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DÁNIEL MOLNÁR & DIÁNA HORVÁTH & GÁBOR REGŐS: MONETARY POLICY
IN THE FOUNDER COUNTRIES OF ASEAN

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Foreword

PÉTER GORECZKY, Editor

These days it has become an analyst cliché to state that the gravity of growth in the global economy has shifted to Asia. The fact that China is already an economic superpower is hard to dispute and the rise of India as an economic powerhouse is also widely acknowledged. Besides these two giants, there is also a group of countries in Southeast Asia that is attracting growing attention from foreign economic policy makers, investors and multinational companies. The ASEAN (Association of Southeast Asian Nations) region is progressing to be the most promising and diverse centre of economic growth globally. Due to their potential, its countries are becoming key economic partners for China, India, and Japan.

Regarding the geographic proximity and the enormous need for infrastructure development in the region, it is not surprising that the ASEAN countries are in the focus of China's emblematic project, the Belt and Road Initiative (BRI). Beyond the BRI, most economies in the region are deeply interlinked with China in terms of foreign direct investments (FDI) and trade. A partnership which presents opportunities and also the risk of excessive dependency at the same time. This controversial economic relationship makes every chance for diversification more valuable and the possible role of India as a counterweight to China is an interesting concept for further analysis. Traditionally, Japan has been a key player in the region as a source of FDI and official development aid. Hence, the growing presence of China in these fields represents a major challenge to Japan's positions in Southeast Asia. In the past decade, the region has also evolved to become a hot spot for global and regional value chains as a growing number of transnational companies have located manufacturing activity to Southeast Asia. The US-China trade war and the COVID-19 pandemic are both having major impacts on how the ASEAN region can maintain or even develop its positions as an attractive location in the global FDI landscape. The European Union has also recognised the significance of the ASEAN region as a future growth engine of the global economy. However, bilateral disputes between the EU and certain ASEAN member states inhibit the potential upgrade of relations to the level of strategic partnership, which has been a pursuit of the European Union in the last few years.

The outbreak of the COVID-19 pandemic has had an unprecedented impact on the global economy, including the ASEAN region. Nevertheless it is too early to declare how the economic relations in Southeast Asia will be impacted by the crisis. It is anticipated that free trade agreements in the region will receive more emphasis as tools for helping the economic recovery. The pandemic may also catalyse cutting edge sectors like financial technology.

In this issue of our journal, the *Foreign Policy Review*, we have a wide range of articles focusing mostly on these aspects of the ASEAN region's integration into the world economy. I hope that our readers will enjoy the different perspectives of authors who represent various universities, research institutes and think tanks from Hungary through India and Vietnam to the Philippines and Japan. Despite the diversity of views, they all reflect the remarkable potential of the ASEAN region as a player in the global economy.

What do China and the BRI Mean to ASEAN Economies?

ALEXANDRA ZOLTAI & PÉTER KLEMENSITS

Abstract: China's Belt and Road project, announced in 2013, has had a major impact on the world, and the ASEAN countries are, of course, not an exception. However, there is no consensus among the Member States on how to manage China, and therefore the response to the BRI was not uniform, either. Some countries regard the project as a threat, others as an opportunity, but they agree that dependency on China should be kept to a minimum. However, what role this effort plays in the Belt and Road project and how feasible it is, is a major question.

The study assumed that after 2013 (inter alia thanks to the BRI), ASEAN–China relations have substantially improved and economic cooperation has been strengthened. To demonstrate this, by using economic indicators, we sought to create a benchmark by which to compare the impact of China on the economies of ASEAN countries. The results show which country is economically most dependant on China and whether each country's related political narrative corresponds to the change of the economic data.

Keywords: ASEAN, China, economy, Belt and Road

Introduction

The purpose of this study was to present the relationship between the People's Republic of China (China) and the Association of Southeast Asian Nations (ASEAN) countries in the light of the Chinese Belt and Road Initiative (BRI). According to our hypothesis, the Chinese project has had a major impact on the economies of the ASEAN countries, which has also increased their economic dependence on China. In order to demonstrate this, we examined the economic relations of these countries in the year (2012) before the BRI announcement (2013), taking into account their external trade balance and FDI, and looked at the same economic indicators on the basis of the 2018 figures, which allowed us to reject or confirm the hypothesis¹. Due to the elusiveness of the BRI, it is very difficult to measure the impact and dependence on individual countries. Moreover, the issue of ASEAN Member States' indebtedness to China should also be examined, but China does not issue data on this,² so we do not have adequate sources. Due to the limited scope of this study, we only covered the relationship and economic interconnectedness of China and ASEAN countries, and only touched upon the political and economic relations with the United States of America and other major countries in the region, such as Japan, which also play a significant role. It is clear that a number of other



factors – which mainly means geostrategic, political, and cultural considerations – also influence the impact of BRI, a reference to which was made briefly in the study as well. Unfortunately, due to the size constraints, we could not undertake to explain them in detail, although given the heterogeneity of the region, a uniform interpretation of the dependence on China regarding the individual states is a tall order. We first looked at the development of relations between China and ASEAN, and next at the Member States and the evolution of their relations with China in the light of the BRI. By analysing the economic data separately for each country and aggregating them at the end, the study provides a comprehensive comparison of the development of China's economic influence in the region before and after the BRI. We also made an attempt to examine and highlight the political links behind the development of economic relations. After the confirmation or refusal of the hypothesis, the results were used to draw conclusions on the development of the geopolitical situation in the region.

Review of China–ASEAN Relations

The relationship between ASEAN, established in 1967, and China can be divided into three stages. The initial hostile relationship was replaced by the “falling in love” era in the mid-1970s, during and after which close cooperation dominated their relations in the 1980-90s. However, from 2010, as economic interdependence increased, the relationship became more complex due to geopolitical conflicts (“phase of uncertainty”) (Mahbubani & Sng, 2017).

The ASEAN–China dialogue was established in 1991 and China became a full-fledged ASEAN dialogue partner in 1996. In 1997, the first informal ASEAN–China Summit was held in Kuala Lumpur (Malaysia), during which the leaders of both sides announced their decision to establish a 21st-century-oriented, good neighbourly partnership based on mutual trust between ASEAN and China. In November 2011, the ASEAN–China Centre (ACC) was formally established. As a single-contact information and activity centre, the ACC has taken on a role in promoting cooperation between ASEAN and China in the areas of trade, investment, education, culture, tourism, information, and media. The next milestone in relations was the year 2013, when Chinese President Xi Jinping visited Indonesia and Malaysia to intensify cooperation between ASEAN and China for a better common future. In this year, the Maritime Silk Road for the 21st century was also announced, which has a serious impact on the region and its ASEAN Member States. 2020 was designated as the ASEAN–China Year of Digital Economic Cooperation.

ASEAN and China have carried out close coordination and cooperation on international and regional issues. Both sides have jointly committed themselves to promoting a thorough development of regional cooperation in East Asia and have tackled the current and potential challenges of the region. The two parties have also maintained good communication and cooperation within the cooperation mechanisms, including the ASEAN Plus Three (China, Japan, and South Korea) Summit, the ASEAN Regional Forum, the Asia Cooperation Dialogue, the APEC, etc.

Economic and Trade Cooperation

In November 2002, ASEAN and China signed the framework agreement on comprehensive economic cooperation, which entered into force in January 2010 and launched the process of creating the ASEAN–China Free Trade Area (ACFTA). According to the Chinese Ministry of Commerce, bilateral trade between ASEAN and China reached USD 641.46 billion in 2019, an increase of 9.2% compared to the previous year. China's exports to ASEAN amounted to USD 359.42 billion, and Chinese imports from ASEAN amounted to USD 282.04 billion, which represented an increase of 12.7% and 5%, respectively. China has been the top trade partner of ASEAN for 11 years (ASEAN–China Centre, 2020). And since 2018, ASEAN has become China's second most important trading partner (ahead of the United States) after the European Union (Xilian, 2019).

According to the Chinese Ministry of Commerce, at the end of December 2019, investments between the ASEAN and China amounted to USD 236.91 billion. China's investment in ASEAN reached USD 112.30 billion and ASEAN's investment in China amounted to USD 124.61 billion. The year 2019 was the second time that ASEAN was the second largest recipient of Chinese foreign investment. ASEAN is the third largest investment source in China.

In the relations between China and ASEAN, tourism also plays an important role. In 2019, the total number of reciprocal visits exceeded 65 million, with around 4500 flights per week between China and ASEAN Member States (ASEAN–China Centre, 2020).

The coronavirus pandemic opened a new chapter in economic relations between the two countries, since ASEAN became China's largest trading partner in the first two months of 2020, overtaking the European Union. This has demonstrated that there is an unbreakable supply chain between Southeast Asia and China that even external shocks such as the coronavirus (Global Times, 2020) cannot tear. There is no doubt that, once the epidemic is over, the EU will take back its leading role, as it has a 2 to 3 times larger economy than ASEAN, but this shows how close the economic ties and the interdependency are between China and Southeast Asia.

BRI, the New 21st-Century Maritime Silk Road and the South China Sea

In autumn 2013, China announced a global project, known as the Belt and Road Initiative, which is another step toward greater Chinese engagement in the world. This way, the Beijing leadership, following the footsteps of the former caravan trails joining Europe and Asia, committed itself to the development and modernisation of transport networks, envisioned as a China-led (funded) international development program, which also meets Beijing's geostrategic objectives by connecting remote regions to major trade routes (Klemensits, 2016). The project consists of land routes (connecting China to Central Asia, the Middle, East and Europe) and maritime routes (comprising the main commercial routes of Southeast Asia, Africa,



Europe, and Oceania). The Belt and Road Initiative can be described as a network, which can be spatially expanded with great flexibility. China makes use of this exibility and, most recently, has extended the large-scale project with the Polar Silk Road (Zoltai, 2020). Its main concept is to link existing trade routes, reduce freight costs and increase protection, but it is also important to China because it can thus secure huge projects in the construction sector and Chinese goods can penetrate new markets. In addition to economic benefits, the initiative also has very important strategic benefits; the participating countries will become committed to China. It is therefore expected to go beyond simple Chinese-funded infrastructure developments, because its real objective is to promote regional cooperation, financial integration, free trade, and scientific cooperation (Scott, 2016). The planned investments are to be financed by the Asian Infrastructure Investment Bank and the Maritime Silk Road Bank. The Maritime Silk Road is also of great importance in diplomatic terms, and it is no coincidence that it has recently become a key element of Chinese foreign policy. According to China, infrastructure investments are not linked to political constraints, however, the interrelation of interests is indisputable. And in the case of ASEAN countries, the major strategic goal should not be forgotten either: Given the competition of China and the United States, the strengthening of Chinese influence in the region is a priority in both economic and political terms (Klemensits, 2018).

There are, therefore, serious diplomatic, economic, and strategic interests in the background. Firstly, the concept of the New Maritime Silk Road has been developed by China, *inter alia*, to reconcile and quiet neighbouring countries, which feel threatened by the aggressive Chinese territorial demands on the South China Sea (Yale, 2015).

Interdependence may be key to the future feasibility of the BRI. According to 2018 data, the investment in the BRI to Southeast Asia exceeded USD 740 billion. At present, 13 projects have been proven to be operational, representing a very small proportion of the projects planned in the region (Kaneti, 2020).

However, Beijing's sovereignty claims in the South China Sea, marked by the nine-dash line, generates severe tensions in the region and even increases the presence of the US Navy. The situation was compounded by China's refusal to accept the 2016 ruling of the Hague's Permanent Court of Arbitration, which has thus undermined the prestige of international law (Eszterhai, V. & Klemensits, P. 2016). China considers almost the entire South China Sea to be its own sovereign territory, which is in breach of the sovereignty of the Philippines, Vietnam, Malaysia, Brunei, and Indonesia, as these countries also have outstanding territorial demands.

Cambodia

Cambodia is considered to be one of China's main partners in the Southeast Asian region. In addition to good diplomatic relations, China has undeniably become Cambodia's largest economic partner, as it is the largest foreign investor, the largest bilateral donor, the largest trading partner, the largest buyer of Cambodian rice and also, the most tourists to the Southeast Asian country come from China. Since the

announcement of the BRI in 2013, Cambodia has been a strong supporter of the large-scale Chinese project and has great hopes that this initiative will be one of the foundations of the nation's development. The development of infrastructure and physical connections has made significant progress in Cambodia, most of which are related to the BRI. The two most important projects are the Sihanoukville Special Economic Zone (SSEZ) and the planned Phnom Penh-Sihanoukville Expressway, (Kha, 2019), about 20% of which is currently completed (Khmer Times, 2020).

The SSEZ, in itself, has contributed to increasing employment, as more than 20,000 Cambodian employees have received jobs, and it has helped to employ low-skilled and female workers, both from Sihanoukville and other neighbouring provinces. Since trade in goods has become a driving force for growth in the country, the logistics sector is also of particular importance. At present, however, Cambodia lacks sufficient infrastructure capacity and significantly lags behind other countries in the region in logistics performance, leading to higher transport costs and seriously undermining the country's competitiveness. The implementation of the Phnom Penh-Sihanoukville Expressway could greatly improve the efficiency of the country's logistics. This new infrastructure development would modernize the connection between Phnom Penh and the port of Sihanoukville, the only international deep-sea port in Cambodia. In 2017, it accounted for more than 90% of the total container turnover in the country (Kha, 2019).

Against this background, the increasing dependence of Cambodia on China must be taken into account. The Cambodian leadership is clearly responsible for managing the BRI-related projects properly so that the Cambodian population can also benefit from it. Any excessive dependence on China imposes certain limits on Cambodia's foreign policy potential. The Cambodian elite has thus begun to move closer to China, which China has made use of, but ultimately the initiatives related to China and the BRI taken so far have benefited Cambodia. However, local criticism of these initiatives is often expressed regarding the lack of quality and transparency of Chinese investments and the low benefit for the people who live there (Kha, 2019).

In 2012, trade with China accounted for 2.17% of Cambodia's total exports and 22.3% of its imports. In 2018, exports increased to 6.92% and imports to 25.1% between the two countries. Between 2012 and 2018, China was the second fastest growing export market (+ 413%) and the third fastest growing import market (117%) for Cambodia (OEC. Cambodia). In 2018, 19.6% of all FDI in Cambodia was from OFDI from China (Zhōnghuá rénmin gònghéguó shāngwù bù, 2018).

Myanmar

There is an interdependence between Myanmar and China on security issues. When the international community imposed sanctions against Myanmar for violations of human rights and isolated the country, the regime, which had been seized with military support, received support from China to ensure its survival, so that China could become the international ally of the military junta in Myanmar. In addition, China was the main source of military equipment and training for Myanmar, while



China needed Myanmar's cooperation to enforce its own security interests. China is building port facilities in Myanmar, which are of strategic importance in its access to the Indian Ocean (Chen, 2019).

In January 2020, Xi Jinping made an official visit to Myanmar on the occasion of the 70th anniversary of diplomatic relationship between the two countries, and they also strengthened bilateral cooperation. Xi Jinping's visit focused mostly on the Kyaukphyu Special Economic Zone (SEZ) and the deep-sea port. The agreements signed during the visit include a railway line linking the Chinese Kunming (Yunnan Province in southern China) to Kyaukphyu touching Muse and Mandalay, which are located in the northern and middle part of Myanmar, as well as the new Yangon City project developed by the China Communications Construction Company (CCCC). The projects are all linked to the China-Myanmar Economic Corridor (CMEC), which is part of the Chinese BRI. Myanmar is of particular importance to Beijing's geostrategic plans; the country provides China access to the Indian Ocean. The Indian Ocean offers significant shipping routes to China to import oil from the Middle East. Land routes are already in use, the Kyaukphyu pipelines have been transporting gas from Myanmar all the way to Kunming since 2013 and oil since 2017, allowing Beijing to avoid the South China Sea and the strategically vulnerable Malacca Strait.

Myanmarese State Counsellor Aung San Suu Kyi recognized the need to accelerate economic growth in her country and to develop the necessary infrastructure, and therefore agreed to the implementation of the China–Myanmar Economic Corridor connecting Kyaukphyu and Kunming at a meeting with Xi Jinping in Beijing in 2017. Myanmar's leadership has a strong sympathy with the Chinese Communist Party and favours Chinese companies to accelerate economic growth in Myanmar and improve its underdeveloped infrastructure (Marston, 2019).

Outside ASEAN, China, India, Japan, and South Korea have also increased their bilateral trade flows with Myanmar and China has become its main trading partner. Although Thailand remains the largest destination for Myanmarese exports, China has been its largest foreign partner since 2011. Data recorded in 2012 show that 37.7% of the total Myanmarese imports came from China, while 15.8% of its total export flowed into China. In 2018, 24.7% of Myanmarese exports were destined for China, which made China the second largest destination for Myanmarese exports after Thailand. China accounted for 39.6% of the total Myanmarese imports with a slight drop, but still ahead of Thailand (17.2%). As a result, Myanmar's domestic consumption continues to rely heavily on products and services originating in China. Between 2012 and 2018, China was the fastest growing export (+301%) and import market (+89.4%) (OECD, Myanmar). In 2004, the Chinese FDI in Myanmar accounted for only 1.9% of China's total foreign investment. However, following the imposition of economic sanctions by Western countries in the early 2000s against the leadership which was declared to be repressive, China started to make significant investments in Myanmar and became the largest foreign investor by 2011. In 2018, Chinese OFDI in Myanmar already accounted for 14.9% of all of its foreign investment (Zhōnghuá rénmin gònghéguó shāngwù bù, 2018).

Laos

Laos is one of the smallest and poorest countries within ASEAN. Approximately 61% of its 6.8 million inhabitants are of working age, so the country is a popular target for labour-intensive industries. Export and tourism are the main drivers of the country's economic growth, but its trade volume is rather small and its main trading partners are its immediate neighbours: Thailand, China, and Vietnam (Wroblel, 2019).

China and Laos established diplomatic relations in 1961, but the tensions between the two countries remained during the Cold War. Rapprochement only occurred in the 1990s and 2000s, and the countries' relations reached the level of a comprehensive strategic partnership in 2009. There are still many conflicts in the relations between the two countries (whether it be local dissatisfaction with particular Chinese infrastructure projects or the concern that Vientiane is too reliant on Beijing), but bilateral cooperation is still developing.

One of the most important initiatives between the two countries is currently the railway project between China and Laos, which, once completed, will be the longest railway line in Asia located outside China. The project is a 414 km railway line from the town of Boten on the Laos-China border to Vientiane. Trains will be able to run at a speed of 160 km/h on the line, which includes 198 km of tunnels and 62 km of bridges. Of course, the whole project is part of the BRI, the main objective of which is to channel the landlocked country into trade and transform it into a continental hub. The project started in 2016 and is expected to be completed by the end of 2021 (Parameswaran, 2020). As Laos is a rather poor country with limited natural resources, it is highly vulnerable to the Chinese initiative (Lintner, 2019).

Trade with Thailand dominates the foreign economy of Laos: in 2018, 51.2% of its export flows to Thailand, while 66.9% of its import comes from there. Second, however, is China, representing 31.7% of exports and 22.6% of imports in the total Lao trade. China's share grows more year by year compared to that of Thailand, but the difference is still significant. Between 2012 and 2018, the second fastest growing export (+117%) and import market (+48.9%) was China after Thailand (OECD, Laos). In 2010, it preceded Thailand as the largest foreign investor. In 2003, the Chinese OFDI amounted to 1.5% of all FDI in Laos. In 2012, however, it increased to 58.8% and in 2018 to 87% of the total Lao FDI (Zhōnghuá rénmin gònghéguó shāngwù bù, 2018). The figures show that Laos is highly dependant on China, which, on the one hand, places the country in a difficult situation and, on the other hand, represents a potential for Lao development.

Vietnam

China's relationship with Vietnam is greatly influenced by their history and the South China Sea, which is still a source of conflict. However, Vietnam is in favour of the BRI Initiative, yet cautious about the related Chinese loans. There are several factors involved: for example, mistrust toward Beijing and the strategic consequences of



debt to China for the South China Sea dispute as well as unfavourable conditions for Chinese loans. Vietnam's participation in the BRI is therefore rather modest and slow, although the country is in dire need of infrastructure development. The first infrastructure project under the BRI Initiative is the Cat Linh–Ha Dong metro line in Hanoi, which has been under construction since October 2011 and subsequently recognized as part of the BRI by both parties. The total construction is worth USD 552 million, of which USD 419 million is provided by the Chinese Eximbank. In the meantime, the investment cost has almost doubled, and China has granted new loans. Xi Jinping's visit to Vietnam in 2017 led to an agreement to support the "Two Corridors, One Belt" (TCOB) initiative and thus the BRI. The main objective of the initiative is to provide better rail connection between China and Vietnam (Hiep, 2018).

Vietnam's budget deficit remains high, which means that investment in state-funded infrastructure projects is still not expected, and therefore the country remains interested in the BRI. It is likely to participate in pilot projects, but for fear of increasing public debt, it will rather encourage private investors to take out loans. Given the relationship between the two countries, there is no doubt that the BRI will face significant challenges in Vietnam; for example, if the South China Sea dispute intensifies, Vietnam will become more sensitive to the political and strategic consequences of the BRI. However, if the situation continues to be peaceful, there is a great chance of a stronger commitment from Vietnam (Hiep, 2018).

This also shows that Vietnam seems to be trying to avoid economic dependence on China. However, it is becoming less and less able to do so with regard to imports. In 2012, trade with China accounted for 11.3% of Vietnam's total exports and 25.3% of its imports. In 2018, exports increased to 19.6% and imports to 32.9% between the two countries. Between 2012 and 2018, China was the fastest growing export (+271%) and import market (174%) for Vietnam (OEC. Vietnam). In 2012, Chinese FDI amounted to USD 1.6 billion in Vietnam, while by 2018, it was almost four times higher, increasing to USD 5.6 billion. In 2018, 3.8% of all FDI in Vietnam was from Chinese OFDI, thus the country tries to remain independent from China in terms of foreign direct investments (Zhōnghuá rénmin gònghéguó shāngwù bù, 2018).

Thailand

During the financial crisis in Asia, the relationship between China and Thailand has continued to grow and intensify due to economic cooperation. However, since Xi Jinping's assuming of power, the anti-Chinese voices in the country have become stronger. In particular, the younger generation was disappointed with the leadership taking office in 2014, when they became too committed to China, and public opinion is rather sceptical about the Thai–Chinese railway agreement and its bad interest rate conditions, which cause serious concerns about drifting into a debt trap. Thailand's economy is highly dependant on Chinese tourists, which also causes disapproval from local people (Bunyavejchewin, 2020).

The railway project under the BRI Initiative would link Bangkok to Nong Khai, located in the North of Thailand, by high-speed rail technology imported from China. This would make it possible to reach China and Kunming through Laos. Therefore, the construction of the Thailand–China high-speed railway line is a priority project within the BRI, and the connection with the capital of Laos, Vientiane, would also be crucial to Thailand's economy, as it would reduce trade costs. On the basis of the preliminary negotiations, it appears that the project will have a moderate impact on Thailand's debt. The Thai Government is going to spend USD 5.8 billion for the first phase of the project, which will cover roughly half of the line's costs (estimated at USD 9.9 billion based on 2017 figures, accounting for 2% of Thailand's economy). However, the funding proposed by the Thai Government seems to be rather careful and prudent, with at least 80% of the project being funded from internal sources in Thai baht and the remaining 20% in US dollars from external debt (Lam, 2019).

