, liberal framework can be “exported” to other countries within an integrating region. The enlargement of the EU to include 10 Central and Eastern European countries in 2004, and two more (Bulgaria and Romania) in 2007, involved significant technical and financial assistance to the transitional economies joining the EU in order to upgrade business practices to be compatible with the EU. This process on the whole has been successful *in areas relevant to regional economic interchange*.

With respect to ranking for other questions, the transitional ASEAN economies continue to perform relatively poorly, with the exception of Vietnam, which scores well in “dealing with licenses” and “registering property”. Moreover, the Philippines and Indonesia receive lower rankings than Vietnam in most areas. Thailand and Malaysia are generally quite competitive, with a few exceptions (in particular, “trading across borders” for the former and “dealing with licenses” and “enforcing contracts” for the latter). Singapore does well in essentially all categories.

It is also interesting to compare ASEAN to various competing economies in East and South Asia, which are given in Tables 1.5 and 1.6. Interestingly, we see that ASEAN’s two main developing-country competitors, China and India, do far worse than some of the ASEAN countries in most categories. Their respective rank in terms of ease of doing business, for example, are 93 and 134, i.e., not particularly competitive. China, therefore, is probably a great competitor because of its size, wealth, and dynamism, rather than some highly supportive policy framework. ASEAN should be able to exploit this advantage on international markets, and closer economic cooperation and integration will allow it to compete more effectively in terms of size.

In short, there exists a great deal of diversity in the region with respect to the policy framework affecting the private sector in ASEAN Member

Table 1.5. Policy Diversity Towards Business in Japan, China and Asian NIEs: Global Rankings of Private-Sector Efficiency.

Measure	Country					
	China	Hong Kong	Japan	S Korea	Singapore	Taipei, CH
Ease of doing business (overall rank)	93	5	11	23	1	47
Starting a business	128	5	18	116	11	94
Protecting investors	83	3	12	60	2	60
Dealing with licenses	153	64	2	28	8	148
Paying taxes	168	5	98	48	8	78
Employing workers	78	16	36	110	3	154
Trading across borders	38	1	19	28	4	42
Registering property	21	60	39	67	12	24
Enforcing contracts	63	10	5	17	23	62
Getting credit	101	2	13	21	7	48
Closing a business	75	14	1	11	2	4

Source: World Bank, *Doing Business 2007*. (www.worldbank.org)

Table 1.6. Policy Diversity Towards Business in South Asia: Global Rankings of Private-Sector Efficiency.

Measure	Country					
	Bangla	Bhutan	India	Nepal	Pakistan	Sri Lanka
Ease of doing business (overall rank)	88	138	134	100	74	89
Starting a business	68	79	88	49	54	44
Protecting investors	15	118	33	60	19	60
Dealing with licenses	67	145	155	127	89	71
Paying taxes	72	68	158	88	140	157
Employing workers	75	116	112	150	126	98
Trading across borders	134	150	139	136	98	99
Registering property	167	41	110	25	68	125
Enforcing contracts	174	56	173	105	163	90
Getting credit	48	159	65	101	65	101
Closing a business	93	151	133	95	46	59

Source: World Bank, *Doing Business 2007*. (www.worldbank.org)

Countries. The region performs relatively well overall, but there certainly is room for improvement particularly in several Member Countries. While many of these policies tend to be more relevant to national jurisdiction and will not require harmonization in the AIA or the AEC, the potential

for improving the regional environment through concerted action is considerable.

***Case Study: Focus on Microeconomic Policy Change
in Cambodia, Lao PDR, and Vietnam (CLV)***

The above analysis would suggest that the ASEAN countries on the whole provide a positive macroeconomic environment for business but that the microeconomic environment is somewhat mixed across countries and within countries. But how has this environment changed over time? Are the ASEAN countries becoming more or less investor-friendly? All ASEAN Member Countries have stressed that they would like to improve the business environment, and initiatives at the ASEAN level are one way of accomplishing this. But, in practice, is this happening?

This question is especially compelling in the context of the CLV countries (as Myanmar is not included in the *Doing Business* rankings, we are unable to include it here). These transitional economies have had to reform their economic systems extensively, and it is interesting to see how they have fared. Given the base that they started from, it is to be expected that they would rank relatively low. But as most countries have been embracing comprehensive reform, we would also expect that they should be rising in the rankings.