Thailand is the second largest economy in ASEAN, and unlike domestic fears, its economy is quite balanced. In 2012, trade with China accounted for 13.1% of Thailand's total exports and 15.4% of its imports. In 2018, exports fell to 11.8% and imports increased to 20.1% between the two countries, and in the same year, China was Thailand's main trading partner in both respects. Between 2012 and 2018, China was the fastest growing import market (+26.3%) for Thailand (OEC. Thailand). In 2018, 2.6% of all FDI in Thailand was from Chinese OFDI, thus the country tries to remain independent from China in terms of foreign direct investments (Zhōnghuá rénmin gònghéguó shāngwù bù, 2018).

Indonesia

The development of Indonesian–Chinese relations started from the end of the Cold War, since the Suharto Government only established diplomatic relations with China in 1990. However, economic and political cooperation remained limited until the late 2010s. Regarding the Maritime Silk Road, for China, the archipelagic state is the most important Southeast Asian country for geostrategic and geo-economic reasons. Besides the Malacca Strait, both the Lombok Strait and the Sunda Strait allow the largest country in the region to control the strategically important maritime trade routes along which most of the Chinese export-import passes. Therefore, it can be stated that without Indonesia's participation, the whole initiative would fail (Parameswaran, 2018). However, the Indonesian and the Chinese governments soon agreed: according to President Joko Widodo's (Jokowi) concept, he aspired to turn his country into a "Global Maritime Fulcrum" between the Pacific and the Indian Ocean, and Chinese plans are completely adapted to this idea. Although Indonesia is the world's biggest archipelago, the infrastructure is deeply underdeveloped. The government lacks sufficient financial resources and hopes that China will provide them (in the form of loans and aid). Presently Indonesia is the biggest economy in ASEAN and by 2030 it is projected to be the 7th biggest economy in the world; hence the bilateral relationship is especially important to China.



In November 2014, President Jokowi pledged himself “to improve Indonesia as a trade nation through the construction and upgrading of its maritime infrastructure, including 24 strategic ports and five deep-sea ports.” (Duquennoy – Zielonka, 2015). The aim is to boost Indonesia’s connectivity, trade opportunities, and attractiveness for foreign investments. China correctly realised that it is an enormous business opportunity, since Jakarta wants to build these facilities all over the country in the near future, mainly with the help of Chinese companies. The joint Indonesian–Dutch–Chinese development of the Kuala Tanjung port started in 2015 (at a cost of USD 2.5 billion), during which the construction of the multipurpose terminal, industrial zone, and container port has already been completed, while the integrated industry zone connected to the port is expected to be completed by 2023 (Gunawan, 2019). A flagship project of the BRI, the 150 km long Jakarta-Bandung high-speed railway (costing USD 5.9 billion), is expected to be completed by 2021 (CSIS, 2020) from the Chinese loan. Besides the development of the Lembeh International Airport, construction of the Kayan River Hydropower Plant has also begun. The development of tourism has also received priority attention: In the West of Java, covering 3000 ha, the MNC Lido City, a commercial, residential, entertainment, and leisure complex is being built. And in North Sumatra, next to Lake Toba, a Tourism District, comprising 10 villages, is currently being established (Parama, 2020). The investments are part of the Regional Comprehensive Economic Corridor, which comprise North Sumatra, North Kalimantan, North Sulawesi and Bali.

The development of economic relations is well reflected by the fact that China has been Indonesia’s largest trading partner for nine years now. The most tourists also come from China (an average of 2 million people per year). In 2012, 15.1% of Indonesian exports were destined for Japan, with China in second place by 12.3%. China took the lead in 2018 with 14.3%, while Japan returned to the second position with 10.3%. As far as imports are concerned, China was the main partner already in 2012 with 15.9%, increasing to 24.3% by 2018. Thanks to this, China was the fastest growing import market (+45.7%) between 2012 and 2018 (OECD, Indonesia). In 2018, the country received Chinese investments worth USD 1.86 billion, meaning that 5.7% of all FDI in the country was from Chinese OFDI (Zhōnghuá rénmin gònghéguó shāngwù bù, 2018).

Malaysia

Malaysia was the first ASEAN country to diplomatically engage with China in 1974, and the Malaysian governments considered close cooperation with Beijing to be a priority. Under the Prime Ministry of Najib Tun Razak (2009-2018), the country has made a firm commitment to the BRI, and Chinese projects have been expected to significantly benefit the economy. In the framework of this, an agreement has been concluded on the establishment of the Malaysia-China Kuantan Industrial Park, as a result of which China implemented infrastructural investments in the port of Kuantan, located on the eastern shore of the Malaysian Peninsula.

Malaysia's first industrial park, which has been granted national status, was built on 685 ha, and mainly hosts the steel, electronics, communication technology, and renewable energy industry (MCKIP, 2020).

In 2014, the Malacca Gateway Project, which is largely financed by Chinese companies, was launched, which includes the establishment of a vital deep-water port in the Strait of Malacca. The Malacca industrial park is also one of the main components of the project. Within this framework, the aim is to build 3 reclaimed artificial islands and develop one natural island for touristic purposes, with the exception of Pulau Melaka, which has to become a maritime activities centre (FMT News, 2017). One of the most ambitious BRI projects in Southeast Asia has since been significantly delayed, even though it received the green light from the new Malay Government in 2019.

Following the change of government in 2018, Mahathir bin Mohamad suspended the ongoing BRI projects, notably the East Coast Railway Line, the Multi-Product Pipelines, and the Trans-Sabah Gas Pipelines, on the grounds of the country's difficult economic situation. The 640 km long East Coast Railway Line aims to establish communication between the East and the West of Malaysia, which is also of vital interest to China in order to avoid the Malacca Strait. Once the conditions have been renegotiated (Malay companies were granted a 40% share of the construction and the total costs have been reduced to USD 10.7 billion), Mahathir's Government revived the project in 2019, which is expected to be completed by 2026 (Railway technology, 2020). Mahathir has also expressed support for the Bandar Malaysia project, which is a mixed-use, transit-oriented development (TOD) in the capital city. The project is located at the terminus of a new high-speed rail line, which, when completed, will connect Kuala Lumpur to Singapore. The development affects an area of 196.7 ha and costs as much as USD 33.6 billion. The Forest City project, being built from a USD 100 billion investment, will also continue. It aims to establish a city quarter in the Johore Strait opposite Singapore, covering an area of 30 km², which would include commercial, industrial, and residential buildings, ensuring the livelihood of 700,000 people (Clark, 2020).

Malaysia is the world's 35th largest economy in terms of GDP, and China is a very important partner. In 2012, 15.5% of Malaysian exports were destined for China, while 15.9% of imports came from there. In 2018, China's share of Malaysian exports decreased to 13.4%, while its share of imports increased to 21.2%. Between 2012 and 2018, China was the fastest growing import market (+46.1%) for the country (OECD, Malaysia). In 2018, 5.4% of all FDI in Cambodia was from OFDI from China (Zhōnghuá rénmin gònghéguó shāngwù bù, 2018).

Philippines

The Philippines, under President Rodrigo Duterte's Presidency from 2016, realized that the improvement of economic relations with China was of strategic importance. Duterte started to form his new, admittedly "independent" foreign policy, which – in contrast with his predecessor, President Benigno Aquino –



has totally redefined the country's foreign and security policy strategy, the most striking aspect of which is its turning from the United States and opening towards China. Duterte tries to establish good relations with both the rival major powers, and he would not like to relinquish the US investments either, but whereas these have not been able to meet even the infrastructural needs, it is clear that there is a need to look for new partners. China's positive attitude paved the way for Duterte's official visit to the country, held between October 18 and 21. It is no coincidence that he was accompanied in his visit to Beijing by more than 400 businessmen: the improvement of economic relations was of key importance. Finally, 21 different agreements have been signed in total, worth USD 24 billion, of which USD 15 billion is Chinese investment, together with a credit facility of USD 9 billion (Calonzo & Yap, 2016).

The country would not like to be excluded from China's 21st-century Maritime Silk Road Project, therefore, most of the investments are infrastructural developments. In November 2018, the government announced that 12 of the 35 flagship projects would be implemented from Chinese loans and aid. At that time, the first round of projects included the pump station to be built on the Chico river (2.7 billion peso); the Kaliwa Dam (10.9 billion peso); a railway project (151.3 billion peso); and the Binondo–Intramuros and Estrella–Pantaleon bridges (Padin, 2018).

The second round of investments are planned to include: The first phase of the Safe Philippines project; the Subic–Clark railway; 5 bridges over the Pasig-Marikina River and the Manggahan Canal; and the drainage projects of the Rio Grande de Mindanao river (De Vera, 2018). Most recently, in October 2019, the two parties agreed on the details of financing the Panay–Guimaras–Negros Bridge and the Davao high-speed rail. According to the Duterte Government, the country's participation in the New Maritime Silk Road initiative of the 21st-century will clearly improve the international competitiveness of the country, as infrastructure improvements will reduce the cost of trade with China, as well as Europe, the Middle East, and Africa. New markets will open up to Philippine industry and agriculture, while millions of new jobs are created. However, despite the spectacular plans, very few projects have reached the implementation phase by 2020. Red tape, resistance of the military circles, caution on the Chinese side, environmental concerns, or even fear of a debt trap have slowed the majority of investments, or, in some cases, even shut them down temporarily or definitively.

After Indonesia and Thailand, the Philippines has the third largest economy in ASEAN, with a stable annual GDP growth of over 6% in recent years. By 2019, China became the largest trading partner of the Philippines and one of the most popular tourist paradises (Xinhua, 2019). In 2012, the country conducted 23.4% of its exports with China (the largest export market), which decreased to 13.6% by 2018, while it must be noted that the largest export market has become Hong Kong (14.2%). As far as imports are concerned, China was the main partner already in 2012 with 12.7%, increasing to 24% by 2018. Between 2012 and 2018, China was the fastest growing import market (+238%) (OEC. Philippines). However, contrary to government plans, Chinese investment in the country has not increased significantly: In 2018, only 1% of all FDI was from Chinese FDI (Zhōnghuá rénmin gònghéguó shāngwù bù, 2018).

Singapore

The Malacca Straits and Singapore are of strategic significance, but due to the power of the city-state, Chinese influence may be considered minimal here. Nevertheless, China also committed itself to Singapore to strengthen the cooperation. In 2016, considerable progress was made in this respect since, according to the agreement between the China Construction Bank Corporation and International Enterprise Singapore, USD 21 billion were allocated to support infrastructure projects (China Daily, 2016). Singapore has favoured the BRI from the outset, focusing in particular on infrastructure, financial connectivity, and investment in third countries. In April 2019, the two parties signed an extended agreement on e-commerce, logistics, and professional services, while creating a USD 500 million financial fund for infrastructure development in Southeast Asia (Wei, 2019). In order to improve land connectivity, Singapore and Malaysia started building the 350 km long Kuala Lumpur–Singapore high-speed railway worth USD 11 billion in 2017, which is scheduled to start operating in 2031 (Railway technology, 2020). The BRI project is part of the planned Kunming–Singapore railway line. Despite the positive attitude of the government, some consider that the 21st-century New Maritime Silk Road could lead to the loss of the formerly unique shipping hub nature of the Singapore port, as China's improvements in Malaysia and the land routes could cause a decrease in trade flows.

China is Singapore's largest trading partner, while the city-state is China's largest foreign investor. In 2012, Hong Kong was still the main destination for exports from Singapore with 12.4%, while China was the second destination with 10.9%. In 2018, most of Singapore's exports were already directed to China with 13.7% and Hong Kong was second place with 12.9%. As far as imports are concerned, China had a share of 10.8% as the largest partner in 2012, which increased to 14.6% by 2018. Between 2012 and 2018, China was the fastest growing export market (+43.4%) for Singapore (OECD, Singapore). In 2018, China held a 3.3% share of the country's FDI stock (Zhōnghuá rénmin gònghéguó shāngwù bù, 2018). In this year, the city-state was the largest foreign investment destination for China along the BRI, capturing close to 23% of the total investment outflow from China to Belt and Road countries (Wei, 2019).

Brunei

The Sultanate is primarily linked to China by economic ties, since Brunei is strongly in favour of the BRI project, and China has also promised assistance in diversifying its economy. The Brunei economy is essentially based on oil and gas extraction, but the depletion of stocks may cause serious problems in the future and low oil prices have already led to a recession. However, the investment in infrastructure offered by China and the increase in trade flows can be a solution to the problems. One of the largest BRI projects, the construction of an oil refinery started in 2017 by Hengyi Industries and Brunei's partner, with a total cost of USD 3.4 billion, was completed in 2019. The other project, the Brunei–Guangxi Economic Corridor, which includes investment of nearly USD 500 million, is aimed at the reconstruction of the Muara port and the creation of an agricultural and medical park. Within this framework,



in 2017, a joint venture company formed by China's Guangxi Beibu Gulf Port Group and Brunei's Darussalam Asset took over the operation of Muara Container Terminal, the largest container terminal in the country (China Daily, 2017).

In recent years, economic relations between the two countries have been considerably strengthened. In 2012, Japan accounted for 45.1% of Brunei's exports, while China represented 2.58%. In 2018, although Japan's predominance decreased (33.2%), China's share increased to only 3.76%. As for imports, in 2012, China followed after Singapore and Malaysia with 11%, but in 2018 it became the top partner, with 33.9%. Between 2012 and 2018, China was the fastest growing import market (+191%) for Brunei (OEC. Brunei). In 2018, 3.3% of all FDI in Brunei was from Chinese OFDI, thus the country is still largely independent from China in terms of foreign direct investments (Zhōnghuá rénmin gònghéguó shāngwù bù, 2018).

Conclusion

In light of the above, our hypothesis has been proven, namely that the BRI has had a serious impact on the economies of ASEAN countries, which has also led to an increase in their economic dependence on China. However, the data also show that there are significant differences between countries due to geographical, geostrategic, economic, and cultural reasons. In mainland Southeast Asia, the economies of Cambodia, Laos, and Myanmar are heavily dependant on China, but in Thailand and Vietnam, despite the growing position of China in the areas of external trade and FDI, the efforts of the latter states to balance themselves between the major powers and preserve their distance from Beijing are considered effective. Looking at the Pacific, it can be concluded that in the case of Indonesia, Malaysia, and the Philippines, their economic relations with China have become increasingly strong – the fluctuation of political relations set aside –, manifested mainly in the volume of BRI projects and the shift in external trade balance. In Singapore's and Brunei's relations with China, this trend is also observed, while the economic benefits for the latter are more apparent than for the other countries. The strengthening of economic relations between ASEAN states and China also has significant geopolitical consequences, the most prominent aspect of which is the strengthening of Chinese influence, together with the decline of US power in the region.

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Endnotes

- 1 The data relating to China exclude Hong Kong.
- 2 As a result of the crisis caused by the coronavirus, at the initiative of the World Bank, the world's 73 poorest countries' debt towards each country has been made public in order to help developed countries manage their debt. However, only Cambodia, Myanmar, and Laos belong to this group, so a full comparison cannot be made and no data were provided before 2019. (The Economist, 2020).



Laos and the Belt and Road Initiative

*An Interconnector Helping the Chinese Needs?*¹

VÖRÖS ZOLTÁN & PONGKHAO SOMSACK

Abstract: The paper intended to report on the growing activity and presence of China in its Southeast Asian neighbour, Laos, with a particular focus on the ongoing railway construction within the Belt and Road Initiative scheme. Beijing is using the BRI as a key momentum to increase its regional presence beside its already relevant investor and donor-role in the region. Within this context, Laos is essential for the East Asian giant because of its geographic location. It offers the possibility for China to make a physical connection with Thailand, Cambodia, Malaysia and even Singapore. Lao PDR can also benefit from the Chinese presence. Given its own limited financial capacities and infrastructure funds, these investments can turn Laos from a landlocked to a land-linked country. This in turn should contribute to lower costs of transport and logistics and could even help international and internal tourism, thus benefitting the whole economy. Linking the Lao capital of Vientiane with Kunming in China is under construction and scheduled for completion in 2021. This project is just the first phase; once fully completed, the railway will definitely serve as a significant economic route between China and Southeast Asian countries. But many questions were raised regarding who will gain the most benefits from this railroad project and how Laos can avoid the so-called ‘debt trap’. The research paper sought to investigate advantages and disadvantages of Chinese infrastructure projects in Laos and how Vientiane can deal with these challenges in order to accrue more benefits from China’s economic expansion in the region. Besides looking at the consequences from the Lao perspective, we focused on the Chinese benefits as well; how a completed railway connection can change China’s position within the region and further strengthen its role within Southeast Asia.

Keywords: PR China, Laos, BRI, ASEAN, railway, debt trap, connectivity

Introduction

The 21st century is widely perceived as the century of Asia – the period in which PR China gains significant economic influence in different parts of the world. China is not only one of the top investors and donors, but also plays an important role

in infrastructure development in Asian countries, particularly in the Lao PDR. At the moment, China is using the Belt and Road Initiative as a key momentum to increase its regional presence and, at the same time, as a symbol of cooperation, openness and equal opportunities. The possible impact of the initiative generated global interest because of its powerful platform to boost economic growth and regional cooperation based on the concept of connectivity. The initiative seeks to strengthen infrastructure, trade, and investment links between China and some 65 other countries, representing collectively over 30% of the world's GDP, 62% of the global population, and 75% of known energy reserves (World Bank, 2018).

Within BRI, six economic corridors have been designed to link countries in different regions through new roads, railways, ports and pipelines all aimed at boosting connectivity and reducing non-tariff barriers to trade in Eurasia and Africa, with China as the hub (Liu, Pagano, Sánchez, & Tapiero, 2018). So far, the Chinese investments have concentrated mainly on infrastructure development, energy and mining, ranging from a railway project in Kenya to hydropower projects in Cambodia. In the case of the Lao PDR, Beijing is also interested in the construction of infrastructure.

Laos already has a close relationship with its northern neighbor. China is its second largest trading partner, the largest foreign investor, and the largest aid provider of Lao PDR while the country is the third largest destination of China's investments among ASEAN states (Tuo, Hui, & Zhongxia, 2018). While hopes are high on the Laotian side about the future cooperation, the authors wish to highlight that, like all the other Southeast Asian countries, Laos is also aware of the fact that they can't separate themselves from Chinese growth and power. The goal of the country should be to understand how they can live together with the Asian Giant, while benefiting from their presence.

The paper intends to describe the Lao interest towards the BRI followed by the introduction of the geographical and geopolitical position of Laos. Of the many Chinese investments, the focus will be on the China-Laos Railway. It is also important to look at how local citizens, experts and politicians think about China and the Initiative in order to understand all the considerations of such investments, especially in the case of Laos, where the realization of the hoped for benefits is still questionable. Beside the threats of such investments (and financial conditions), we are going to talk about the Chinese position and also about 'Connectivity' – a keyword for future Lao infrastructure projects. Finally, at the end we try to formulate a few recommendations as well.

Why is Laos Interested in the BRI?

First of all, the Initiative is aligned with the Lao government's policy of turning itself from a landlocked to a land-linked country, which could contribute to lower costs of transport and logistics for export products. The BRI also complies with the Lao National Socio-Economic Development Plan for 2016-2020, the National Development Strategy (2016-2025) and the Vision of Lao PDR until 2030. The main goal of Lao PDR is to graduate from the Least Developed Country Status by 2024 and become upper middle-income by 2030.



Since 1986, Lao PDR implemented an open-door policy aimed at developing (a controlled) market economy to finance the country's infrastructure development and also to boost economic growth through attracting FDI. While there is an increase in investments, most of it still arrives into the resource sector and China became the biggest foreign investor in the country. "Capital inflows from Chinese foreign direct investment (FDI) to Laos accounts for 25.2 per cent of the total FDI of the country. Chinese investments in Laos are mostly in the resource-related sector, such as mining and hydropower, which two sectors constituted more than 70 per cent of total Chinese investment. From 2005 to 2018, China had over 840 projects in Laos, with a total investment of over 11 billion US dollars" (Phommouny, 2019: 184).

Apart from the FDI, Beijing plays an important role in the trade relations of Laos as well. According to Comtrade, the value of Laos' export to China rose from 1.54 billion USD in 2018 to 1.67 billion USD in 2019 and further growth is expected. Meanwhile, the imports from China also increased and by 2019, Laos ended up with a small trade deficit: while in 2018 Chinese export to Laos was 1.28 billion USD, in 2019 it was 1.68 billion USD. The export products from China to Laos include electronic equipment, machinery, iron, steel and vehicles. Conversely, Laos dominantly exports natural resources and edible fruits (Comtrade, 2020). As we'll see, there still is potential for the country regarding trade opportunities with China by developing the infrastructure between the two countries. Through the BRI projects this Lao dream can become a reality.

There is another push factor for Laos: tourism. The upgraded infrastructure can benefit the internal mobility of tourists and, of course, it can help the visits of the Chinese tourists as well: in 2012, only 200,000 Chinese tourists visited Laos rising to more than a million in 2019 (Xinhua, 2020).

Eventually, Laos believes that the BRI can help them to address their geographic disadvantages through improved infrastructure connectivity since Beijing is actively interested in the Pan-Asia Railway Network, also known as the Kunming-Singapore railway – a concept already coined by the British and French colonial powers. The network is planned for two² routes out of which the central route would link Kunming of Southwest China, Laos, Thailand, Malaysia and Singapore. Once completed, the mixed conventional/high-speed railway will serve as a significant economic corridor between China and the region and possibly will further promote Laos-China bilateral trade cooperation in a number of sectors, notably the service industry, processing, logistics, ecological agriculture, catering and light industry.

The Geographical and Geoeconomical Position of Laos

Due to its strategic and geographical position, Laos can serve as a bridge between China and ASEAN member states and can benefit from transit services. The country enjoys political and social stability, there are no ethnic or religious conflicts, creating a suitable and favorable site for investments and businesses (Tuo et al., 2018: 19). Laos is also abundant in natural resources, due to its huge potential for hydropower development, Laos plans to turn itself into the "battery of Southeast Asia" (Globe, 2018) by exporting electricity to the rest of the region. The country has a young society, with nearly 60% of the population under 25 – providing a possibility for future (skilled and equipped) labor force.

However, there are limitations as well that come from its geographical position. Being a mountainous and landlocked country with poor infrastructure, economic development faces obstacles. The geographic barrier and the lack of conventional infrastructure makes it difficult for Lao products to compete with others in international markets due to the high costs of transportation. Surveys found that the cost of logistics in Laos is twice higher than that of other ASEAN countries.³ Even though the major roadways have been paved over the past few years, most of the nation is still only accessible through unpaved roads.

Besides, the country's institutional capacity remains weak, lack of transparency and the presence of corruption still defines the state. Due to the high percentage of unskilled labourers, Laos needs to immediately upgrade the quality of education and develop the skills of its young population. The agricultural sector represents 70% of employment, but the growth of this sector is very slow due to low productivity and old-fashioned farming methods (McGrain, 2014). Laos is ranked the 73rd most vulnerable country to climate change (particularly floods, droughts and typhoons), due to the fact that it relies too much on the extraction of climate-sensitive natural resources to sustain the economic growth of the country (WFP, 2017).

A final, but important obstacle to overcome is the unexploded ordnance from the Second Indochina War. Over 500,000 bombing missions dropped more than two million tons of ordnance from 1964 to 1973. About 30% of the bombs failed to detonate (UN, 2015).

Even though the government enacted and amended laws to attract more foreign investments to Laos, the investment climate in the country has not been improved. In 2019, Laos was ranked 154th among 190 economies in the World Bank Ease of Doing Business annual ratings. Whereas based on how easy it is to start a business, the country was ranked 181th (World Bank, 2019).

The BRI in Laos: The China-Laos Railway

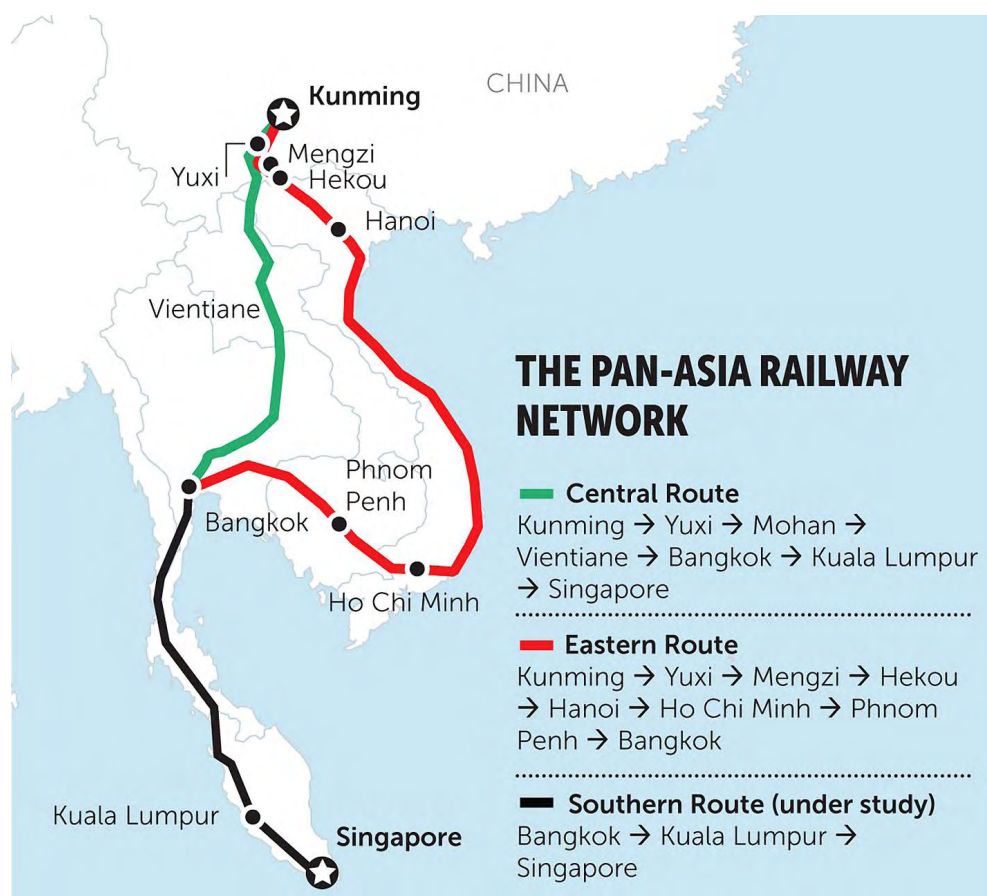
The Belt and Road Initiative is of great importance in promoting economic cooperation between Laos and China. Since the launch of the initiative in 2013, a number of development projects have been started and implemented. These include the railway, the Boten-Mohan Economic Cooperation Zone, a satellite project (Lao Sat-1), an expressway from Vientiane to the Chinese border, hydropower projects and connected grid network constructions. These are the most relevant development projects which not only create job opportunities and increase revenue for Laos, but also bring extensive benefits to the long-term development of Laos as well as providing stable dynamics for economic cooperation between the two countries.

The railway project is part of the Pan-Asia Railway Network, connecting the southern mainland of China with Southeast Asian nations through Laos. Built under the Belt and Road Initiative, the Vientiane-Kunming link is the first modern railway line in Laos which will eventually stretch towards Thailand and Malaysia before ending in Singapore. For China, the railroad, which reflects Beijing's ambitions to access seaports in ASEAN countries, is a significant step closer to their future dreams (MYHSR, 2017). For Laos, the railway connectivity will help the government to



realize its decades-long aspirations of serving as a land bridge for the region. Laos wants to improve its infrastructure in a move to better connect with the rest of the region and expedite the process of economic development. Using Chinese technological standards and Chinese equipment, the China-Laos railway is not only a model cooperation project promoted by top leaders in Laos and China, but it is also an interconnectivity infrastructure project implemented between China and ASEAN countries. Given that the China-Laos railway is the central route for the BRI in the Southeast Asia region, the construction of this railroad project in Laos started in 2016 despite the fact that the construction of other rail lines in Malaysia and Thailand are still in question. The construction is scheduled for completion in 2021, by the end of 2019, around 70% of the construction was completed. Built by Chinese contractors, the 5.95 billion USD railway goes through the mountainous region in northern Laos and requires many tunnels and bridges.

Figure 1
The Pan-Asia Railway Network⁴



The governments of the two countries set up a joint venture company known as “Lao-China Railway Company” with China holding a 70% share and Laos being responsible for the remaining 30% (SCMP, 2019). The financial background was not clear for months until the Railway Company shared some news about it. According to Nikkei Asian Review, the project requires contributions of 715 million USD from Laos and 1.67 billion USD from China. Laos will finance 250 million USD of its share from the national budget and borrow the remaining 465 million USD from the Export-Import Bank of China at 2.3% interest with a five-year grace period and 35-year maturity (Nikkei, 2017). The paper also highlights that the report is not clear about the remaining 60% of the costs. It just says, it will be financed by Chinese Banks meaning that this amount also comes in the form of Chinese loans (Ibid).

With a total length of 414 kilometers, the single track (with a 1.435-metre standard-gauge) rail network will consist of 32 stations. Over 62% of the track consists of bridges and tunnels because of the geographic conditions. The designed speed for passenger trains is 160 km⁵ per hour, for freight trains is 120 km per hour (The Laotian Times, 2017). The China-Laos railroad will connect and continue with the future railway in Thailand.

The Vientiane-Kunming link will cut the travelling time between the two cities from three days to several hours. This will enable investors to save time and money from lower transport costs, contributing to a boost in trade and people-to-people exchange between Laos and China.

Lao Minister of Public Works and Transport, Bounchanh Sinthavong said in April 2019 that the railway will benefit Lao PDR and Lao people, serving as a key momentum to push for greater advancement of commercial agricultural productivity in parallel with development of the trade and industrial sector in the country (LNA, 2019). Lao Railways’ Director General, Somsana Ratsaphong said during the Asia-Pacific Rail conference in Hong Kong in 2019 that the railway will boost tourism industry and bring about new developments along its route, particularly the new investment of industrial parks, hotels and other tourism related businesses (SCMP, 2019). The railway project will not only bring new technology to Laos but also encourage Lao people to boost their agricultural productivities for export to the Chinese market. According to feasibility studies and reports, the constructors expect “6.11 million passengers annually in the first few years of the railway’s operation and 8.62 million passengers each year in the long term.” (China Daily, 2017).

The construction of railways, including the China-Laos line, made it clear that China aims to engage with Southeast Asian nations since China actively takes part in such projects (Renliang, 2016). All these infrastructure schemes will not only bring China closer to ASEAN countries, but also offer opportunities and pose challenges for these countries including Laos. In fact, many Laotians are concerned that the railway will stimulate an influx not just of Chinese tourists but also investors, fearing that they will be allowed to buy land and other properties which will eventually put Laos closer into the orbit of China. Laotians also worry that local markets could be dumped with cheap products imported from countries across the region. But altogether, within ASEAN, Laos is still more optimistic about the Chinese ‘intervention’.



Perceptions of ASEAN and Lao Residents on the BRI, China and Major Powers

In 2018 the ASEAN Study Center and the ISEAS Yusof Ishak Institute conducted an online survey titled “State of Southeast Asia: 2019”. The move aimed to seek views of Southeast Asian residents on regional affairs. Using the purposive sampling method, the survey collected views from a total of 1,008 Southeast Asian experts and stakeholders from the policy research, civil society, media and business communities (ASEAN-ISEAS, 2019:3). As a result of the survey, 45.4% of respondents think that “China will become a revisionist power with an intent to turn Southeast Asia into its sphere of influence.” (Ibid: 18). Laotians were the least critical after Myanmar respondents, only 24.1% of them shared the same view, 48.3% of them said (compared to the overall ASEAN 22.5%) that “China will remain a status quo power and continue to support the existing regional order.” (Ibid). 47% of the respondents said that BRI will “bring ASEAN member states closer into China’s orbit” (compared to the Laotian 31%). Lao experts dominantly (75.9%) responded by saying: it will “benefit regional economic development and enhance ASEAN-China relations.” (Ibid: 19).

When asked about which country/regional organisation has the most influence economically in Southeast Asia, 73.3% said China (Laos: 82.8%), and when they were asked about political and strategic influence, 45.2% answered with China, followed by the US with 30.5% (Laos: 41.4 and 20.7% respectively) (Ibid: 21-22). When asked about a possible debt-trap, citing Sri Lankan and Malaysian cases, 70% said that his/her “government should be cautious to avoid getting into unsustainable financial debts with China”, but only 46.2% of the Laotians replied the same way, there 42.3% answered: “My view on the BRI’s positive impact has not changed, as these experiences do not apply to my country” (Ibid: 20).

Can Laos Benefit from the Chinese Presence and the BRI?

Laos is located in-between growing economies (China, Vietnam, Thailand) and can become an interconnector, a bridge for these countries. China aims to use the ASEAN-China railway as a significant route for exporting its products to ASEAN markets due to cheaper transportation costs while ASEAN countries are looking for opportunities to penetrate Chinese markets. There is an opportunity for Laos to act as a distributor of goods and services by purchasing goods from neighbouring countries and exporting them to others. Nevertheless, Laos needs to focus on developing its human resources; training people how to do business and offering transit services. Laos also needs to frame promotion policies and create incentives to attract more investment in the agriculture sector for export while analyzing market demand in China and other ASEAN countries and trying to satisfy their needs.

But the forecasts are not really beneficial for Laos. Major cities outside of Laos, like Bangkok, Hanoi, Kuala Lumpur and Singapore are expected to receive the greatest benefits from these railway infrastructure projects (Morris, 2019) and for Laos it will only bring a large amount of debt while providing a disproportionate economic benefit to China. This does not mean that Laos will not gain any benefit from the regional connectivity, but the main question raised is how the country can manage to repay its debts owed to China and what kinds of products does Laos plan to produce to export to regional markets.

In 2017, the two-way trade between China and Thailand reached USD 73.6 billion, and the two sides agreed to upgrade their cooperation into a comprehensive economic partnership in order to double the two-way trade value to USD 140 billion in 2021 (Bangkok Post, 2018). Coming from this, the railway might be designed to serve China's trade needs and benefit its economic relations with more relevant ASEAN economies.⁶

Eventually we can say Laos needs to invest in education and support its entrepreneurs and companies through creating a stable and transparent legal and economic environment. This is because the infrastructure investments alone will not deliver the hoped benefits without Lao actors being able to enjoy its gains. Besides this, it is also important to note, probably Laos had little room for manoeuvre and had no choice but to accept these investments, especially since the region cannot escape from the growing Chinese activity.

If they want to serve as a regional hub, they need such investments and they need investors – and China is ready for such moves, which is essential in times of global economic turbulence. A close cooperation with China and the infrastructure can actually be beneficial for them because of the US-China trade war as well: multinational corporations forced to relocate their production base from China might end up in ASEAN nations (and Vietnam is already active in this field) and good connectivity can put Laos in position as well.

The Threats of These Projects

The construction of Vientiane-Kunming rail line is a landmark. However, the railroad requires over 4,400 families in 167 villages of 13 districts to leave their homes to make way for construction. More than 3,830 hectares of land and 3,346 buildings along with crops, fruit trees, fences and forestry are affected by the project. (ANN, 2018). Many villagers fear that compensation offered by the government will be lower than the actual value of their properties. The total value of the project compensation is estimated to cost about USD 297.73 million, but due to financial difficulties, as of the summer of 2020, many villagers have yet to receive any compensation.

With regards to the labour force employed for the railway, the Lao government struggles to ensure that the project will generate as many jobs as possible for Lao people. Unfortunately, China employs its own labour force, claiming that Lao people are unskilled hence the necessity for the railway construction companies



to import Chinese workers. By December 2018, a total of 17,115 workers were employed for construction of the railway tracks, tunnels and other necessities. Only 4,032 Lao workers were employed in the project, the rest of them were dominantly Chinese nationals (Jarabejo, 2019).

Laos also struggles to develop a skilled labor force to respond to the needs of train operation and services. There is the concern that the railway will put greater economic pressure on domestic industries by opening up the local market to Chinese imports. However, if local producers are not prepared well enough to compete with those of wider Asian region, the railway will only bring tougher competition into the domestic market. The main problem in Lao PDR is that the downsides and risks regarding the railway have not been explicitly discussed, particularly issues relating to governance, corruption, pollution and adverse social impacts.

A further threat is connected to the financial aspects of such projects, and it is not just about the railway: how the country will be able to pay back those loans. In 2015, the outstanding public debt was recorded at around 66% of the GDP, rising from 62.5% in 2013 (World Bank, 2017: 24-26). According to an IMF report, almost 65% of the total external debt in Laos is owed to bilateral lenders, particularly China (IMF, 2019: 6). As a result, the fiscal space of the country for future borrowing has considerably narrowed. Despite rising public debt, Laos continues to borrow more money from development partners to finance its large infrastructure projects. For instance, the total investment cost of the China-Laos railway project is more than 30% of the country's annual GDP. The International Monetary Fund has warned that the railway project ramps up pressures on Laos' external debt, forcing the country to further seek for more loans to repay interest and principals as well as to fund other infrastructure projects (Ibid).

The more Laos is indebted to China, the more pressure the country will face as Beijing can use its power to influence the policy-making process in Laos in exchange for FDI and Official Development Assistance (ODA). The so-called debt-diplomacy, where the creditor country intentionally offers loans to struggling host states in need for the purpose of extracting economic or political concessions, is an agenda in Southeast Asia as well – as we could see from the ASEAN report. Although in this case, both sides are refusing to talk about possible financial difficulties, it could take decades for the Lao government to make a profit from the railway project and it is unclear whether the calculation of the railway's future profits is accurate based on the real and verified data and whether the railway can generate sufficient income to repay China's loan or not. Laos needs to have a *plan B* to respond to economic shocks if the country wants to avoid defaulting on its debt repayment. In Malaysia, when Mohamed Mahathir became the Prime Minister in 2018, he cancelled the Chinese-funded East Coast Rail Link Project which was approved by the Najib Razak administration. He told China that the value of the project was too high, and Malaysia was unable to repay it and asked to renegotiate the deals with China. As a result of their renegotiation, China agreed to reduce the costs of the first two phases of the railway by over 30% from USD 15.8 billion to USD 10.7 billion (ASEAN Today, 2019). However, Laos has not challenged or asked for a renegotiation of the deals with China.

The Chinese Position

China has multiple considerations regarding the BRI and its infrastructure investments and loans. Besides the obvious benefits of the Initiative, how they can gain outlets for its SOEs and its economy through attracting host countries, Laos offers further gains. These include: regional and international support of the country on a global and on an ASEAN level by the Lao government, access to the natural resources of Laos and, through these projects, they can get closer to further ASEAN member states and economies. Laos, with its geostrategic position, can serve as a gate, a bridge and also as a buffer zone which gives Beijing an opportunity to create and maintain a close control (and domination) over the Southeast Asian region.

When it is about the loans and the threat of Laos not being able to pay those back, Beijing does not worry that much. The natural resources are the guarantee for them. For instance, when Laos failed to repay an USD 80 million loan provided by China to construct the National Stadium for the Southeast Asian Games in 2009, the Lao government granted a long-term land concession project to the contracted Chinese enterprise over an area of 300 hectares, instead of repaying the debt to China (The Laotian Times, 2017). As the Lao government's measures to service its debts remain unclear, China has seen long-term benefits from giving a huge amount of loans to Laos.

“Connectivity” is the Keyword

Laos depends mostly on its neighbours, mainly Thailand, for seaport services. The country's road network “represents 98% of total passenger-kilometers travelled, and 86% of freight moved in the country” (Xinhua, 2017). One of the main challenges for Laos is that its road network lacks proper maintenance and is far from the required quality due to limited funding. Apart from the China-Laos railway, the Lao government unveiled its plan to build expressways and motorways stretching over 1,700 km. These roads will connect Laos with China, Thailand and Vietnam as Laos aims to serve as a regional hub of mutual connectivity between China and other ASEAN neighbours.

- The first expressway linking the Lao capital of Vientiane to the northern tourist town of VangVieng has already commenced construction. The USD 1.3 billion project will run 113.5 km northwards from the capital and is scheduled for completion in 2021 (Bangkok Post, 2019a). The Vientiane-Vangvieng expressway is part of a larger future project that will connect the Lao capital to Boten in Luang Namtha province, near the Chinese border.
- Meanwhile, the 585 km long expressway from Vientiane to Pakxe city in southern Laos is in the process of a feasibility study and project design which is carried out by Lao and Chinese companies (ASEAN Travel, 2017).



- Furthermore, a feasibility study is being conducted to develop a capital-to-capital motorway, which stretches 707 km from Vientiane to Hanoi, Vietnam, with an estimated cost of the project construction amounting to USD 4.5 billion. In addition, the government of Laos and Vietnam signed an agreement earlier in 2019 to build a railway linking Vientiane to the Vung Ang seaport in Vietnam over a distance of 555 kilometers, which will be another significant component of the regional trade route (Bangkok Post, 2019a).
- Another railroad project under construction will connect Savannakhet province in the central part of Laos to Vietnam, known as Savannakhet-Lao Bao Railway, the expected completion date is the end of 2020 (Reconnecting Asia, 2020).

If all transportation infrastructure projects will be completed, Laos can become both a hub and an interconnector for the regional actors and, with the connected services and transfers, it can benefit from the regional economic and trade relations. However, it is still required that the country's entrepreneurs, companies and actors are prepared for this role. Otherwise, these further investments, the Vietnam link as well, might just further expose the underdeveloped economic environment of Laos to the international actors. That said, the main challenge right now is for Laos to balance its infrastructure needs and debt management to avoid a financial crisis in the future.

Conclusion and Recommendations

We can conclude that China uses its economic influence to achieve its strategic and geopolitical goals. From an economic perspective, the BRI provides opportunities for international cooperation and connectivity, serving the Chinese needs. As we could see in the case of Laos, these projects might fit the interests of the affected countries as well. Although, through these projects, and especially through the financial-loan constructions, Beijing might influence the decision-making process of the host countries or gain even more benefits. Due to its increasing financial dependency on China, Laos is on the verge of indebtedness and, if these infrastructure projects will not deliver the hoped for benefits, the country might find itself fully exposed to the Chinese intentions. While there are doubts about the cooperation, the Lao government still firmly believes that the initiative (and especially the railway and further infrastructure projects) will help the country to overcome its geographic disadvantages and they can turn themselves into an interconnector and a regional economic hub for the region.

In the paper a number of problems have been identified which need to be promptly addressed so the key recommendations can be summarized as follows:

- The policy formulation of the BRI and its activities are mostly driven by China and although we could see that the host countries' interests might meet with these plans, a more transparent public-driven process is required where experts, scholars and entrepreneurs can sound their opinions about the planned projects.

- The Lao government needs to invest more in its education sector to produce more skilled human resources to satisfy the national development needs and it should also push for a more active participation of the Lao workforce in BRI projects.
- Infrastructure is essential for Laos to transform itself from a landlocked to a land-linked country, but the government needs to diversify its development partners and closely monitor and control the indebtedness.
- The government needs to invest more in research programmes, particularly in the area of agriculture and transit services and focus actively on the tourism sector if Laos wants to serve as a regional land bridge and become the economic hub of the region.

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Endnotes

- 1 EFOP-3.6.3-VEKOP-16-2017-00007- Young researchers from talented students – Fostering scientific careers in higher education
- 2 For years there were plans for a Western route as well through Myanmar, but lately there is no information about that project.
- 3 “According to a recent study by the Japan External Trade Organization, logistics costs in Laos are as high as double those of other countries in the Association of Southeast Asian Nations, likely due to poor basic infrastructure. The cost in Laos works out at 2.50 USD per km, while in Thailand it only costs 1.10 USD per km, the study showed.” (China Daily, 2017).



- 4 Bangkok Post, 2019b
- 5 Early ideas were about a high-speed railway connection, but probably the financial conditions changed those plans.
- 6 It was already visible, that Thailand and China are active about their cooperation: “Already one Lao industry, trucking, has seen a loss in opportunity due to new regulations and procedures that will speed transshipment and customs clearance. A 2011 memorandum of understanding between Thailand and China allows pre-inspected fruits to be transported from Chiang Khong district in Thailand via Laos uninterruptedly to the border crossing in Mohan, in China’s Yunnan Province, without being reloaded onto Lao trucks. The agreement has helped boost overland shipments of fruit from Thailand to China to a 45% annual growth rate, up from an annual average of 20 % before, but Lao truckers do not benefit. This case underscores the importance for Laos of building up its own production capacities.” (Bangkok Post, 2013).

Counterweight to China?

The Potential of ASEAN's Economic Relations with India

TEMJENMEREN AO

Abstract: On August 8, 1967, the foreign ministers of Indonesia, Malaysia, Singapore, the Philippines, and Thailand met in Bangkok, Thailand and signed a document. By virtue of that document, the Association of Southeast Asian Nations (ASEAN) was born. Bloc politics of the Cold War made the formation of ASEAN a necessity for the nations of the region. It was a step to safeguarding their interests, overcoming economic backwardness, and ensuring the continuity of reconciliation by helping address the intra-regional tension due to the unresolved territorial disputes. The nations in Southeast Asia, by adopting a policy of 'Look East' along with a mixed form of capitalism (with the government playing a prominent role in the economy) were able to enhance their economic growth. By the 1980s, ASEAN countries such as Indonesia, Malaysia, Singapore, and Thailand gained reputations as 'tigers' for their economic dynamism. Despite the economic fallout in the aftermath of the Asian Financial Crisis and also the global slowdown as a result of the 2008 financial crisis, the economic resilience and dynamism of ASEAN is viewed as a potential counterweight to China.

This paper studied the evolving contours of the ASEAN-India economic relations and highlighted how the partnership has grown substantially over the last few decades. The paper attempted to examine how this economic engagement is helping build a discourse aimed at limiting the impact from the emerging global economic realities; where nations distrust global commerce and trade for more nationalist policies. The realities of a post COVID-19 period which would be marked by a global slump and resource crunch offers further potential to strengthen the ASEAN-India relations.

Keywords: ASEAN, India, China, South China Sea, Economic Engagement, COVID-19, Technology

The Idea Behind ASEAN

ASEAN was established in 1967 during the peak of the Cold-War. The Association has grown from the original five countries-Indonesia, Malaysia, the Philippines, Thailand and Singapore to include Brunei (1984), Vietnam (1995), Myanmar (1997), Laos (1997), and Cambodia (1999).