Table 1.7 summarizes the changes in various categories in ASEAN countries over the past two years. We are limited to the 2005–2006 period because, while there has been an annual survey for each of the past five years, in the 2005 survey the World Bank changed significantly the format of analysis, such that only a few questions overlap with the earlier surveys. Hence, we only have two data points (2005 and 2006, which emerge from *Doing Business* 2006 and 2007, respectively). In the analysis below, we focus on the transitional ASEAN countries, but interesting results emerge for the original ASEAN countries as well.

One important caveat before beginning: rankings reveal *relative* changes. Hence, a country may indeed be enacting effective reforms but may not improve much (or even fall) in the rankings if the rest of the world is doing more. We would suggest that this is still appropriate; a competitive environment particularly for FDI must be evaluated in a comparative context. Globalization does not give good marks to a country for its reform program unless it is outperforming its competitors. However, in the analysis of the Cambodia, Laos, Malaysia, Vietnam (CLMV) countries, we look beyond

Table 1.7. Diversity in Business-Related Reform in ASEAN: Changes in Global Rankings of Private-Sector Efficiency.

Measure	Country							
	Camb	Indo	Laos	Malaysia	Philip	Sing	Thai	Vietnam
Ease of doing business (overall rank)	-1	-4	5	0	-5	1	1	-6
Starting a business	-4	0	38	-5	-9	0	-5	-8
Protecting investors	-2	-2	0	-1	0	0	0	0
Dealing with licenses	4	-2	3	-3	-1	2	3	3
Paying taxes	-1	-4	0	0	-10	0	-3	-4
Employing workers	0	1	1	-1	0	1	0	33
Trading across borders	0	-5	2	-5	-2	-2	-6	-7
Registering property	-6	-2	0	2	-7	0	-2	-4
Enforcing contracts	-3	-1	-1	-3	-9	0	-1	-4
Getting credit	0	-7	0	0	-5	0	8	-7
Closing a business	0	-10	0	-4	-4	0	-2	-11

Note: Bold/italicized numbers indicate large changes in rankings (rise or fall of six or more places). Positive numbers indicate a rise (improvement) in the rankings; negative indicates a fall.

Source: World Bank, *Doing Business 2006–2007*. (www.worldbank.org)

the simple rankings to try to capture whether or not reform is taking place at the micro-level in various countries by including additional information in the dataset.

1. Cambodia. In overall ease of doing business, Cambodia dropped one place in the ranking, attributable to a fall of six in the “registering property” category ranking. Of the elements that make up this index, the only change was a very small (two per cent on a base of 4.7) drop in the “registering property cost” as a percentage of property value, which actually is a slight improvement. This leads to the conclusion that other countries made reforms that improved their spots in the rankings, rather than steps backward on the part of Cambodia.

2. Lao PDR. Laos rose five spots in the overall rankings, attributable to a 38 spot improvement in the “starting a business” category. Laos saw little change in the other categories. This 38 spot jump can be traced to changes in three different components: (1) an 18 percent reduction in the number of days to start a business (better); (2) a 15 percent increase in business start-up costs as a percentage of per capita income (worse); and

(3) a 100 per cent reduction (from 23.4 to zero) of minimum capital required to start a business as a percent of per capita income.

3. Vietnam. This dynamic transitional economy paradoxically fell six spots in the overall rankings. There was one major improvement, that is, a rise of 33 spots in “employing workers”, offset by large steps backward in five other categories. The big jump in “employing workers” was due to very large improvements in both the Difficulty of Hiring Index (from 33 to 0) and Rigidity of Employment Index (48 to 37).

On the other hand, as with Cambodia, the categories in which Vietnam fell in the rankings are, on the whole, attributable not to steps backward on the part of Vietnam, but improvements in other countries. For example, Vietnam fell eight spots in the ‘Starting a Business’ ranking, despite a 12 per cent reduction in Starting a Business Cost as percentage of per capita income (50.6 to 44.5). Likewise, a fall of seven spots in ‘Trading Across Borders’ (68 to 75) was accompanied by an eight percent reduction in the number of days required for export (38 to 35).

In short, the CLV countries are making progress in a number of areas, but they still have a long way to go in terms of improving the micro-economic environment in which their respective private sectors and foreign multinationals can flourish.

3. Summary of Chapters

The topic of ASEAN economic integration is, indeed, a vast one. Gone are the times when we could merely focus on (often half-hearted) ASEAN initiatives in trade and investment and feel confident that we had captured most of the issues. Today, ASEAN cooperation extends to almost all areas of economics as well as many social, cultural and security areas. Indeed, the AEC is but one pillar of the “ASEAN Community”, the others being the ASEAN Security Community and the ASEAN Socio-Cultural Community. Still, given the enormous scope of the task, this book endeavors to concentrate as much as possible on the policy dimensions of trade, investment, finance, and development in the region.