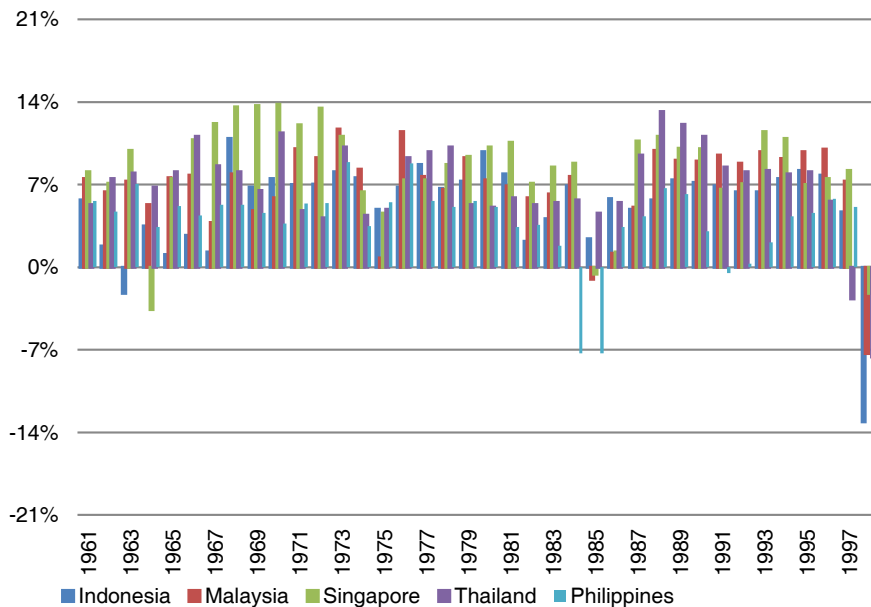
Southeast Asia was at the centre of Cold War rivalry and the countries felt the need to adopt a cooperative approach among each other to ensure that any form of expansionist aggression did not occur in the region. By adopting this outlook



and through dialogues, members were able to resolve their differences and diffuse intra-regional conflicts, such as the ‘Crush Malaysia’ campaign, while preventing new ones from arising. Under the Bangkok Declaration of 1967, the formal purpose of the Association was to enhance cooperation in the economic, social, cultural, scientific, and administrative fields, that were deemed to be crucial in promoting regional peace and stability. An official commitment to political cooperation was expressed in a Declaration of ASEAN concord, while provision for regional order was contained in the Treaty of Amity and Cooperation (TAC) (Majumdar, 2003). Through their adherence to TAC, peaceful settlements of regional disputes under the principles of non-interference and decision making through consensus (also known as the ‘ASEAN way’) were undertaken. This became crucial to manage internal as well as external threats in order to ensure a stable political and economic environment in the region (Li, 2016).

According to the National Intelligence Estimate by U.S. Department of State issued in 1968, by leaving out the military aspect from the scope of ASEAN, the newly formed regional grouping kept its focus on the socio-economic development of the region (U.S. Department of State, 1968). The Association was right in doing so, since the ASEAN Member States (AMS) did not possess the prowess to undertake such a role in the region. By keeping security out of its ambit, ASEAN emphasised on improving its economic and cultural relations with the other member states of the Association. The partnership was based on equality amongst the members which was crucial in realising their interests by overcoming their challenges.

Figure 1
Indonesia, Malaysia, Singapore, Thailand, and The Philippines: GDP 1961-1998¹



Note: The graph shows the nominal GDP in percentage of the five original ASEAN countries from 1961 to 1998.

As shown in Figure 1, the five original ASEAN countries witnessed a high GDP growth following the establishment of the Association. A relatively stable regional atmosphere made it possible for member states to channel all their resources into the goal of nation-building and economic development. Many of the ASEAN states, inspired by Japan's industrialisation of the late 19th century and then its rapid recovery following World War II, began adopting a policy of 'Look East'. The adoption of a market-based economy with a heavy hand of the government in most of the ASEAN member states in the early years, helped millions improve their living standards. In terms of investments, as Southeast Asia provided multinational cooperation with low manufacturing costs between 1980 and 1996, the region's share in terms of global Foreign Direct Investment (FDI) rose from 6.7% to 14.7%. According to the United Nations Conference on Trade and Development (UNCTAD) Report (1997), out of the USD 256 billion global FDI in to the developing countries, USD 90 billion went to Southeast Asia. Thus, FDI in ASEAN increased by over six-fold since 1980 and by two-thirds since 1990 (Bartels & Mirza, 2005).

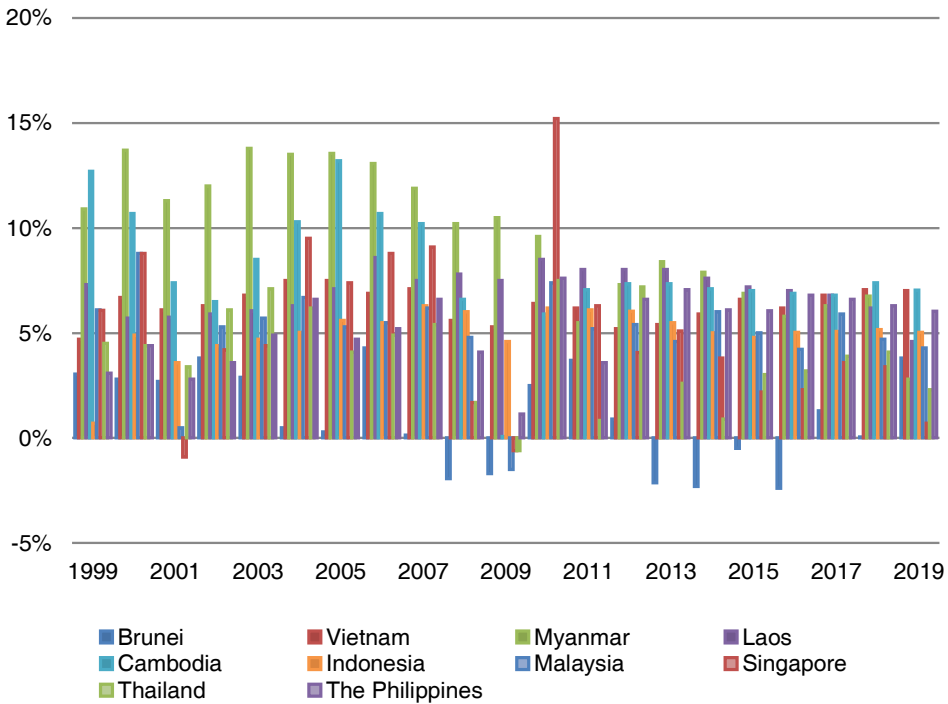
In January 1992, the ASEAN Free Trade Agreement (AFTA) was signed which enabled GDP growth of over 6 to 10% for most of the ASEAN states, as shown in Figure 1. This made Southeast Asia one of the most attractive markets for investors for its low cost and high production capabilities, until the Asian monetary crisis hit the region in 1997. As shown in Figure 1, the ASEAN states had to face the onslaught of the financial crisis that had a ripple effect across the region, with Indonesia, Malaysia, Singapore, Thailand, and the Philippines, witnessing a GDP of -13.1%, -7.3%, -2.2%, -7.6%, and -0.5% respectively.

The Asian Financial Crisis (AFC) of 1997 led to a long and difficult recovery for the ASEAN states which now included its new members along with the original five countries. The AFC more than anything shook Southeast Asia's confidence in open trade and financial globalisation. Paul Krugman in a paper titled "The Myth of Asia's Miracle" published in *Foreign Affairs* (1994), wrote that the increase in labour inputs was mainly responsible for the high growth rate in Southeast Asia. However, this growth was not accompanied with the technological development needed for a sustained growth trajectory. According to Krugman, the economic progress of Southeast Asia in the 1980s was very similar to the one experienced by most Eastern European countries, which also faced collapse at the end of the 1980s (Krugman, 1994).

It was argued that growth in the absence of any fundamental increase in its labour productivity, contributed to the fragility of the markets in Southeast Asia which could not withstand the shock of the financial crisis (Nam, 2005). Further, international bodies such as the World Trade Organisation (WTO), the International Monetary Fund (IMF), and the World Bank, by enforcing the rules of globalisation resulting in the liberalisation of the financial markets, put an end to many restrictions that formerly regulated the flow of capital into and out of Southeast Asian States. On the positive side, these policies led to double digit growth and an increase in trade in many of the ASEAN states along with growth in the number of joint ventures and foreign-financed enterprises. However, this also made their economies more vulnerable and eroded their capacity to withstand the financial crisis (Dayley & Neher, 2013).



Figure 2
ASEAN Member States GDP 1999-2019²



Note: The graph shows the nominal GDP of all the ten ASEAN States in % from 1999-2019.

The graph in Figure 2 indicates the GDP of the ASEAN member states in the post-AFC period. The AFC of 1997 had a major economic fallout in the ASEAN countries by halting the entire growth momentum of the region. And while most of the ASEAN states were able to make some recovery, the aftermath of the global financial crisis of 2008 that led to a decline in global demand impacting trade and commerce, fuelled a further decline in growth across the region. To a significant degree, the two financial crises put many of the ASEAN states into a slower growth trajectory, which persists till today.

In seeking deeper cooperation towards addressing the slowdown of economic growth being witnessed by some of the AMS there are also other internal and external challenges. In terms of the internal challenges, the intra-ASEAN disputes and disagreements over issues such as unsettled territorial disputes amongst some of its member states is the Achilles heel for the Association. This ongoing discord over territorial claims has led to the adoption of policies by the individual ASEAN states contrary to the broad agenda of the Association. This is not only impacting the unity but also causes a lack of unanimity for the passage of any resolution towards establishing a robust economic partnership amongst the

member states. The result is also being felt on the process of establishing an ASEAN economic community and its union, which would enable regional stability and security (Dibb, 2001). Apart from the internal challenges, today ASEAN is also facing a changing external environment with a stronger China which has become more assertive in the region. This is coupled with the region being at the centre of the emerging geo-political environment, which is shaping the future role of ASEAN.

China's Emergence and the Changing Role of ASEAN

The economic slowdown in the post-AFC period not only highlighted the limits of globalisation but also ASEAN's own internal weaknesses as an institution. The post-AFC and the start of the 21st century witnessed the emergence of China. Due its continuous hyper economic growth throughout the 1990s, it was able to widen the economic gap with the rest of Southeast Asia. It also subsequently helped China build its military advantage over ASEAN. China's Grand Strategy, which is based on the narrative termed the 'China Dream' is being aggressively floated today. The intent of this grand strategy is to develop China into an economically prosperous nation, with a military that is capable of safeguarding national sovereignty along with the interests of Beijing far beyond the mainland. China's definition of national sovereignty and territorial integrity is not limited to the defence of the mainland against attack. It is also being applied more widely to include the need for maritime expansion to secure its seas (Wanli, 2011).

China has numerous territorial claims, however, the need to have a stable neighbourhood has made it settle or defer most of its land-border disputes. While deferring its land-territorial claims, China has become more adamant, impatient, and rowdy over its maritime-territorial claims (Gompert, 2013). Much of China's economic success can be attributed to the operations of multinational companies that import components from Asia, assemble goods using Chinese workers, and export the finished products to markets in the U.S., Europe and elsewhere. One of the consequences of this was the increase in the demand for energy in order to fuel its manufacturing sector which became a major pillar for China's economic modernisation (Saunders, 2010).

Until 1993, China was not concerned so much about energy security as it was an exporter of energy resources. However, the rapid economic modernisation and growth that witnessed a spike in demand in the 1990s along with a stagnant domestic supply, saw China transforming from a net exporter to a net importer of energy resources. Further, as a latecomer to the international energy markets as well as China's physical distance, and the presence of western oil companies in every resource rich region, made it difficult to gain a secured possession over oil and gas fields (Panwar, 2009). This factored into China's maritime expansion in the disputed South China Sea (SCS), where it became more assertive over its claims causing an imbalance to the regional order as being witnessed today.



China is already asserting itself militarily through the deployment of its naval forces at strategic locations in the SCS. This military posturing is being used to reinforce its claims to the disputed islands and reefs in the SCS. The need to assert its claims in the SCS through its military presence emerges from China's dependence on maritime trade which is crucial for its commercial interests (Duo, 2012).

The situation in the SCS continues to remain tense with China increasing its assertiveness over the disputed islands and reefs. China has increased its military presence in the region and in particular its naval build-up along with the construction of artificial islands by increasing the area of landfills around the existing islands and reefs. IHS Jane's Defence Weekly, in 2015 reported that the Chinese infrastructures developed in the disputed sites were explicitly military in nature. Satellite images indicate that these artificial islands have helipads, airstrips, harbours, and facilities to support large numbers of troops. According to U.S. officials, China seeks to establish an Air Defence Identification Zone [ADIZ] through the new infrastructure that would be used to enhance radar coverage of the area, support a small presence of military personnel, and provide logistic support for ships patrolling the farther reaches of the SCS (Page & Barnes, 2015). While China and ASEAN are working towards finalising a draft Code of Conduct (COC) for the SCS, differences on its modality remain. Over the last few years the ongoing dispute between China and the ASEAN states, that have maritime claims and rights over the resources in the SCS, have escalated. The AMS are wary of any form of conflict in the SCS as it may impact the sea lines of communication throughout East and Southeast Asia (Majumdar, 2003).

China's repeated intrusions into the Exclusive Economic Zone (EEZ) of the other parties are challenging the existing status quo and undermining the security and stability in the region. China's assertion in the disputed waters through the deployment of its naval crafts and other illicit activities being carried out, has been possible due to its increasing economic power. However, the changing internal and external environment could pose some challenge to its economic growth which has been crucial in fuelling Beijing's outreach.

Factors Limiting China's Momentum

The Economic Fallout of the 2008 Global Financial Crisis

At the turn of the 21st century, China emerged as a major economic power by adopting an aggressive mercantilist trade policy and currency intervention undertaken by its government, which helped make its exports more competitive compared to its competitors. While China's accession into the WTO in 2001 led to it adopting a more liberal trade policy it was done so in order to gain further access to the large Western markets (Blumenthal, 2007). As a consequence, its dependence on foreign trade as a driver of its economy increased sharply, with the ratio of total imports and exports to GDP of 43.8% in 2000 increasing

to 63.9% in 2005 (Jianwu, Shantong & Polaski, 2007). China being an export driven economy has continued to witness a decline in its GDP which is attributed to the changing external as well as internal environment.

One of the major impacts of the 2008 global financial crisis was a sharp decline in global demand resulting in the contraction of trade and commerce. China's exports fell by as much as 20% in early 2009, and since its economy is highly dependent on foreign trade, with 40% of its GDP being driven by exports, it had an impact on its economic growth. When foreign demand dropped sharply, a large number of factories located in the southeast of China, who were mainly exports-oriented, closed down. The same period also saw a fall in China's foreign investments. In the first half of 2009, FDI into China decreased by 17.9% according to the 2009 World Investment Report issued by the UNCTAD. This was the first time in 30 years that China's FDI receipts dropped dramatically (Sun & Fu, 2012). Prior to the financial crisis, China witnessed a sustained double-digit GDP growth rate reaching a high of 14.2% in 2007. The crisis had an adverse impact on China's economic growth with its GDP declining to 9.6% in 2008 (National Bureau of Statistics of China, 2008).

China's Emerging Debt-Crisis

Internally, there is the growing debt to GDP crisis which China is currently facing. In order to limit the negative impact of the 2008 global financial crisis, China launched a major investment programme in the second half of 2008 and 2009, which saw credit expansion and large-scale investment in real estate and infrastructure. The results of China's stimulus programme were impressive, making China the first globally significant economy to begin to recover from the global economic recession. As the stimulus package began to take hold, China's growth accelerated significantly, to 9.5 and 11.4%, respectively, in the first and second quarters of 2009 (Lardy, 2012). This expansionary fiscal policy approved by the People's Congress in 2009, led to a total government deficit of 950 billion Yuan (US \$ 139 billion), the highest in six decades (Sun & Fu, 2012).

According to a report by McKinsey Global Institute, China's debt has quadrupled since 2007, rising to USD 28 trillion by mid-2014, from USD 7 trillion in 2007. At 282% of GDP, China's debt is larger than that of the United States or Germany (Dobbs, Lund, Woetzel & Mutafchieva, 2015). According to some estimates, China's total debt hit 237% of GDP at the end of the first quarter of 2016 (Wildau & Mitchell, 2016). According to the Institute of International Finance, China's debt-to-GDP ratio rose 11 percentage points in 2019 to 310%, and rose a further 7 percentage points in the first quarter of 2020 to reach 317% (China's Debt to GDP Ratio Surges, 2020). The IMF has warned China on the risk of its growing debt burden, and urged more aggressive action to curb its credit growth. There is the possibility of high-risk spill-overs to the broader global economy if its debt burden, due to its excessive credit, is not contained (Wildau & Mitchell, 2016).



The Unfavourable Demographic Profile

The evolving issue of an unfavourable demographic profile that China would witness in the future because of its 'one child policy' is another factor. From 1980 to 2000, the average annual growth rate for the total population was about 1.3%, while the working-age population grew at an average of over 2% (Jianwu, Shantong & Polaski, 2007). Realising the impending demographic challenge, the 5th Plenary Session of the 18th Chinese Party of China Central Committee (November 2015), recommended expansion of the policy to two children per couple. According to a 2015 World Bank report, China's working age population is expected to decline, and labour's contribution to growth will turn negative. This would also lead to an ageing population which would cause a shortage of not only human resource but also a fall in the rate of savings which in turn would cause a fall in China's capital formation (World Bank, 2015).

Withdrawal of Foreign Corporation from China

Another factor impacting China's growth today is the outflow of foreign companies with their manufacturing bases in China to other countries in Southeast Asia. One of the reasons for this is due to the minimum wage levels in China which have been increasing steadily over the last decade. Driven by rapid economic growth, declining population growth, and with workers becoming better organised, employers in many sectors were forced to pay higher wages in order to recruit and retain staff. Further, in March 2004, Minimum Wage Regulations were implemented by the then Ministry of Labour and Social Security which established a comprehensive framework for calculating and adjusting the minimum wage. The new regulations took into consideration the minimum living costs of local employees and their dependents, consumer price index for urban residents, social security and housing fund contributions paid by individual employees, the level of economic development, and the supply and demand of labour in the locality (China Labour Bulletin, 2019).

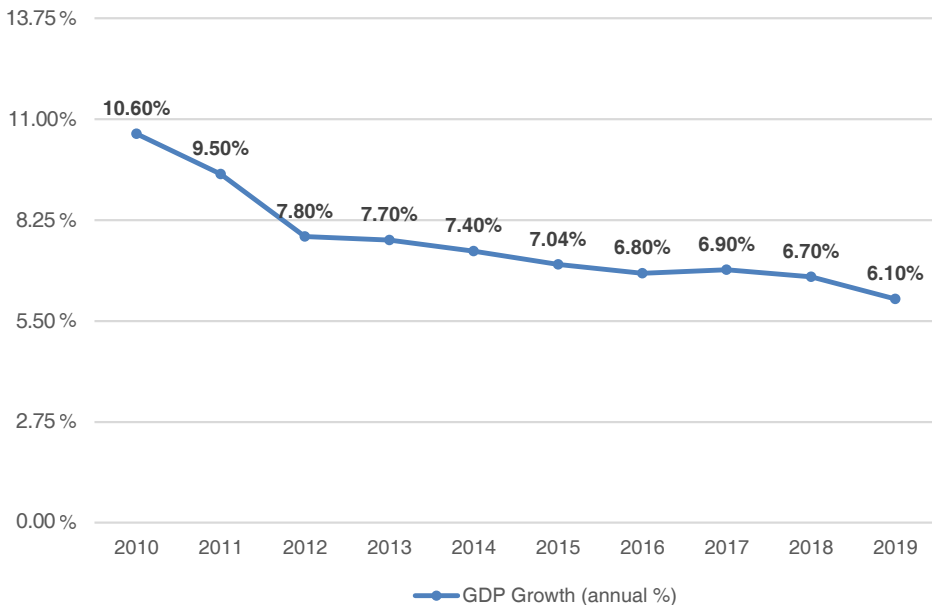
Based on these new regulations, there has been a substantial increase in the level of China's minimum monthly wages. This has made China less attractive to foreign investors today who, in the past, ventured into China to secure business contracts in order to take advantage of its low-cost labour and increase their profit margins. The rise of labour costs in China's manufacturing sector has thus, led to foreign manufacturers moving away from China into other low labour cost nations in Southeast Asia such as Cambodia and Vietnam (Ao, 2019).

The COVID-19 pandemic and the uncertain outcome of China's ongoing trade tension with the U.S. is further affecting its growth. For the first quarter of 2020, due to the COVID-19 outbreak, China's economy posted its first contraction in decades, falling to -6.8% according to data from China's National Bureau of Statistics (Huimin & Nian, 2020). And while China's economy witnessed a modest growth of 3.2% in the second quarter of 2020, its growth for the remaining quarters for this year would depend on the recovery in the West and its bilateral trade with ASEAN, which over the years has increased dramatically (Wenbo & Nian, 2020).

The disruptions to the supply chains due to the pandemic and the trade war with the U.S. is making foreign companies re-assess their long-term strategy in China. Today, major foreign corporations that include Original Equipment Manufacturers (OEMs) of automobiles and computers, are shifting their plants out of China into other countries in the region. Other Asian countries, including ASEAN member states, have stepped up efforts to attract foreign investments by targeting companies that are rethinking their supply chains in the wake of the disruption caused to the supply chain across China (Jibiki, 2020).

These factors have impacted China's growth as indicated in figure 3 where its GDP, from a high of 10.6% in 2010, has continued to decline. In 2016, its GDP fell below 7% for the first time since at least the early 1990s after its economic reform was launched in 1978.

Figure 3³
China GDP Growth (annual %), 2010-2019



Note: The graph shows China's nominal GDP growth in percentage, between 2010 to 2019.

The Changing Role of ASEAN

According to Chapter one, Article one of the ASEAN Charter, the primary purpose of the association is to maintain and enhance peace, security and stability and further strengthen peace-oriented values in the region (ASEAN, 2008). The emerging traditional and non-traditional security challenges in the 21st century along with an assertive China and its claims in the SCS, has pushed ASEAN to establishing a



security community in order to help bring conflict resolution and reduce the threat or use of force (Weatherbee, 2013). ASEAN has begun to seek a multilateral approach towards building partnerships in order to reduce the increasing tensions in the region. The establishment of the ASEAN Regional Forum, the East Asia Summit, and the ASEAN Defence Ministerial Meeting Plus, indicate emerging security challenges that are impacting the regional stability (Dibb, 2001).

With the evolving discourse on security expanding in scope and becoming more complex, economic necessity remains crucial in building any new partnership. China's illicit activities, particularly in the SCS, remain far from benign, in fact, they seem to be escalating. China, by stepping up its activity in the disputed SCS during the pandemic, has offset the gains of its economic regionalism that spurred growth especially in the less-developed ASEAN states. At the 36th ASEAN Summit held on June 26, 2020, while not specifically mentioning China, the Chairman's Statement clearly raised concerns about the ongoing activities in the SCS that include land reclamation activities and serious incidents which, as expressed, have eroded trust and confidence and could undermine peace, security, and stability in the region. The statement emphasised the importance of non-militarisation and self-restraint in the conduct of all activities by claimants and all other states, including those mentioned in the Declaration of Conduct (DOC) that could further complicate the situation and escalate tensions in the SCS (Chairman's Statement of the 36th ASEAN Summit, 2020).

While China agreed with ASEAN for peaceful negotiations through the 2002 DOC, nonetheless, by constantly engaging its naval power to assert its claims, today China is witnessing pushback from ASEAN and its member states that are not willing to be undermined despite the prevailing power asymmetry. As a result, ASEAN is beginning to incorporate security as part of its mandate to ensure stability in the region which is crucial for promoting trade and commerce.

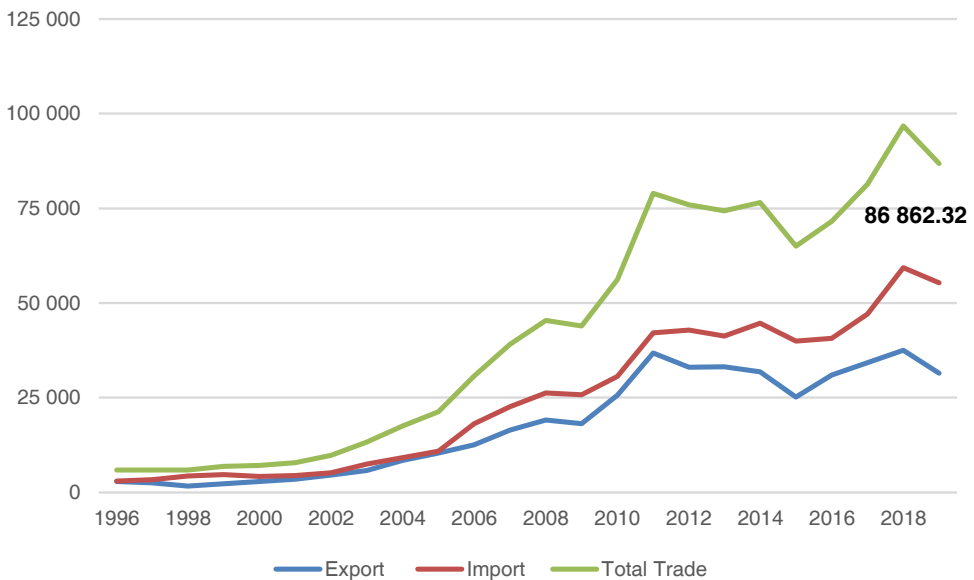
India is also concerned about the growing Chinese assertiveness in the Indian Ocean region along with the transgression on its land borders. In an effort to address security challenges through partnership, India and ASEAN signed a Strategic partnership in 2012 which was a natural progression given their deep historical and cultural ties. Further, no direct conflicts exist pertaining to territorial disputes between India and ASEAN countries and both sides share the principle of non-interventionism in the affairs of the other states. Uncertainties brought about by the financial crises of the past to the retreat being witnessed in the existing multilateral trading order, and now the pandemic, have opened opportunities for India and ASEAN to further build their economic cooperation.

ASEAN-India Economic Engagement

India and ASEAN began to rapidly expand their economic relations in the post-Cold War period. India's 'Look East' policy in 1991 focused on expanding relations with ASEAN, with economics at its core. This new diplomatic outreach provided dividend as India's two-way trade with ASEAN more than doubled to USD 6 billion from 1992 to 1996, and crossed USD 10 billion in the year 2002 (Jha, 2010). India and

ASEAN signed the Comprehensive Economic Cooperation Agreement (CECA) on October 8, 2003, in Bali, Indonesia, to institutionalise a framework for future economic cooperation (EXIM Bank India, 2018). India also began building bilateral economic relations with the individual AMS such as implementing the Early Harvest Scheme (EHS) with Thailand on September 1, 2004, and the CECA with Singapore and Malaysia in August 2005 and July 2011 respectively.

Figure 4⁴
The graph shows India's Export, Import, and Total trade with ASEAN in USD million, between 1996 to 2019



Note: The graph shows India's Export, Import, and Total trade with ASEAN in USD million, between 1996 to 2019

The graph shows India's Export, Import, and Total trade with ASEAN in USD million, between 1996 to 2019. The graph in figure 4 indicates the bilateral trade between India and ASEAN which has been increasing over the last two decades. India was seen as an important partner for ASEAN to help circumvent the economic slowdown in the post-2008 financial crisis period which was marked by a major decline in global trade and commerce. The two signed the India-ASEAN Trade in Goods Agreement in September 2009 which came into effect in January 2010 and the Agreement on Investment and Trade in Services which was signed and came



into effect on July 1, 2015. The signing of these agreements has had a positive impact on the economic engagement with total trade increasing sharply since 2010, as indicated in figure 4. India-ASEAN trade was USD 86.86 billion in 2019 and it is estimated to reach USD 300 billion by 2025 (India-ASEAN bilateral trade may double by 2025 to USD 300 billion: Study, 2019).

The ASEAN-India FTA provided Indian industries and exporters opportunities to expand operations and explore other areas of investment in the ASEAN markets. A significant proportion of Indian global outward FDI (OFDI) stock is in ASEAN, which remains a major investment destination for Indian companies. A majority of Indian OFDI go to service sector industries, primarily in banking and finance, IT and IT-enabled services (ITeS). Indian manufacturing OFDI in ASEAN is significant in metal and transport equipment industries. According to a joint ASEAN-UNCTAD Investment Report published in 2017, Indian manufacturing investments are about 32% of the OFDI concentrated in technology-intensive industries and during 2005–2015, the medium-technology industry, namely basic metals and fabricated metal products, accounted for the largest share, followed by the high-technology industry such as motor vehicles and other transport equipment with a 34.3% share. These two industries received about 72% of Indian manufacturing OFDI flows to the region. In addition, Indian investment in pharmaceuticals has grown rapidly in recent years, particularly in 2015. Indian investment activities in services in ASEAN have expanded rapidly during 2005–2015 and were 62% of the total Indian OFDI. The bulk of these investments went to communication services, followed by construction, and transportation and storage. Professional services, scientific and technical activities, and IT and ITeS services are also significant and growing. ASEAN is also a major source of FDI to India with a total investment of USD 45 billion in cumulative FDI equity capital during 2010–2015, which represented 16% of FDI flows in India. Singapore accounted for the lion's share of FDI into India. Most of the ASEAN companies are involved in India's infrastructure development and other services industries. As is evident, the bilateral investment relationship between ASEAN and India is growing stronger (UNCTAD, 2017).

India's economic engagement with ASEAN over the last two decades has increased substantially. However, in terms of trade, there is emerging asymmetry. While India's exports to ASEAN have been increasing, its imports have witnessed a much higher jump, leading to an increasing trade deficit. In order to address the increasing trade asymmetry and establish a more balanced trade, during the 16th ASEAN Economic Ministers-India Consultation, held on September 10, 2019, in Bangkok, both sides reached an agreement to review the existing Free Trade Area (FTA). In a written reply to the Upper House of the India Parliament (Rajya Sabha) on November 29, 2019, the Commerce and Industry Minister of India, Piyush Goyal, stated that the proposed scope of the review of the ASEAN-India FTA could include: implementation issues, rules of origin; verification process and release of consignments; customs procedures; would consider negotiations on further liberalisation of trade in goods; and sharing and exchange of trade data (India-ASEAN FTA review, 2019).

The India-ASEAN Partnership in a Changing Global Economic Environment

Security challenges in the past two decades has ushered the need for ASEAN to build a new narrative for multilateral partnerships. China has emerged as ASEAN's largest trading partner after their FTA came into effect in 2010, nonetheless, its increasing assertiveness, particularly in the SCS, remains a concern. The AMS are today attempting to find the right balance between engagement and containment of China (Mohan, 1995). The AFC altered the power symmetry between China and ASEAN in favour of the former. However, the consequences of the global financial crisis of 2008, the ongoing trade tension with the U.S. along with the internal changes taking place in China have eroded some of its growth momentum resulting in a mixed outcome. China has been able to consolidate its economic leadership amongst some of the ASEAN countries by pushing economic regionalism through the Greater Mekong Subregion initiatives. ASEAN states on the other hand, by taking advantage of the changing economic environment along with their own rapid economic growth, are emerging as China's competitors in certain sectors such as manufacturing. Some of the ASEAN countries, by developing their manufacturing capacities and capabilities, have integrated and are part of the Global Value Chain (GVC). Further, by offering low-cost manufacturing alternatives they are becoming a strong competitor and a viable option to the various multinational companies that are looking to move out of China.

The global economy has still not fully recovered from the economic fallout of the 2008 financial crisis which has had an impact on global trade and commerce. This global slowdown has also resulted in the increasing resistance to the global liberal economic order with restrictions on the free flow of trade. This has led to a call for greater multilateral cooperation and dialogue amongst institutions and countries. In the midst of these challenges, the world is also witnessing an unprecedented health crisis with major economic implications.

India and the ASEAN countries are facing the onslaught of the pandemic with their growth projections being downgraded for the current fiscal year. The Asian Development Bank has estimated the growth for Southeast Asia to decelerate to 1.0% in 2020 on account of COVID-19 (Asian Development Bank, 2020). As the outbreak spread, it has impacted the economies of Southeast Asia which are centred mainly on tourism and export-oriented industries. The imposition of travel restrictions has impacted the tourism sector and the disruption of supply chains and temporary shutting of plants is affecting the ASEAN economies that rely on export-led growth (Ao, 2020).

The Reserve Bank of India (RBI) in May 2020, projected that India's GDP growth on account of the COVID-19 during 2020-21 is likely to remain in negative territory. The World Bank projected India's economy to shrink by 3.2% in the current fiscal year while international rating agencies like Moody's Investors Service, Fitch Rating and S&P Global Ratings have all predicted a 4-5% contraction (Indian economy to contract, 2020). In this emerging scenario, ASEAN and India would



be crucial partners for a post-COVID-19 economic recovery through greater intra-regional trade. India and ASEAN need to further build their partnership and look at the crisis for the opportunities it presents. COVID-19 has revealed major flaws in the existing supply chains such as single-source dependencies which led to production and supply across the globe coming to a halt (Cordon & Buatois, 2020). Experiences from the outbreak of the pandemic are pushing foreign companies, including OEMs, to move towards establishing flexible and adaptable supply chains. This move towards more flexible and multi-level sourcing provides an opportunity for India and ASEAN countries, such as Indonesia, that are looking to enhance their manufacturing sector and participation in the GVC (Making India an Alternative Supply to China, 2020). As mentioned earlier, some of the ASEAN countries are already well integrated and have one of the highest GVC participation indices in the world, and would be an ideal partner for India (EXIM Bank India, 2018).

While many of the global corporations are reworking their long-term strategies and looking to withdraw from China, there is also a sharp decrease in foreign investment into emerging Asian economies. On account of the pandemic, foreign investors today are looking to invest closer to home for sourcing. Further, with falling demand and disrupted supply chains, many multinational enterprises have already slowed their capital expenditure in the wake of declining profits. This results in lower reinvested earnings and, as a consequence, is leading to a decline in the FDI inflows being witnessed in all the emerging economies in Asia. However, this would be a short-term hurdle. In the long-term, supply chains will continue to evolve and re-invent through the adoption of new technologies and thus, would be dependent on pricing irrespective of the distance of the supply source (Thapar, 2020).

Many of the ASEAN countries have already been offering incentives for new companies to move factories from China in light of the U.S.-China trade war. For instance, Indonesia plans to set up 19 industrial parks by 2024. It is also cutting the corporate tax rate to 22% from 25% this year, then to 20% in 2022, a year earlier than it had previously planned. Malaysia, as part of its economic package announced in June, offered a 15-year tax exemption for manufacturers that are willing to invest 500 million Ringgit (USD 117 million) into the country (Jibiki, 2020). India has also been promoting the development of its domestic manufacturing sector as part of its 'Make in India' initiative and, as mentioned earlier, is keen to get integrated into the GVC. Over the last few years, India has undertaken reforms that resulted in the deregulation of FDI rules for several sectors. In 2019, India was amongst the top ten countries in terms of attracting foreign funds into a variety of sectors including services, technology, IT and telecom, and construction. The role of FDI for India and ASEAN countries cannot be overstated since it brings the capital that helps in the upgrading of supply chains and removes inefficiencies. Further, foreign capital also brings the technologies and experience that helps build not only the capacity but also the capabilities in the region (Bhasin, 2020). The enhanced capabilities along with a deeper partnership between India and ASEAN has the potential to become a growth engine which would be crucial in fuelling the global economic recovery in the aftermath of the pandemic.

Conclusion

While the actual economic cost of the COVID-19 pandemic is yet to be measured, it has already caused major disruption to the flow of trade and commerce (including tourism) and impacted economies and livelihoods across the globe. The economic fallout from COVID-19 would be a major challenge marked by a further decline in global demand in the post-pandemic period. The economic recovery process would also be shaped by a global environment where there would be the further resurgence of the antithesis to globalisation. This new environment, with a weaker economic system and marked by increasing mercantilism tendencies being adopted by some countries, will put stress on the economic health and make the recovery a long and uphill challenge.

The economic growth and resilience that India and the ASEAN states has showcased over the last decades has enabled them to become a part of the global economic machinery and today they are being invited to take part at the high table of premiere economic arrangements. While both have witnessed economic slowdowns in the past, their resilience has made them emerge stronger by adapting and building new partnerships. In the advent of COVID-19 and the economic uncertainties of the trade war with the U.S., global corporations are moving out of China and looking to relocate. India and ASEAN are viable options with their favourable demographics, massive consumption, and their adaptability to new technologies which enable production efficiency while being cost effective. COVID-19 has altered the world permanently and it has also impacted the way businesses will be carried out in the future. In this changing economic environment, technology, which includes automation and digitalisation, will become even more crucial. India and ASEAN need to accelerate their economic partnership through greater intra-regional trade. Further, this partnership needs to become more agile by deepening cooperation in the technology sector. The 'Make in India' initiative while looking to enhance India's domestic manufacturing capabilities, also provides a platform to build partnerships. The India-ASEAN partnership, through co-production and co-development, would enhance production capabilities, which are required in a changing global economic environment. As the future of global trade and commerce will be technology driven, innovations and capacity building will be fundamental in establishing the India-ASEAN partnership as an alternative to the pre-existing driver of global growth.

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Endnotes

- 1 Source: Author's combination based on World Bank Database
- 2 Source: Author's combination based on World Bank database
- 3 Source: <https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=CN&view=chart>
- 4 Source: Author's combination based on Export-Import Databank, Department of Commerce, Government of India.



Sino-Japanese Competition over the “aid market” in ASEAN: Political Tensions and Consequences

TAKESHI DAIMON-SATO

Abstract: This article aimed to shed light on viability of politically motivated Sino-Japanese aid competition in Southeast Asia and its social and economic implications from the recipients’ perspectives. One of the central messages of this article is, “local conditions matter” for aid projects to attain their expected economic outcomes. Post-war Japan started as a recipient country of World Bank loans, with monumental infrastructure, most of which were considered a success. This article challenged this conventional view and argued that they had mixed results at least in the short-run for those politically motivated projects. China and Japan seem to be competing over “national pride” rather than “national interests” when it comes to foreign aid in infrastructure. The rivalry challenges the unity of Association of Southeast Asian Nations (ASEAN) from the member countries’ points of view, where there seems to be a widening gap between nations that are increasingly integrated into BRI networks through “connectivity” rhetoric and those that remain disconnected from the network. The paper concluded with the implications of Sino-Japanese aid competition for post-COVID international relations.

Keywords: ASEAN, COVID-19, Belt and Road Initiative (BRI), connectivity, aid competition

Introduction

The COVID-19 pandemic is quite likely to be remembered as the most significant turning point in history after World War II. In the same year that the World Bank, in its World Development Report 2020, shed light on the effectiveness of “global value chains,” quite ironically, a “negative globalization” has become apparent as the poor, the elderly, and other weak groups within society have suffered considerable setbacks in both developed and developing countries. The plan for a “post-COVID” reconstruction must start from the decision of whether countries should progress in the direction of co-existence and co-prosperity or that of isolation. Given the influence held by Japan and China in the Asian economy, one must be aware of how much responsibility each country holds. The unfortunate reality is that on-going battles of words between America and China have gathered attention as the world strives to find countermeasures to COVID-19,

and it exemplifies the “G-Zero World” (Bremmer, 2014), the power vacuum in international politics. Is there a way for Japan to contribute to the international public good without being involved in the conflict between these two countries?

Looking back, China and Japan waged war twice in modern history, and both countries have even scores. Japan defeated China in Sino-Japanese War (1894-1895) and gained Taiwan’s territory as well as territorial status of the Korean Peninsula as a result, making Japan a military power in East Asia in the late 19th century. Japan was later defeated by China in the “Greater East Asia War”¹ (Second Sino-Japanese War 1937-1945, World War II 1941-1945, combined). Diplomatic ties were reestablished in 1972 with a historic reconciliation and symbolic “handshake” between Premier Zhou Enlai and Prime Minister Kakuei Tanaka. Despite occasional tensions over political or territorial issues over the Senkaku Islands, the two countries have intensified economic interdependence ever since. Until the outbreak of the COVID-19 pandemic, major touristic destinations in Japan were hospitable to visitors from China who spent thousands of dollars during their stay. With a decreased young population in Japan, top universities in Japan depend more and more on tuition paid by wealthy Chinese students who also study really hard.

Despite economic and cultural rapprochement over the past several decades, a business war has been severely fought between these historical rivals across the globe in recent years, and most fiercely in Southeast Asia. During Deng Xiaoping’s state visit to Japan in 1978, he rode on the Japanese high-speed railway (HSR) or ‘Shinkansen’ (new line) and was reported as saying “this is the speed [to which] we must catch up.” (People’s Daily online, 2008) Who imagined that in just 30 years China and Japan would compete for speed and contracts of HSR in the world? In September 2015, Japan lost a USD 5 billion contract to China to build Indonesia’s HSR connecting Jakarta and Bandung. In the same year, Japan won a contract over China to build India’s first HSR connecting Mumbai and Ahmedabad. Competitions have been witnessed in other countries; Thailand, Singapore-Malaysia, and Vietnam, though some of these countries have given up their HSR plans as it turns out that it is not cost-effective enough and thus difficult to convince taxpayers who would bear the financial burden.

The clash over HSR is inevitable. On one hand, Chinese HSR has been a major tool to enhance economic as well as political “connectivity” among major cities in China. China’s HSR serves half of the entire population of China and, with more than 4,000 km of HSR network, it has caught up with and gone beyond Japan’s HSR despite the latter being inaugurated much earlier. Beijing, Shanghai, Guangzhou, Hong Kong, and up to Ürümqi (Uighur) are all serviced. It is not surprising and geographically (or geo-economically) natural for China to try to extend its network from Kunming to Phnom Penh (Cambodia) or Bangkok (Thailand) in the Greater Mekong River Sub-Region (GMS) Countries, as an important vehicle to promote its Belt and Road Initiative (BRI). On the other hand, the Shinkansen, the fastest and safest train in the world for decades since inauguration in 1964, has been a source of national pride for many Japanese. The defeat of Shinkansen in Indonesia in 2015 prompted the Abe Administration to announce the Quality Infrastructure Partnership (QIP) campaign in 2015 (Zhao, 2019), and more recently, the Free and Open Indo-Pacific (FOIP) Initiative. The FOIP has been received with great concern among



policymakers in China, it is viewed as a “negative campaign against BRI” (China net online, 2019) working as a strategy against China to contain it through the networks of US, ASEAN member countries and increasingly India. Japan sees BRI rather negatively meanwhile China regards FOIP/QIP in quite the same way.

Obviously, HSR represents only a small part of official development assistance (ODA) for both countries. Other fields of regional public goods, such as public health (medical assistance, for example) against pandemics, maritime security against pirates, and employment creation programs during the economic crisis, could be less mutually exclusive and thus there is still room for possible collaboration in the future. Though public transportation is in the general public interest, riding the HSR is a luxury for most users in developing countries. This was also the case for Japan around the time of its inauguration in 1964. Therefore, HSR has been seen as a more lucrative investment than non-lucrative aid for China and Japan. Competition in the market can maximize social surplus, as economics textbooks tell us, but only with a perfectly competitive market. There are only a limited number of players in the HSR market, and these companies are *virtually* state-owned or government supported. This results in conditions (costs and benefits) that may well fall below the level of efficiency, which makes such projects economically unviable for the recipient country.

Regardless of whether one likes or dislikes the concept of “international connectivity”, its permeation and expansion within various fields is an undeniable social phenomenon of modern times. Its influence in diplomatic policy is considerable as is how it affects economic policy. The Belt and Road Initiative reduces the trading and logistics costs between countries thus helping them achieve peace and prosperity through international trade, consistent with the type of liberalism that has supported post-Adam Smith (The Wealth of Nations, 1776) free market theory and international organizations such as the World Bank and the World Trade Organization (WTO). From a free competition viewpoint, competition between Japan and China to provide the best quality aid is desirable.

This article tries to shed light on the viability of politically motivated Sino-Japanese aid competition in Southeast Asia and its social and economic implications from the recipients’ perspectives. One of the central messages of this article is, “local conditions matter” for aid projects to attain expected economic outcomes. The post-WWII Japan started as a recipient country of World Bank loans spent on monumental infrastructure projects (dams, power plants, roads and railways, in particular), most of which were considered a success. This article challenges this conventional view and argues that they had mixed results at least in the short-run for those politically motivated projects (with parochial interests), such as HSR. Already back in the early 1960s, the World Bank report (1961) warned against the various risks of Japanese HSR, which are quite suggestive for Sino-Japanese competition over HSR in Southeast Asia. Today, the two countries seem to be competing over “national pride” rather than “national interests” when it comes to rail. The paper attempts to capture the significant lack of internal and external coherence for China to push the HSR bids in Southeast Asia, where the term “connectivity” is interpreted as a hidden agenda for Chinese

leadership. It also explores the unity of Association of Southeast Asian Nations (ASEAN) from local views, where there seems to be a widening gap between nations that are increasingly integrated into BRI networks through “connectivity” rhetoric and those that remain disconnected. Finally, the paper concludes with implications of Sino-Japanese aid competition on post-COVID international relations in Asia.

Sino-Japanese “War” Over Southeast Asia in the 21st Century

During the summer of 2020, Ginza streets in central Tokyo were decorated with “Tokyo 2020” flags, despite no real Olympic Games being held due to the COVID-19 pandemic. Olympic Games held in Japan and China marked somewhat fateful turning points in modern history - characterized by wars and conflicts. For instance, the Tokyo Olympic Games have been cancelled twice, the first one in 1940 due to the Sino-Japanese War, and the second one in 2020 was “postponed” due to the pandemic “war”. The 1964 Tokyo Games was seen as a turning point of the *post-war* reconstruction of Japan. The Shinkansen (or Japanese HSR), the world’s fastest train at that time, started to operate just a week before the Olympic Opening Ceremony. In the 1960s, China was completely isolated from the rest of the world and their economy deteriorated amidst the ideological campaign during the Cultural Revolution. The country launched drastic economic reforms with an open door policy under Deng’s leadership in the late 1970s, leading the nation eventually to become a major economic power by the early 2000s. The 2008 Beijing Olympic Games marked another turning point in Sino-Japanese history after which China overtook Japan as the second largest economic power in the world.

Since around the 2008 Beijing Olympic Games, however, China started to play a role of regional leadership, or in the eyes of most Western observers, an emerging “hegemonic power” threatening the Pax-Americana that characterized, for better or worse, most of the time in the post-war period. For most developing countries, the so-called “spirit of Bandung”² (from the Bandung Conference of 1955) survived the Cold War period as common values if not *binding principles*. At the same time, it was often used as political rhetoric justifying non-interference policies for assisting authoritarian regimes in developing countries by donors (including Japan). Together with India and some 30 representative countries from Asia and Africa, it is well known that China and Japan were among the participants of the Bandung Conference. Both of which later became major donors, loyal to the Bandung spirit of non-interference, where *virtually* only economic interests matter. Bandung received international attention 60 years after the conference over the Sino-Japanese diplomatic battle over the Jakarta-Bandung HSR.