Part I focuses on issues of ASEAN economic development and integration. Chapter 2 gives a broad overview of ASEAN economic integration in the Asian context. It tries to answer the following questions: What is shaping structural change in the region in the 2000s? Which are the most important variables determining competitiveness and productivity? How

has policy change been reshaping Asia in an era of increasing globalization? How can regional integration be bolstered through formal and informal channels? It argues that structural change in Asia has been impressive over the past few decades, and much of this change can be attributed to economic liberalization. It underscores the importance of production value chains and fragmented trade in the globalization process in Asia generally and in ASEAN in particular, and argues that deeper economic cooperation, if it is outward-oriented and based on the principle of best practices rather than mere national treatment, will be an effective tool in bolstering regional competitiveness. This is rightly the most important economic priority of the AEC.

Next, Chapter 3 considers the question of how ASEAN countries should align their commercial policies as they create the AEC. It is a complicated question: to create a “single market and production base”, one arguably needs a customs union, as was the case in the EU experience. But the diversity of the tariff structures in the ASEAN countries makes this a challenging process. The chapter explores how this might be done from a variety of perspectives, including the possibility of an extremely liberal Common External Tariff, which it argues would allow the region to be inclusive of all Member Countries (rather than having to resort to the “10-X” formula) and could generate maximum economic gains.

Chapter 4 considers ASEAN investment cooperation. While FDI in ASEAN has been relatively strong over the past few years, it has generally been disappointing in most countries since the Crisis, and its share of global FDI as present is only about half of what it was in the mid-1990s. As FDI is an important priority in the ASEAN region, it is important to assess how effective investment cooperation has been in the region thus far, and what can be done in the future to improve its attractiveness. We find that ASEAN has made a good deal of progress in this regard, but that much more can be done in order to exploit the potential of the region. We suggest that the ASEAN Comprehensive Investment Area (ACIA), which will be the instrument through which the common investment area envisioned in the AEC will be realized, has considerable potential to create a unified market, with likely very high returns.

Financial issues are covered in Chapters 5 and 6,² which focus on fixed-income and stock markets, respectively. Financial market development

²These chapters were adopted from work done with Reid Click of the George Washington University.

revealed itself to be the Achille's heel of ASEAN development when the Asian Crisis hit; improving these markets continues to be a high priority in the region. In Chapter 5, we consider the development of bond markets and compare the inter-relationship between the bond markets of the ASEAN Member Countries, with a view to underscoring key areas that need to be addressed. We also consider the potential for the creation of an ASEAN bond market. Chapter 6 has a more specific purpose: It tests the degree to which ASEAN stock markets are integrated. Our hypothesis is that ASEAN stock markets are co-integrated and, hence, integration of these markets can be done without losing any diversification advantages. Thus, by increasing potential scope and liquidity, closer integration of these markets would make the region more attractive for portfolio investment flows.

Part II focuses on ASEAN's economic relationships with its most important economic (and strategic) partners. Chapter 7³ looks at ASEAN regional economic integration in the broad context of Asian integration. Given the rising importance of Asia in the global economy and in ASEAN's trade and investment, it is only natural that ASEAN considers how it might "nest" its approaches to economic integration with the Asian region in its entirety. It considers related questions in terms of real and financial cooperation. Using a CGE model to simulate various scenarios of potential trade agreements, it concludes that an ASEAN + 3 agreement would generate most of the benefits that one would expect from any configuration of regional agreements. Moreover, it shows that ASEAN countries are becoming more integrated in terms of macroeconomic variables and demonstrates that while ASEAN/Asia may not be an Optimal Currency Area, in terms of economics, it performs pretty much as well as the EU. The problem relates to the political will to embrace closer forms of monetary union. The chapter argues that the free-trade areas being negotiated in Asia will likely increase the probability of deeper monetary integration in the medium-long run.

Chapters 8 and 9⁴ explore ASEAN's relationship with the EU and the United States, respectively. These markets are traditionally very important for ASEAN trade and investment; the EU is the most important source of FDI and the United States has traditionally been the most important market for ASEAN's exports of manufactures. In both chapters, we argue

³This chapter was adapted from work undertaken with Ganeshan Wignaraja of the Asian Development Bank.

⁴Chapter 9 represents an updated version of Naya and Plummer (2005).

that closer economic cooperation between ASEAN and these key dialogue partners make a good deal of economic sense, as well as having important political benefits.

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