In terms of an aid menu, it is no surprise that more similarities than differences exist in terms of what Japan and China can offer to the recipient countries. The very similar aid models of the two countries can be said to be a version of the Harrod-Domar (HD) model, where financing of economic infrastructure entices private investors to follow suit and, paired with a high savings rate, aims to achieve high economic growth. The HD model was also consistent with the Keynesian model of public investments. Long



before the shift toward the “Washington Consensus” paradigm in the 1980s, with the denial of the government’s role, it can be said that this was the *modus operandi* of financing for the World Bank, which became the default model for international financial institutions such as the Asian Development Bank (ADB).

Another, albeit related, point is that Japan and China both use loans as a type of foreign assistance, helping the building of infrastructure (as an economic basis) such as roads, bridges, electric power plants, and so on in Southeast Asia. Following the HD theory, these public investments are intended to have spillover and multiplier effects that result in an increase in private investments, which in turn, lead to high economic growth. Both countries achieved double digit economic growth in this way. On the other hand, European and American donors, whose aid policy is more centered around grants than loans, warn that this may create a “debt trap.” Therefore, both countries are accountable for the world to address if extending well-targeted loans are more productive than devastating in attenuating this debt trap, in their assistance for HSR and all other investments abroad.

In the economic growth period of the 1980s, Japanese aid was criticized internationally as being developmentalist, mercantilist, having strings attached, being anti-environmentalist, and having a low *grant element*. In those days, Japan was pursuing the so-called “trinity” model of aid, in which a powerful Japanese Ministry of International Trade and Industry (MITI, currently METI) was playing a role of benign “broker” of private sector interests, pursuing foreign aid as a promoting mechanism of Japanese exports and investments particularly in the Southeast Asian market, which was the real cause. Whereas as rhetoric, aid was promoted as a catalyst for private sector-led growth, as a counter argument against Western criticisms. Also, in those days, there was even a “religious” belief among Japanese aid professionals and supportive researchers that Japanese *trinity* model was superior to any of the Western models.

With the shift toward a more collaborative form of aid in the 2000s, exemplified by the Poverty Reduction Strategy Paper and international goals (MDGs, SDGs), Japan has followed international requests for debt reduction, increasing the grant element (or making its loan menu more concessional) while decreasing the amount of overall aid. The country has fallen from first place within the G7 to a relatively lower one. During this period, China has surpassed Japan’s GDP to become the world’s second largest economy and, as it now aims to become the largest economic power with the Belt and Road Initiative (BRI), its ODA is now receiving the same criticisms as Japan did earlier. Japanese politicians and experts have started boasting qualitative superiority in somewhat ideological statements, focusing on “Free and Open Indo-Pacific (FOIP),” “Quality Infrastructure Partnership (PQI),” “international rules,” and so on.

Before the “tragedy of Bandung” in 2015, when Indonesia turned down the Japanese proposal of HSR, Japan was overly confident about their superiority over China in obtaining the HSR bid. The total “defeat” of Japan therefore was seen as a diplomatic humiliation for Japan. However, if the project was targeted at something else, both nations could have been more cooperative with each other. For instance, highway or toll road networks could be nicely sliced into packages

of co-financing projects, which could then be mutually beneficial, unlike HSR which remains too exclusive to be sliced into those co-financing packages among competitors. What this example seems to show is that some projects are “zero-sum” while others are “win-win”, depending on the nature of the invested sectors. It seems that, however, with a little bit of mutual effort, the HSR could be at least partly converted into a “win-win” sector if both countries are ready to work on a common basis, such as achieving safety rules or guidelines on rail traffic, for example.

In the case of the Jakarta-Bandung HSR, when Indonesians said “Sayonara to Shinkansen,” (Tempo, 2015) they compared the two countries’ proposals. The Jokowi Government, who would face reelection for a second term in 2019, opted for the Chinese menu that offered a more timely schedule, thus making it politically more attractive.

Table 1
China-Japan Competition Over HSR in Indonesia³

	China	Japan
Cost	USD 5.5 billion	USD 6.2 billion
Government	No government guarantee req’d	State guarantee (50% of project value)
Contract	B-to-B → G-to-G	G-to-G
Financing	25% equity, 75% CDB loan 40 (10 grade period) years terms	75% JICA loan, 25% state budget 40 (10 grade period) years terms
Currency	60% USD, 2% interest/year 40% RMB, 3.46% interest/year	100% JPY, 0.1% interest/year
Speed	350-380 km/h	320 km/h
Schedule	2016-2018, Operational 2019-	2017-2019, Operational 2021-
Ticket Price	IDR 200,000 (14.8 US\$)	IDR 200,000 (14.8 US\$)

Indonesia wishes to extend its HSR network to Surabaya, the second largest city in East Java, as was originally planned. Bandung was NOT included in the original master plan, financed by Japan, but it was added later to make the project more lucrative; capturing higher expected demand than connecting Jakarta and Surabaya directly, costing much more, and generating much less cash flow. In transportation economics, it become more apparent that, despite what is widely believed, HSR is NOT economically viable. Firstly, since neither the Japanese nor Chinese HSR system can be constructed on the existing railtrack, the new land purchase requires huge capital investment and social costs. Secondly, higher speed imposes higher operational and maintenance (O&M) costs per kilometer, which is often difficult to recover by operational revenue (ticket prices), which is set generally lower than its marginal costs. It is well known that the Taiwanese Shinkansen system has been running operational deficits since its inauguration in 2007.

The World Bank report of 1961 already mentions the risk of rising O&M costs, when it financed the Japanese HSR system. (The World Bank report. 2019)The report mentions that the HSR (“New Tokaido Line”) should consider having a dual operational system for “around the clock” operation: during the day, for passengers,



the train goes faster (200 km/h), while for cargo operations, the train should go slower (150 km/h) during the night in order to save costs. Japan spent 200 billion yen on the first HSR, when the national budget was 1,500 billion yen, of which 50% went towards land purchase costs. Unfortunately, the cargo plan was never materialized due to the high land purchase costs and noise pollution concerns for residents.

In the 1960s in Japan and across the world, air travel was pricey, and trains were the only means of transportation for most people. Railway was, in those days, run by the Japan Railway Corporation (a 100% state-owned enterprise). It took over three decades before the privatization of the national railway took place. All ticket prices were therefore heavily subsidized (subject to approval by Diet, or parliament in Japan) making it difficult to achieve a full cost-recovery. In many parts of the developing world, train tickets are still heavily subsidized, and Thailand, for example, gave up on HSR due to financial unviability.

As shown above, the competition over the HSR market may not make economic sense. The competition between China and Japan has been heavily politicized by the diplomatic rivalry beyond economic profits in Southeast Asia, and it matches exactly what recipient country want to satisfy politically. In the same year Japan “lost” the HSR deal in Indonesia, it “won” another with India for its Mumbai-Ahmedabad HSR, with very generous lending condition for India (2 trillion JPY with 0.1% interest rate for 50 years), though tied with Japanese companies. By 2020, both projects have seen major delays and cost overruns. After all, competition over national pride is very costly.

Does Chinese Aid Create More Debt Trap than Japanese Aid?

Chinese aid has been criticized by Western observers as it creates a “debt trap” and dependence on the Chinese supply chain. Japan used to face similar critiques in its heyday of aid power in the 1980s. The Japanese “trinity” hypothesis, once justified as motivation for developing countries to make efforts toward more sustainability (in a narrow sense, the ability to repay financing, and, in a wider sense, the driving force behind economic growth). Can Japan say that its loan-type of foreign aid has contributed more than China’s?

As seen in the previous chapter, the answer to this question may largely depend on which sector the lending finances; if it generates higher or lower economic returns. It may also depend on the susceptibility of borrower nations, which can be defined both economically and politically, for foreign intervention in the form of aid. Susceptibility should refer to debt sustainability in an economic sense, while it could imply matching with the needs of local political elites. Prime Minister Kakuei Tanaka, best known in China as a Japanese leader who established diplomatic relations with mainland China in 1972, is known as a corrupt politician in Japan who favoured the parochial interests of his constituency in rural Niigata by connecting it to Tokyo via HSR. The Indonesian President Jokowi behaved like Tanaka, when he chose Chinese HSR in 2015, for his reelection in 2019.

When Japan launched the first economic assistance to Southeast Asian nations (Myanmar, to begin with, then extended to the Philippines, Indonesia, Thailand and Malaysia) in the 1950s, as *de facto* war reparations, there was no consensus among donor nations about the scheme or modality of assistance. Gradually, by the 1970s, the OECD member countries have agreed to define Official Development Assistance (ODA) as financial flow whose “grant element” (calculated on the basis of interest rate, year of repayment, and grace period) is over 25%, while that with a grant element below 25% is called “Other Official Flows (OOF).” It was the first efforts for aid harmonization, which culminated as MDGs three decades later. After decades of administrative chaos for aid administration in Japan, by 2008, the Japan International Cooperation Agency (JICA) had been given a function as a principal agency responsible for all ODA operations in Japan, including soft loans, grant and technical assistance. Meanwhile, the Japan Bank for International Cooperation (JBIC) has been conceived as a more private-oriented financial institution specialized with the OOF, such as equity participation for Japanese investors in emerging economies in Asia. The Chinese definition of aid is ambiguous, however. China is not a member of the OECD, which implies that it does not have to report data to the OECD secretariat, so it does not distinguish between ODA and OOF; aid is calculated as public investments mainly financed by the Export Import Bank of China and Development Bank of China. Despite its definitional ambiguity, it is clear that, after 2000, Chinese lending has kept increasing and has become the biggest creditor in many developing countries, including Southeast Asian countries.

Whatever the definition of ODA could be, the point seems to center around the question of how more inducive the lending condition can be towards promoting growth than aggravating debts. Lending, by definition, increases the debt stock, while it can reduce the burden of debt repayment, by expanding the economic base with growth-oriented industries. In other words, “quality” of lending matters much more than quantity.

On the other hand, quantitative analysis, conducted separately (Japan Society for International Development. 2020), shows first that regarding the aid quality and debt trap, the grant element and deferment period are significantly negatively correlated with the DSR, and significantly positively correlated with the debt stock. The same analysis also shows that the grant element and economic growth factor are significantly positively correlated. These results imply that making loans more concessional (by increasing the grant element and grace period) is likely to reduce the aid burden in the short term, but with the risk of increasing it in the long term.

Somewhat counter-intuitively for those who believe in the “trinity hypothesis”, Japanese yen loans show a significant negative statistical correlation with the debt stock, while Chinese loans show a significant negative statistical correlation with the DSR, according to the same analysis. This hypothesis may not be easily interpreted as useful policies, while it shows that the Japanese ODA loans, by creating the basis for the economy (infrastructure) allow for an increase in self-sufficiency efforts. In the long term, this mechanism reduces



the debt stock. Chinese loans might improve the debt burden in the short term, which goes against a widely-held view. Increasing the grant element of aid reduces the debt burden in the short term, but worsens the debt stock in the long term. Furthermore, making loans more concessional may help increase the economic growth factor, but the results hold regardless of the lending countries and it does not depend on individual countries such as Japan and China, as the money is fungible.

The problem of aid money being fungible has been debated for more than two decades. This also means that the source country for foreign aid should not, in practice, present a problem itself. In addition, for most high performing Southeast Asian economies, the debt sustainability has not been a major economic issue; as their continued economic growth has functioned as a secure collateral against default (unlike some countries in Sub-Saharan Africa or Latin America). For Southeast Asian borrowers, Sino-Japanese competition over more concessional lending scheme has been more diplomatic in nature. The more the two countries compete, the more financial beneficial it becomes for borrowers; and this will mean a lot during the next few years for most ASEAN member countries which will have barely started to launch their recovery plans from the COVID-19 recession in 2020.

Susceptibility of ASEAN Member Countries to Aid from China and Japan

Rhetorical battles over Chinese “Belt and Road” (BRI) or Japanese “free and open” (FOIP) have been waged in diplomatic games, but both sides have somewhat calmed down their tones in diplomacy in recent years. In 2019, Xi and Abe met *face-to-face* in the G20 summit held in Osaka, and Xi was also invited as an official State guest to Japan in 2020 (though this was suspended due to COVID-19). As China faces more economic confrontation with the United States, it makes more economic sense to set aside its own political agenda temporarily.

After all, Japan was the first pro-Western nation that re-opened diplomatic relations with China (interrupted by the Tiananmen Square massacre of June 1989) in 1992 with the state visit of Japanese Emperor Akihito and Empress Michiko who were received with enthusiasm by the Chinese people. In that sense, Japan has been a loyal observer of the “Bandung Spirit” of non-intervention.

Japan was the only OECD country, after all, that continued to assist Myanmar under the military dictatorship until the early 2010s. Japan was also generously assisting other authoritarian regimes in Southeast Asia during much of the Cold War period. In this way, most ASEAN member countries became borrowers of Japanese ODA loans in major infrastructure, while their governance structure remained non-democratic.

Today, ASEAN member countries seem to be split between “democratic” vs. “non-democratic (authoritarian)” sides, which does not necessarily correspond with how rich the country is in terms of income per capita. Almost all member countries

started as newly independent nations in the post-war period, without charismatic political leaders, who used all their powers to mobilize resources towards making the HD model achieve the miraculous growth of the late 1980s or early 1990s.

Lee Kuan Yew said, “You’re talking about Rwanda or Bangladesh, or Cambodia, or the Philippines. They’ve got democracy. But have you got a civilized life to lead? People want economic development first and foremost. The leaders may talk something else. You take a poll of any people. What is it they want? The right to write an editorial as you like? They want homes, medicine, jobs, schools.” Neighboring ASEAN countries followed the Singaporean model, some of which, like Indonesia or the Philippines, became more democratic, while others remain authoritarian.

The crucial point is how susceptible a country is in terms of accepting “democracy”, which, for most political leaders in ASEAN is some sort of luxury good after you achieve economic growth successfully. Until that stage is reached, most Asian people live their lives happily as long as they will have better jobs tomorrow rather than today! Some GMS countries remain single-party governments with a “communist” party without communist economic principles, while their political system is as authoritarian as the Chinese system. It is no wonder that these countries are leaning towards China in receiving aid and investment, as they are more susceptible. Once Japan starts to switch its non-interference principle (of Bandung) to a pro-Western democratic position, as has been interpreted by some, these countries will get further away from Japan.

Implications for Post-COVID International Relations in Asia

Faced with both domestic administrative needs for streamlining operations as well as international demand for increased transparency of foreign aid in China, Beijing established in 2015 the China International Development Cooperation Agency (CIDCA) as a foreign aid agency to perform what was previously done through a complex network of independent channels with the Ministry of Commerce, Ministry of Foreign Affairs, various financial institutions, and so on. This administrative reform is still underway as of 2020. CIDCA has started promotion and public relations (including some sort of “propaganda”) activities on its homepage which is also available in English. Thus slowly making its presence more noticeable. (China International Development Cooperation Agency) CIDCA moved quickly in the COVID shock; much quicker than JICA. One of the remarkable CIDCA achievements during COVID was providing emergency medical aid to countries such as Ethiopia, Angola, Sri Lanka, and more, which had a history of receiving aid from China. Between March and April 2020, information on the CIDCA emergency medical aid was updated daily, describing China’s aid in great detail. However, starting from the 1990s, the JICA was the main actor in the field of international emergency medical aid through the dispatching of the Japan Disaster Relief. Its modus operandi was to promptly help with natural disasters, and so on, and



to praise Japan's role in overcoming them. In 2015, an "Infectious Disease Response Team" was inaugurated, based on the experience of the previous year in helping with the Ebola epidemic in West Africa. However, as far as the COVID response is concerned, the JICA was not as active as CIDCA, and centered more on the infection status of employees and experts as well as news on the halted dispatch of volunteers (at least in the initial stages of COVID-19). As other donors, such the World Bank and the Asian Development Bank, keep giving notice of emergency aid one after the other, Japan seems to have lost its position as an aid provider in emergency relief. On the other hand, in China, in cooperation with the Alibaba Group Holding (and its founder, Jack Ma), an internet platform for sharing medical information in Chinese and English, "One World One Fight," was promptly established, greatly surpassing Japan. Even when it comes to information warfare, Japan focuses on inbound information.

In his keynote speech in that forum, Jack Ma said in English (Global MediXchange for Combating COVID-19, 2020), "we should cooperate with Africa in fighting infectious diseases. In this field, it should be obvious what is preferable between competition and cooperation among countries, but we are responsible for that decision. In only two weeks, China has been able to provide 50 countries with emergency medical supplies, and this is also thanks to the aid of Ethiopian Airlines. We want to keep strengthening the relationship between China and Africa."

The post-COVID international relations might be characterized by how much "social distance" people are ready to take in terms of a dire dilemma between authoritarianism versus democracy. Some European countries have obtained more complete social security through a complete lockdown albeit a significant limitation of individual freedom. The transfer of personal rights to the state and life security are, in a sense, a trade-off. In Japan, this limitation was not as strict and thus the economic security obtained was not total. Furthermore, contact route tracing via AI empowered smartphones, as was performed in South Korea, was not performed in Japan because the people are not ready to provide private information due to strong privacy concerns. In practice, local prefectural requests were observed by people as if they were administrative orders or laws. As the industries, shops, and so on that did not comply with these requests were made public by the government without any mercy, the first pandemic wave was thought to have subsided. However, as of August 2020, the virus is spreading rapidly. Japanese society is paying the cost of democracy in the end.

Many developing countries have been unable to limit personal rights, failing to provide complete life security and leaving many citizens (some of which turned to rioting) without opportunities for employment. This has led not only to financial disaster but also to a threat to the continued existence of these countries as a whole and to the risk of overall worsened security. As developed countries are focused on reconstructing their own economies, it is unlikely that developing countries would be able to receive sufficient aid. Considering that China is the largest source of aid for these countries, the risk of the authoritarian state model, where "personal rights are limited but without economic security," spreading worldwide is rather high. International relations will be decided by the extent to which people accept the Chinese model.

According to officially published data, the number of COVID cases in China has settled after March 2020. The “sudden appearance” of new deaths in mid-April of the same year has been reported to have been caused by a review of the statistics. European countries and America are requesting the Chinese government investigate and provide clarity regarding the origin of the virus. At the same time, the American government has been spreading the rumor, as if it were fact, of the Wuhan Institute of Virology intentionally spreading the virus in order to dodge criticism regarding America’s poor response to the pandemic, and this has further worsened the relationship between America and China. As the pandemic leads the European economy to destruction, even the leaders of countries such as France and Germany, who had taken a positive stance toward the Belt and Road Initiative, have had to criticize China’s response.

In an interview with the Australian Financial Review, the Chinese ambassador to Australia said that “The investigation that America is requesting (probing into the truth) is politically motivated, and, as such, I cannot agree with it. We should rely on WHO’s investigation. If Australia happened to join America in this request, there is no doubt that the Chinese people would have second thoughts about coming here, as tourists or to study abroad, and about consuming Australian products such as wine and beef,” implicitly criticizing the Australian government.⁴

When compared to this, the Japanese government could be said to have not openly taken an adverse stance towards China. Traditional media (newspapers, TV, etc.) simply repeat the information coming from the Prime Minister and the Tokyo Metropolitan Government, without criticism. There are not requests for investigations aimed at China as there are in the European and American media, nor independently performed research. The South Korean media does seem to praise its country’s response to COVID while criticizing Japan’s, but again, there seems to be no criticism toward China. As we will explain later, this cannot be unrelated to the growing reliance of Japan’s and South Korea’s economies on China. The main Singapore media outlets show a similar affinity to China in their reports (Straits Times, 2020).⁵ In May 2020, the People’s Daily published an article titled “10 doubts regarding the disease – The American government has the duty to take responsibility and answer,” strengthening the confrontational attitude toward the US (Renmin Wang, 2020). The 2020 “Global Development Report” from the World Bank warned that, while the global value chain is evolving, some countries and people are being left behind, and it is important not to fall prey to the increasing country-level individualism and isolationism. This could be said to be a type of idealism that goes against the “liberal” view that the main consensus of economists bases their opinion upon⁶ (Deudney-Ikenberry, 1999). This way of thinking directly confronts the retrospective “realist” view of considering aid (as well as trade and investments) as “a diplomatic tool to pursue the benefit of one’s own country” (Morgenthau 1962). While different from the classic realism of the period that saw America and the Soviet Union fight against each other in the Cold War, this neo-realism can be seen as a characteristic of this “G-Zero period,” marked by the trade competition between the US and China among other things. Propelled by international relationship theory (which focuses on regionality, identity, and social



norms), constructivism has positioned itself even within aid theory, for example through promoting the eradication of poverty and SDGs as a high-level norm (Hume-Fukuda-Parr 2009). From any perspective, aid can be said to be a diplomatic and political mediation tool.

There is little doubt that the post-COVID foreign aid market in Asia and Southeast Asia will be influenced by Chinese power, and the position of traditional aid powers including Japan and US will suffer from retreats at least in the short run. Chinese authorities have been using foreign aid as an important diplomatic tool everywhere in the world, in order to keep its influence in the recipient countries, and this is exactly why ASEAN countries are facing an important decision about the extent to which they can give up their institutionalized democracy while using resources from China in order to accelerate their economic recovery from the COVID shock.

Conclusion

In 2019, the World Bank published “Belt and Road Economics,” describing the importance of creating and connecting infrastructure in South Asia and adopting policies that obviously show a favorable stance toward the Belt and Road Initiative, such as a publication celebration seminar to which executives from offices throughout South Asia, including Japan, have been invited. In the 2020 “Global Development Report,” the general tone was that of promoting a further strengthening of the global value chain while fighting isolationism. Such is the condition of organizations such as the World Bank, which has often sided historically with the American government. The current international society has reached the point where UN organizations, especially the WHO, are increasingly reflecting the opinions of the Chinese government.

The Japanese economy cannot sustain itself without China. The core industries that aid the Japanese economy have widely relied on materials and food provisions from China. For example, most of the metals the automotive industry relies upon are imported from China, as are more than half of all imported vegetables. Most IC chip exports are towards China showing that, whatever the political differences, the import/export symbiosis between Japan and China is unavoidable; the Japanese economy is very much dependent on China.

Today, COVID has provided further challenges for Asia and the world. Dealing with the continued expansion of China’s power in the “post-COVID” (with COVID) international community framework is an unavoidable issue. The Belt and Road Initiative is a core diplomatic strategy for this expansion, and Japan must find a realistic stance within the future international framework.

Haruki Murakami spoke publicly in his radio broadcast in May 2020, with a calm but warning tone, “Some politicians compare the fight against COVID with a war, but I am against that comparison. Unlike a war, where there are allies and enemies, now we must all cooperate and rack our brains to find ways to survive through this ordeal.” Unfortunately, the world is still far away from what Murakami dreams of, but there is some progress made.

During the video conference held by the ministries of the ASEAN Plus Three (China, Japan and South Korea) countries on COVID-19 in April 2020, the necessity for cooperation within the region has been confirmed. Furthermore, the expectations regarding the contributions of China and South Korea, who have already “defeated the coronavirus”, and of Japan, who is on its way to “defeating” it have been made clear. Infection countermeasures are a public good for the whole region, just as countermeasures are against terrorism and illegal drugs. The healthcare systems of most ASEAN countries are already insufficient during normal times, and during an emergency such as this, very few countries are able to survive without external help, creating fear of the demise of entire countries. The economic system of East Timor, which, while not part of the ASEAN, is geographically located in the ASEAN region, depends on petroleum income, making the downfall of the country a realistic threat.

As shown by the relations between America and China, Japan and China, and China and South Korea, direct negotiations between two countries tend to result in antagonism as each pursues their own benefit. The existence of the ASEAN Plus Three forum (a non-traditional security threat framework) is able to relax this antagonism and ease conflicts thus providing a framework for all countries to contribute to the public good of the region; this should be actively praised.

Competition over aid between China and Japan has triggered many expected and unexpected repercussions in recipient ASEAN countries. Despite economic damage caused by COVID, the two countries are expected to play important roles for post-COVID reconstruction of the world in the long-run, not only as financial sources but also as sources of knowledge and experience about how they have survived conflicts of interests in economic and political fields.

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Endnotes

- 1 This appellation was originally adopted by the Tojo Administration (1941-1944), though it was banned by the US Occupation Forces under General McArthur in the postwar period as it was considered 'symbolic of Japanese militarism.' It is more common now to use the term Asia-Pacific War in media, though carrying definitional ambiguities, thus this paper keeps its original title.
- 2 The ten principles of the Bandung Conference included, "1. Respect for fundamental human rights and for the purposes and the principles of the Charter of the United Nations." "2. Respect for the sovereignty and territorial integrity of all nations." "3. Recognition of the equality of all races and of the equality of all nations large and small." "4. Abstention from intervention or interference in the internal affairs of another country." "5. Respect for the right of each nation to defend itself singly or collectively, in conformity with the Charter of the United Nations." "6. Abstention from the use of arrangements of collective defense to serve the particular interests of any of the big powers, abstention by any country from exerting pressures on other countries." "7. Refraining from acts or threats of aggression or the use of force against the territorial integrity or political independence of any country." "8. Settlement of all international disputes by peaceful means, such as negotiation, conciliation, arbitration or judicial settlement as well as other peaceful means of the parties' own choice, in conformity with the Charter of the United Nations." "9. Promotion of mutual interests and cooperation." "10. Respect for justice and international obligation."
- 3 Salim, W. and Nagara, D. S.(2016), "Why is the High-Speed Rail Project So Important to Indonesia," ISEAS Perspective No. 16.
- 4 See the website of the Chinese Embassy in Australia
- 5 For example, the Straits Times (online version) <https://www.straitstimes.com/> (May 1, 2020 edition) criticized the request for an investigation against China from the Australian PM.
- 6 Liberalism (internationalism) has been said (Mawdsely, 2012) to even be able to counter the effects of the threat of a pandemic, but a comparison with the reality has shown that this view was exceedingly optimistic.



Global and Regional Supply Chains in East-Asia and the Evolving ASEAN Regionalism

ANIKÓ MAGASHÁZI

Abstract: The paper departs from the analysis of the regionalizing processes, as Björn Hettne coined the spontaneous empirical trend driven by transnational corporations. They evolved within Southeast-Asia from the end of 1980s, despite a very low level of intergovernmental institutionalization within ASEAN. The activity of global and regional value chains increasingly webbing the ASEAN region is traced back to trade and investment relations and their change over time in 1995-2018. Regionalizing processes have been followed from the mid-nineties by intergovernmental negotiations on membership expansion and moving towards a single market and production base, facilitating the “bottom up” dynamics from the “top-down” level. Impacts of the US-China Trade War and Covid-19 pandemic are analysed to draw future prospects.

Keywords: East-Asian regionalization, ASEAN+3, AEC 2015, global value chain disruptions

Introduction

The notion of the ‘Asian Century’ has surfaced in academic literature and political discourse over the past decade, claiming and prophesying that growth and development in the 21st century will be spearheaded by Asia (following the US dominance of the 20th century, with the 19th century being Europe’s). A recent study by McKinsey Global Institute provides facts and forecasts on how the global centre of gravity is shifting towards Asia. A substantial rise was demonstrated already between 2000-2017 in Asia’s share in global GDP from 32-42%, in global consumption from 23-28% and in the world’s middle class from 23-40%. By 2040, Asia is likely to generate more than 52% of real world GDP (in purchasing-power-parity), and could account for 39% of global consumption and 54% of the share of the world’s middle class according to the study (Tonby, Woetzel et al., 2019:2). Parag Khanna¹ paints in his recent book, *The Future is Asian, an Asian Century* which is not to be marked only by China’s increasing global role, but a multipolar, multifaceted, entangled Asia, with a further strengthening position of ASEAN and India as well (Khanna, 2019).

Reflecting on Asia's increasing geo-economic and consequently geo-political importance, this paper intends to shed light specifically on the ASEAN region and the ASEAN+3 area, involving China, Japan and South Korea too and the evolving regionalizing processes around them driven by global value chains of transnational corporations since the 1990s.

Catching a glance at the history of the Association of South-East Asian Nations (ASEAN), we can observe, that although it was established only a decade later than the European Economic Community was created by the Treaty of Rome, the way and speed of integration of the two groups of countries followed an entirely different path. ASEAN is seeking to unite very heterogeneous nations both in terms of their political systems and their economic development levels in a non-binding, non-interfering, consensus-driven way even after the 50th anniversary of its foundation with the Bangkok Declaration. ASEAN plays a central role in the regional Asia-Pacific architecture interconnecting Asiatic and Transatlantic nations, just to mention a few examples: APEC, ASEAN+3 (APT), and the RCEP. A rapid spread of bilateral Free Trade agreements (FTAs) webbing the ASEAN region and its East-Asian neighbours has been experienced since the mid-nineties, bringing to the fore East-Asia² globally by the 2010s in this field. These developments were further spurred by two major economic crises: the 1997 Asian Financial Crisis and the 2008 Global Financial and Economic Crisis. It has been referred to in Asian academic and expert literature as the “noodle-bowl” or “spaghetti bowl effect”, used interchangeably, referring to the fact that the individual FTAs, like individual pieces of noodles add to the whole, instead of a multilateral framework. The “noodle bowl effect” has a negative connotation since by keeping a multitude of overlapping rules of origin (ROO) legislation in the individual FTAs, any gains from the increased trade turnover are reduced due to the transaction costs, estimated by economists to 3-5% of the total export value (ADB 2008:22). ASEAN members initiated their internal FTA in 1992 and as a direct partner signed so-called ASEAN+1 FTAs with major regional powers: China, Republic of Korea (ROK), Japan, Australia, India and New Zealand. The latest ASEAN+1 FTA came into force with Hong Kong and China in 2019.

One of the distinct features of the ASEAN integration process is, that after decades of intergovernmental status quo, the integration started to unfold very slowly as a response to the activity of global value chains of transnational corporations (TNCs) in the region (Magasházi, 2015).

The current paper starts out from theories and concepts that try to grasp the specificities of the “ASEAN way” of integration, the move from regionalization to regionalism. Empirical analysis will follow to depict the trends of intra-regional trade and investments among the ASEAN as well as the ASEAN+3 member countries (China, ROK, Japan), their global connectivity, steered by global value chains (GVCs) in the 1996-2018 period. A major milestone of the evolving intergovernmental institutionalization from the 1990's has been the endeavour to create the ASEAN Economic Community (AEC) 2015, followed up by the envisaged ASEAN 2025 strategy. A region entangled so densely by activities of GVCs has found itself from 2018 in the forefront of global economic tensions. Provoked by the USA-China



Trade War and the Covid-19 pandemic causing disruptions and reconfigurations of GVCs with regional impacts, emerging countries on other continents can draw conclusions as well.

Literature Review

Alongside the statistical trends and empirical results behind the development of the ASEAN integration, concepts that intend to explain the impacts of global forces – global value chain, global production network research frameworks as well as specific concepts of scholars in economics, management and theory of international relations are worthy of review.

Based on the Southeast Asian experience, Das brought into the literature, the terminology of the market-driven integration. He claims that “microeconomic decision-making in large firms, particularly transnational corporations (TNCs) played an active role in the spread of regionalization” (Das 2005:1). While liberalization of trade and FDI has evolved already from the 1970s in the Southeast-Asian countries and attracted transnational corporations seeking profit optimization into the region, it was the Plaza Accord in 1985 which changed the currency value configuration and spurred Japanese investments across the region.³ The strategy of the TNCs in organizing their manufacturing from the nineties shifted from head-office-subsidiary relations to network aspects. Southeast-Asian countries, led in this process by Singapore, used the opportunity by conscious state policies for industrial upgrading already in the nineties (Gereffi, 1995). The global value chain literature deals in detail with theoretical concepts and empirical studies, how TNCs fine-slice parts of their production processes with a punctuality that has never been seen before, and settle individually to optimal places according to competitive advantages (Buckley, 2009). The global production network (GPN) literature inspired by the discipline of geography, concentrates specifically on the changing configuration of the networks (Coe, Dicken, Hess (2006)) compared to the governance aspect focus of GVC literature (Gereffi, Humphrey, Sturgeon (2005)). The fragmentation of production processes has created transnational and cross-border production systems, causing intense integration and functional interconnectedness. Southeast-Asian countries were the first ones that collected the valuable practices in this new division of labour. Production networks became a major force behind the market-driven integration of the region.

Hettne's distinction between regionalism and regionalization connects simply and well the macro and micro level analysis. The notion of regionalism describes the process initiated by governments in a top-down way, while the notion of regionalization is “an empirical trend depicting a multidimensional process of regional change that occurs simultaneously at several levels of social, political and economic interactions in a bottom-up process” (Hettne, 2003). Hettne (1996) calls the top-down process of evolving regionalism in the 1990s as “new regionalism”, which differs from the “old” post WW2 form, providing one way of coping with global transformation, since most states lack the capacity and the means to manage such a task on the national level. While the old regionalism emerged in a bipolar Cold War context, the new one is

taking shape in a multipolar world order, exemplified also by the turn in the ASEAN integration process from the nineties. When examining the top-down “regionalism” aspect of the ASEAN integration, scholars of international relations (IR) look at the question of rules versus relations in regional governance. They intend to resolve how ASEAN could achieve several decades of peace and economic development despite its informal, loose framework. They claim that “the ASEAN way” cannot be explained purely by the mainstream (IR) theory – as it is based more on relations due, in part, to several Confucian societies existing among its members. Yaquing (2001) argues that the unit of analysis is relations among individual actors, and how relations harmonize during the process. Wunderlich, in his comparative view between the EU and ASEAN brings a historic element, the unfinished state-building in the post-colonialist Asian states, into his concept. I tend to agree with his statement: “While European integration is partially driven by the drive to restrain or at least pool sovereignty, ASEAN regionalism is driven by the desire to consolidate state-building and sovereignty in Southeast Asia.” (Wunderlich, 2007:5). It was the European example of widening and deepening integration in the nineties, that “triggered a wave of new regionalism (APEC) or revival of old ones” (Wunderlich, 2007:29), that acted as one of the factors impacting the development of ASEAN integration as well.

It can certainly be said that discussions behind the decisions in East-Southeast Asia are different from the EU. There are long chains of informal interstate consultations for years till the full consensus is reached. In several cases the issue lost its relevance in the meantime. This process has been convincingly explained by the Secretary-General of ASEAN 2008-2012, an opinion leader in the region, the late Surin Pitsuwan⁴ at the conference held in the Institute of Foreign Relations and Trade on March 31, 2016 in Budapest. He claimed that ASEAN “got the inspiration from the EU, but ASEAN is very different. While in the EU, legal documents regulate interstate relations, East-Asia is in continuous flux, and cannot be constrained by rigid frames.” While the level of democracy and main macroeconomic indicators of the member candidates to the EU are thoroughly analysed before accepting a new member, it is enough in Southeast-Asia that the respective countries belong to the same geographical area. Thus the 10 member states of ASEAN, with a total population over 649 million (ASEAN Statistical Yearbook, 2019) encompasses states with entirely different political regimes: from royal monarchies, socialist countries, capitalist “one-party systems” to (as Pitsuwan described them), “noisy young democracies”. The countries in the latter category are most often slowing down the process to find the common denominator. “The speed of ASEAN is equal to the speed of the slowest country”- he noted. (Pitsuwan, 2016).

Global Value Chains and East-Asian Regionalisation – Facts and Figures

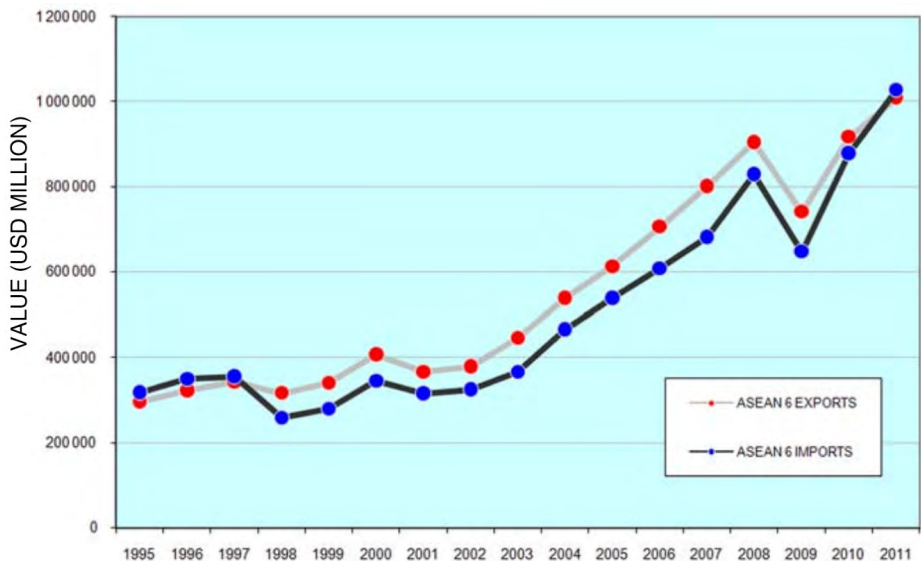
Looking behind the trade and FDI developments in the region, emphasis is put on intra-ASEAN relations, connectivity between ASEAN and its three major East-Asian partners: Japan, China and the Republic of Korea (ROK) as well as ASEAN’s relations



with the major advanced global centres of gravity: EU and USA. By 2017, 50 years after its establishment, ASEAN has become the 4th major trading area (after EU, US and China), with 7.2% share in global trade.

Looking at the 1995-2011 export and import developments of the ASEAN five founding members⁵ and Brunei, a major increase can be followed starting from 2002, leaving behind the drops in export and import figures due to the 1997 Asian financial crisis and the 2001 dot.com crisis of the digital industry, illustrated on Figure 1.

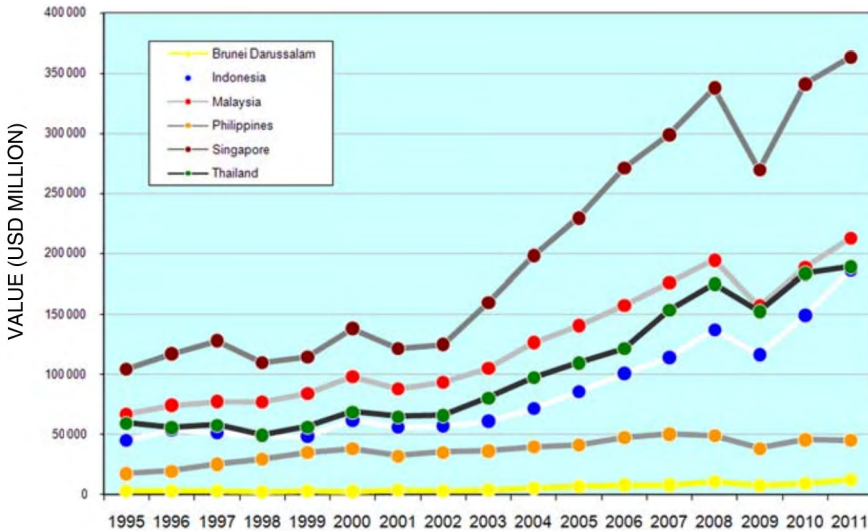
Figure 1
Trend of ASEAN 6 Total Exports and Imports, 1995-2011⁶



A study by Gopalan (2020) underlines in his analysis, that the domestic value added share (DVA) in exports of the ASEAN countries fell in the 1995 to 2011 period from 70% to 67%, while total exports increased many times, driven by intermediate exports – mostly related to GVCs. The remarkable increase in gross exports also led to substantial growth in jobs. Using empirical evidence, researchers showed that increase in imports is equally advantageous in the time of GVCs; intermediate imports of goods and services (foreign value added – FVA) play a positive role in enhancing employment as well as productivity in the ASEAN countries. Rapid trade increase went hand in hand with substantial per capita GDP increase, an emerging middle-class and increasing domestic markets.

Trade developments of the individual ASEAN 6 countries in the 1995-2011 period show that Singapore had built up its leading role with a widening gap from the rest of ASEAN. Malaysia, Thailand and Indonesia followed with a similar speed of up-ticking exports and, like Singapore, they had the momentum for a dynamic increase in exports after the 2008-2009 crisis as well.

Figure 2
Trend of ASEAN Total Export by Country, 1995-2011⁷



A concise statistical analysis backed summary (UNCTAD, 2013) on the activity of GVCs concluded that *foreign value added in exports provides for a good estimate of the extent to which a global or regional value chain is segmented*. This proportion is *especially high in the electronics and automotive industries* (UNCTAD, 2013:131). The UNCTAD summary states furthermore that *Southeast Asia has the highest level of GVC participation*. De Backer and Yamano's research findings confirm that emerging countries such as China, Singapore and Malaysia were the most successful in increasing their specialization in intermediates (de Backer & Yamano, 2012:16).

Based on the above findings, current analysis intends to get a closer look at the product group H85 "Electrical Machinery, Sound Recorders etc."⁷⁸, to track the increasing role of GVCs in East-Asia within the ASEAN+3 context and review ASEAN's global interconnectedness. Of the ASEAN member countries, and from the newly industrializing East Asian economies and China, the electronics industry only dominated in Singapore in the early 1990s, accounting for 46% of total output in manufacturing, thanks to the country's FDI-based, export-driven industrialization. She not only gained competitive advantage since the 1970s, but could also retain this advantage through continuous and conscious upgrading of the electronics industry in the 1990–2015 period (Magasházi, 2018.). Similar processes started in advanced East-Asian countries from the mid-nineties.

The inclusion of East-Asia into electronics GVCs can be seen by the multiple increase in the HS85 product category in the 1996-2000 figures (Table 1). The share of the product group substantially increased in intra-ASEAN trade too - both on the export and import side and especially in the export relations with the major advanced economies (EU, US and Japan), the main markets of their products. Exports to the US grew in this product category 46 times within 4 years; 34 times to the EU and 29 times to Japan. A dynamic upsurge of imports from the US and Japan can be observed in the same period suggesting the dominant activity of TNC networks headquartered in those countries



Table 1
The role of electric machinery, equipments and parts, sound recorders etc
(HS 85) in ASEAN trade (1996-2018)⁹

	1996		2000		2010		2018	
	USD mill.	%	USD mill	%	USD mill	%	USD mill	%
<i>Intra-ASEAN</i>								
HS 85 exports	12380.5	26.4	34441.2	38.1	59490.4	22.2	77958.1	22.5
Total exports	46926.0		90440.8		267981.0		346462.0	
HS 85 imports	12293.7	21.4	28195.1	40.1	55184.4	21.9	66540.6	21.9
Total imports	57380.5		69150.7		251823.8		304267.2	
<i>ASEAN-US</i>								
HS 85 exports	520.7	26.2	24014.0	35.5	23911.9	23.8	39626.2	24.7
Total exports	1988.2		67685.0		100464.7		160283.5	
HS 85 imports	322.2	13.2	18598.9	40.2	22862.6	26.5	21254.1	20.7
Total imports	2445.6		46315.3		86220.0		102739.6	
<i>ASEAN-EU</i>								
HS 85 exports	674.2	9.0	22957.7	40.0	26983.8	23.5	46693.5	29.0
Total exports	7474.1		57555.0		115036.4		160936.5	
HS 85 imports	1982	21.5	11340.5	30.1	19015.2	20,3	19795.5	15.6
Total imports	9217.6		36934.8		93548.4		127288.8	
<i>ASEAN-Japan</i>								
HS 85 exports	464.1	12.5	13526.7	26.0	22069.1	21.4	27053.2	23.6
Total exports	3722.8		51982.8		102890.8		114833.5	
HS 85 imports	174.2	6.1	21215.0	34.6	24106.1	23,2	27053.2	23.1
Total imports	2843.8		61404.9		103746.3		116881.9	
<i>ASEAN-China</i>								
HS85 exports	3308.7	31.3	2561.2	21.0	28951.8	25.6	54039.7	27.2
Total exports	10571.6		12222.7		112999.8		198955.7	
HS85 imports	1607.2	27.4	5355.9	31.8	30754.9	25.8	85521.3	30.0
Total imports	5866.7		16840.1		119013.4		284809.0	
<i>ASEAN-Korea</i>								
H85 exports	1496.1	15.8	3699.1	26.1	11322.6	25.2	17616.6	29.1
Total exports	9446.4		14145.2		44980.1		60489.6	
H85 imports	4760.8	35.8	6300.9	43.5	20319.8	37.9	43553.4	43.1
Total imports	13294.4		14470.7		53648.2		101025.0	

Note: Figures for 1996 and 2000 cover only ASEAN 6 in the ASEAN Trade Statistics Database

The involvement of the Republic of Korea (RoK) increased considerably from 2000 onwards, both as a market of the products and even more substantially on the import side, providing valuable electronic input and advanced products to the ASEAN markets, thanks to their own TNCs' regional and global networks. According to the micro-level analysis of Apple products, after Apple, the next biggest beneficiaries in the iPhone supply chain were South Korean companies, as upgrading within the value chain in the period 2000–2010 had been achieved by them. The initial stage of iPod manufacturing relied on Japanese (mainly Toshiba's) hard drive technology, while Korea's Samsung and LG became the prime suppliers of the flash memory technology used in the iPhone and iPad (Kraemer et al. 2011).

Generally, the reconfiguration of GVCs to increasingly East-Asian regional supply chains is reflected in the rapid emergence of China from 2000 onwards. Exports to China in the HS85 product segment increased 11-fold, imports from China 5.7-fold between 2000 and 2010, marching further in the concise data availability 2010-18 period as well. The figures show furthermore that imports from Republic of Korea (RoK) increased substantially on the account of the first-mover supplier countries: Japan and US as well as the EU. Intra-ASEAN exports and imports in electronics increased substantially in the 1996-2010 period – showing an increasing level of integration – in the sense of “regionalization” as defined by Björn Hettne.

Alongside this multifaceted integration by global firms in the ASEAN region, vertical disintegration can be also observed in TNC networks. In the late 1990s and early 2000s, as a result of the trend to outsource electronic manufacturing activities by TNCs to third parties rather than perform them at their own plants, contract manufacturing had been growing by 20% per year compared to previous decades (Buckley & Ghauri, 2004). Some former East-Asian domestic suppliers, such as Foxconn/HonHai (Taiwan) or Venture Corporation and WBL (Singapore), benefitted from this new trend after the new millennium and have become TNCs of global significance themselves, taking over the lead from the US first mover contract manufacturers (Flextronics, Celestica). At first, East Asian firms joined GVCs as simple component suppliers, then they developed their own production planning and design capacities to become original design manufacturers (ODMs). This radical organizational change within the industry provided a new global opportunity for domestic firms of emerging economies contributing to further increase of the region's flagship industry. GVCs interweaving East Asia had, and still have, a definitive role in the economic development of countries covering the region as a whole, as also seen in the continuous increase of the intra-ASEAN trade in the product category in the 1996-2000 and 2010-2018 period.

However, it has also to be mentioned regarding the soaring figures that, as a result of cross-border stages of production, today the processes within the world economy can hardly be explained by statistical evidence on gross trade flows between national economies. In various stages as a semi-finished product, the same product may cross the borders of a country multiple times back and forth until it reaches its ultimate destination as a finished product. This causes double counting in global gross trade figures (Koopman et al., 2010; Timmer et al., 2013).



According to experts, the average foreign value-added in exports at the global level was approximately 28% in 2010 (UNCTAD, 2013). This information gap gave rise to the creation of new input-output databases that are still far from being fully developed with respect to the scope of countries included, the periods examined and data updates (WIOD, TiVA, ICIO, UNCATD-Eora). ASEAN member states (AMS) with higher shares in goods trade also have higher shares in services relative to other AMS with the exception of Singapore and Vietnam. Singapore has a much higher share of trade in services (47.1% versus 27.8% for trade in goods) in 2017, while Vietnam's trade is more tied to goods. (17.1% versus 5.4% for trade in services).

While the expansion of GVCs are mirrored by trade developments, FDI flow is a major driver behind the regionalization of ASEAN and East Asia, and the region's growing embeddedness into the global economy. Comparable figures are available only till 2018, thus

Table 2
Inward FDI Flows to ASEAN by Selected Source Countries 1995-2018¹⁰

	1995		2000		2009		2014		2018	
	mill USD	%	mill USD	%	mill USD	%	mill USD	%	mill USD	%
ASEAN	3187.7	15.2	959.1	9.2	8807.8	20.3	22180.9	17	23188.4	15.1
China	113.7	0.5	57.1	0.5	2068.7	4.8	6165.2	4.8	9940.1	6.5
Japan	4238	20.2	-55.5	n.a.	3451.1	8	13436.1	10.3	20964.5	13.7
RoK	627.9	3	179.7	1.7	1804.1	4.2	5257.2	4	-223	n.a.
EU28	3648.9	17.4	2905.8	27.9	5659.9	13.1	28943.3	22.2	21613.5	14.1
USA	3262.1	15.6	2320.4	22.2	5180.8	11.9	21141.3	16.2	8340.7	5.5
Total	20912.1		10408.4		43365.4		130114.5		152755.3	

As Table 2. illustrates, total inward FDI flows into ASEAN, as well as intra-ASEAN flows were 7.3 times higher in 2018 than in the starting year of analysis, in 1995. As annual FDI flows have seasonality, the trend in the selected years in the period confirm a major jump especially following the 2008-2009 crisis. While in the 1995-2001 period ASEAN countries following FDI-led industrialization strategy relied mostly on Japan, EU and USA, the East-Asian emerging economies, China and also Republic of Korea represent an increasing share from 2009. According to figures in 2017, about 95% of intra-ASEAN investments came from three source countries, Singapore (69% share), followed by Malaysia and Thailand. Singapore's contribution surpassed even Japan, in an East-Asian context – confirming how intensely the city-state is entangled in GVCs, investing out of Singapore, as their regional hub. According to final FDI figures in 2018, ASEAN received in 2018 USD 154.7 billion inward capital flow, which made up 11.9% of total global FDI inflows. The figure was the highest in its history, ranking third after the EU and the US. The region's outward investments also grew markedly amounting to USD

69.6 billion – 6.9% of the world total. (ASEAN Integration Report 2019) As an example, Thailand's outward FDI surpassed in 2018 substantially its inward FDI flow, amounting to USD 20.7 billion (Bank of Thailand, 2019).

Table 3
Inward FDI flows into ASEAN by Host Country 1995-2018¹¹

	1995		2000		2009		2014		2018	
	mill USD	%	mill USD	%	mill USD	%	mill USD	%	mill USD	%
Indonesia	4346	20.8	-4550	n.a.*	4876.8	11.2	21810.4	16.8	21979.9	14.4
Malaysia	3007	14.4	1309.7	12.6	1405.1	3.2	10875.3	8.4	8071.6	5.3
Singapore	7208.8	34.5	6390.9	61.4	18916.8	43.6	73284.5	56.3	77630.5	50.8
Thailand	2004	9.6	3280.2	31.5	6411.5	14.8	4975.5	3.8	13205.1	8.6
Vietnam	1780	8.5	1289	12.4	7600	17.5	9200.1	7.1	15500	10.1
Philippines	1578	7.5	1726	16.6	1963	4.5	5814.5	4.5	9832.3	6.4
Brunei	582.8	2.3	600.2	5.8	371.2	0.9	568.2	0.4	503.9	0.3
Cambodia	150.7	0.7	127.7	1.2	539	1.2	1726.5	1.3	3102.6	2.0
Myanmar	317.6	0.2	203.6	2.0	963.3	2.2	946.2	0.7	1609.8	1.1
Lao	88.4	0.4	33.9	0.3	318.6	0.7	913.2	0.7	1319.6	0.9
Total	20912.1		10408.4		43365.4	100.0	130114.5	100.0	152755.3	100.0

Note: 2018 figures are preliminary

*divestments because of political and economic crisis in Indonesia

From the individual ASEAN countries Singapore is the main recipient of inward FDI flowing into the region amounting to 34.5% -61.4% share in 1995-2018. ASEAN's strategy to invite and integrate the less-developed Southeast-Asian economies (Cambodia, Lao, Myanmar, Vietnam – CLMV countries) from 1995 onwards shows its results in the FDI statistics as well. In 2018, Vietnam took the third place behind the globally more entangled Singapore and Indonesia, which attracts investors with a consumer market of 267.7 million population (2018) in terms of inward FDI-share, surpassing large ASEAN founding nations such as Malaysia, Thailand or the Philippines. (Table 3). In an East-Asian context, Japan, the Republic of Korea and ASEAN were the main investors in Vietnam, contributing 67 per cent of inward investments in 2017 (ASEAN Investment Report 2018).

Fukinari Kimura argued that although we observe similar cross-border production sharing in the US–Mexico nexus and in the Western Europe (WE)–Central/Eastern Europe (CEE) corridor, they have not yet reached the level of development that East Asia has accomplished” (Kimura, 2006, p. 326), which is even more true in 2020, with the increasingly complex intra-regional East-Asian GVCs, connected to extra-regional European and North-American GVC networks.



ASEAN Economic Community (AEC) and the Future of Integration

The evolving regionalization driven by global and regional value chains of TNCs increased global competition in the increasingly multipolar world order and induced the ASEAN member states (AMS) to facilitate their economic development by trying to clear away obstacles from the activity of GVCs and RVCs. However, the “ASEAN way” caused a very slow movement going forward. With continuous tariff reductions, the ASEAN Free Trade Agreement signed in 1993 was implemented in 2010 in the first ASEAN countries (ASEAN 6). To facilitate free trade of services, which represents 40-70% share in the GDP of the AMS, an agreement was signed in 1995, but nothing moved ahead in the first 8 years. The bottleneck was solved by deciding on the ASEAN-X formula, enabling those ASEAN countries ready to liberalize certain sectors of services to go forward without any obligation to provide benefits to the non-participating ASEAN countries. Special bilateral agreements were approved from 2015 to slowly start the liberalization of financial services among those AMS that were more ready than others. These processes underline the combination of economic pragmatism and insistence on national sovereignty of the ASEAN member countries,

The ASEAN Charta, signed by all 10 member countries in 2007, was the first legally binding agreement among AMS. It paved the way for the establishment of the ASEAN Economic Community, envisaged for December 2015, which has laid a foundation for a functioning single market and production base. The commitment to step on the path of AEC 2015 was induced to facilitate the activity of GVCs in the region in order to gain increasing competitiveness and thus a higher share in the crisis – hit world economy. Although the roadmap till 2015 included strict, regular monitoring by scorecard mechanism, they did not refrain from the ‘ASEAN-way’; dissents were mitigated by negotiations, sanctions were not applied. In order to achieve the goals set forth by AEC 2015. A new integrative agreement – ASEAN Comprehensive Investment Agreement (ACIA) - was agreed in 2009 and implemented in 2012. ACIA encourages such investments from third country investors (external to ASEAN), that are undertaking investments through their subsidiary based in ASEAN in further ASEAN member countries. Preconditions to be eligible for third country investor incentives are:

- The company owns or controls (appoints the majority of Board Members) the ASEAN legal entity
- The legal entity, which was established first in the ASEAN area, has to conduct real business activity.

Although some elements of AEC 2015 were not implemented fully by the original target date, it has created new opportunities for the regional integration and gradual unionization of a large trade and investment market with full global integration of the area. The attractiveness of the region is enhanced by the rapidly growing middle class of the region with huge demand for goods and services

(banking, insurance, tourism etc.) with an age pyramid relying on a broad base. In the meantime, Singapore has been experiencing a continuous decline, and the lowest level in birth rates worldwide for two decades, along with other East-Asian advanced economies such as Japan, Taiwan and the Republic of Korea – increasing the demand for healthcare services for the aging population.

AEC 2015 was not a final goal, but a point of reference which has been followed by the ASEAN Community Vision 2025, a roadmap titled: Kuala Lumpur Declaration on ASEAN 2025: Forging ahead together. The declaration signed by all members envisages a “future direction for a politically cohesive, economically integrated, socially responsible and a truly rules-based, people-oriented, people-centred ASEAN”. The document signed on November 22, 2015 unfolds the necessity of a rules-based approach and the adherence to international human rights principles in the ASEAN Political and Security Community 2025 Blueprint. Let us refer to Surin Pitsuwan’s analysis shared on ASEAN, in March 2016 in Budapest, where he suggested that in the implementation, the “ASEAN way” will still be followed, however.

The strategy towards AEC foresees by 2025 a “highly integrated and cohesive; competitive, innovative and dynamic community; with enhanced connectivity and sectoral cooperation” It includes “supportive policies towards innovation, science-based approach to green technology and development, and by embracing the evolving digital technology; promotion of good governance, transparency and responsive regulations; effective dispute resolution; and a *view towards enhanced participation in global value chains*” – as indicated in section 10.2 of the declaration.

There is empirical evidence, that TNCs look more and more on ASEAN as an integrated region. “Foreign multinational enterprises MNEs and ASEAN companies continued to expand in the region across a broad range of industries and in many cases with multiple investments. MNEs such as Aeon (Japan), Seven-Eleven (Japan), Continental (Germany), Alibaba (China) and ASEAN companies such as Axiata (Malaysia), Ayala (Philippines), San Miguel (Philippines), Keppel (Singapore), Maybank (Malaysia), RedDoorz (Singapore) and Siam Cement (Thailand) expanded in multiple ASEAN countries”. Looking at the 100 largest non-financial ASEAN domestic companies, 77 have operations in other ASEAN countries. The other 23 are purely domestically focused due to the nature of their business (ASEAN Investment Report, 2018). ASEAN countries with varying economic development levels entered differently into GVCs and have achieved different levels of integration. They are specialized in different industries, or within the same industry in different stages of production according to the comparative advantage of their domestic economy.

The region’s trade has substantially grown due to the conscious efforts to boost integration from 2007 with the ASEAN Charta and AEC-2015, 2025 strategy. Trade in goods, encouraged by cross-border fragmentation of production stages, increased from USD 2 trillion in 2010 to USD 2.8 trillion in 2018.



Global and Regional Value Chains in East-Asia, Recent Disruptions and Future Prospects

More than 60% of world trade occurs through global value chains (when production stages are realized at least in two countries. (UNCTAD, 2013, WTO 2019.). From the beginning of the 21st century, international organizations and national public policy focus strongly on GVC movements as they impact advanced/emerging and developing economies alike relying on data collected in input-output databases (OECD-WTO TiVA database, WIOD, APEC-TiVA, UNCTAD-Eora GVC Database etc.). A joint effort by IDE-JETRO, OECD, the Research Centre of Global Value Chains headquartered at the University of International Business and Economics (RCGVC-UIBE) in Beijing, the World Bank Group, and the China Development Research Foundation, published Global Value Chain Development Reports in 2017 and 2019 to shed light on developments till 2017, the latest input-output data availability. The growth of global value chains has slowed since 2008-09, measured by the GVC participation index.

Figure 3
World GVC participation from 1990-2018 (%)¹²

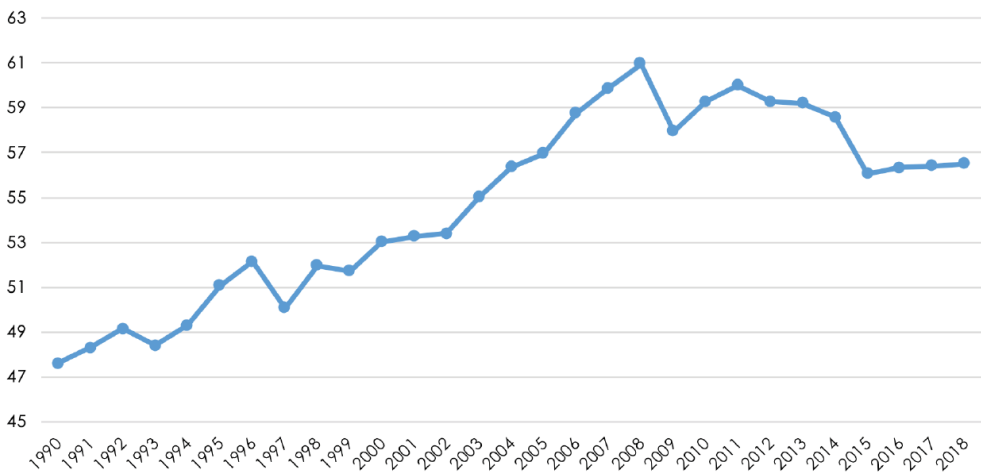
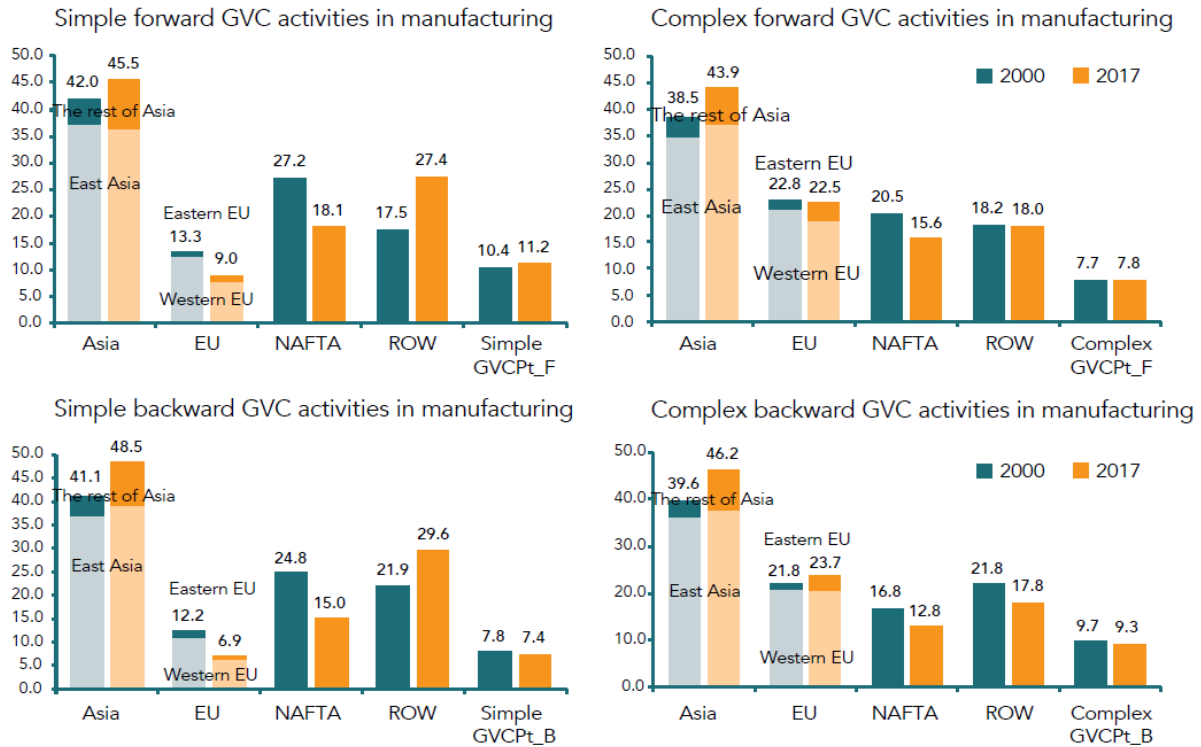


Figure 3. illustrates that the expansion trend of GVCs halted already with the 2008 Great Financial Crisis (GFC) and has not gained back momentum ever since. Discourses on possible de-globalization tendencies and reshoring of certain businesses started to emerge from 2012. While certain IP-Protection-sensitive Western-European medium-size producers withdrew from their Chinese ventures, the robust and expanding East-Asian market remained attractive for global manufacturers, placing certain stages of their production on the continent.

In spite of the declining trend, the expansion of complex global value chains (GVCs) was confirmed with the help of various input-output tables showing that the segment grew faster than GDP in 2017. In a more detailed picture, the growing importance of “Factory Asia” was identified, thanks to the increase of cross-country production sharing activities in the last decade and led by intra-regional complex GVC activities. The share of Asia’s total forward/backward complex GVC activities increased from 38.5% / 39.6% in 2000 to 43.9% / 46.2% in 2017 (WTO, 2019:20) to the detriment of “Factory America”. While in “Factory Europe” the increasing share and volume of GVC activity involving Eastern Europe can be seen on account of Western Europe from 2000 to 2017 (Figure 4).

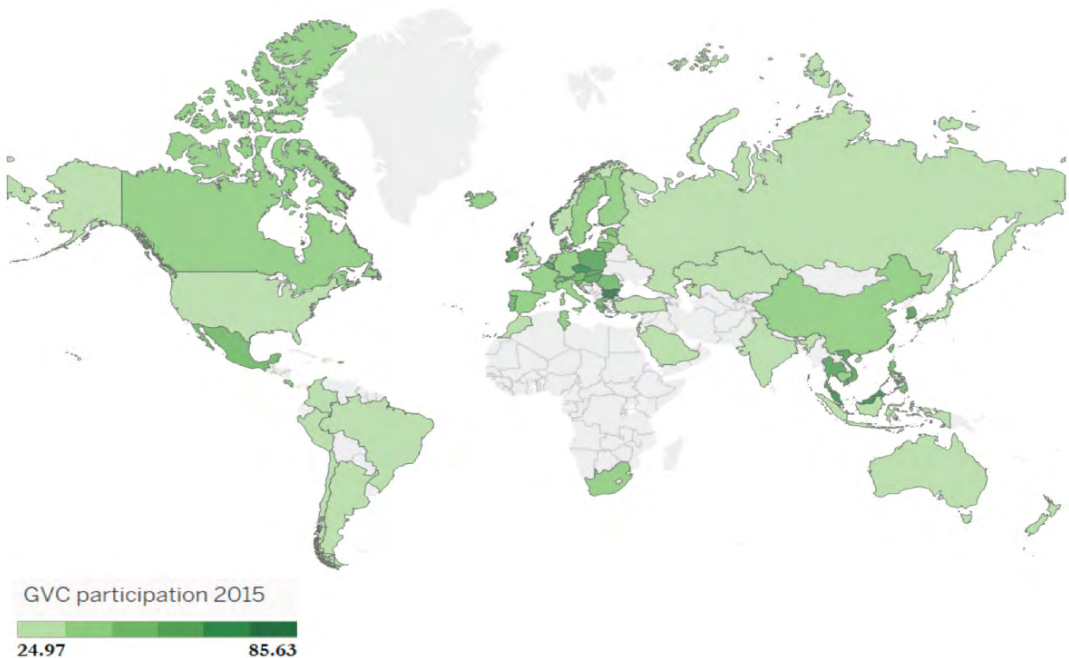
Figure 4
Forward and backward (simple/complex) GVC participation, share of intra-and inter-regional GVC activities in manufacturing, (%), 2000 and 2017, Asia¹³



Note: the last set of bars represent the overall GVC participation ratios for Europe. Data calculated from the UIBE GVC indexes derived from the ADB 2018 ICIO tables.



Figure 5
Global GVC Participation Index 2015¹⁴



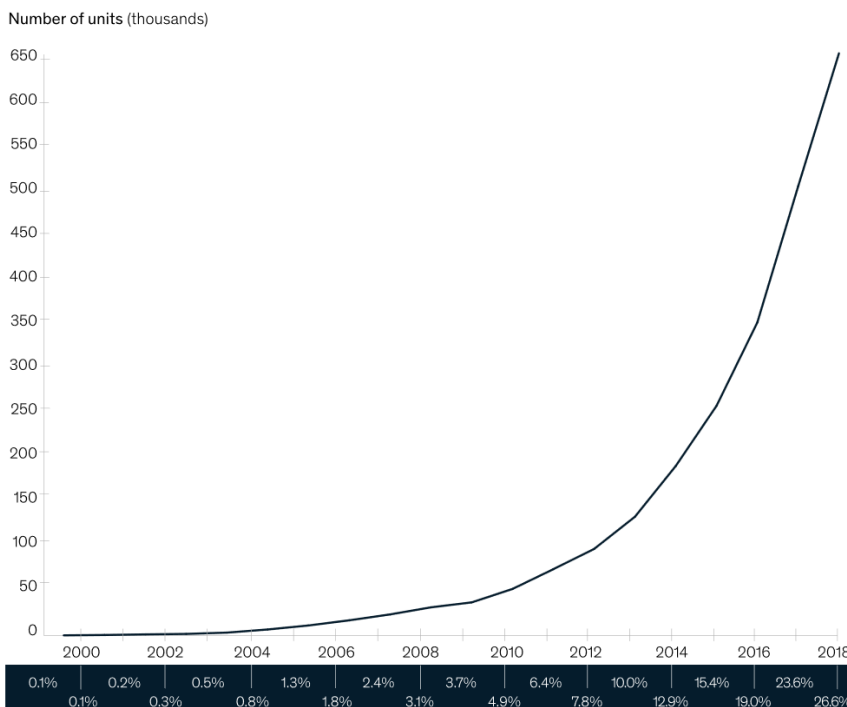
As Figure 5 presents with dark colours, both CEE and Southeast Asia show a high participation rate in global value chains, from the ASEAN countries particularly Singapore, Malaysia, Thailand and Vietnam. GVCs have made it easier for developing countries in East Asia to move away from export reliance on unprocessed primary products to step first into the simplest stage of manufacturing operations, e.g. electronics assembly activities. Research applying network analysis to illuminate the typology of foreign value added embedded in bilateral manufactured exports for the 2000-2015 identified major shifts in the period.

The substantial role of China in GVCs is reflected on Figure 5, too. Research into trade in value added regarding China has shown that integration of the Chinese economy into GVCs and reaching new export markets are achieved through foreign subsidiaries processing for manufacturing exports. However, the biggest contributor to GDP is the domestic private sector; firms plugging into the supply chains and generating a major part of the domestic value added (UIB-GVC, 2017). Certainly, the first wave of industrialization of East Asia from the end of the eighties, was dominated through production ties with Japan (described as the flying geese model with Japan's leading role). More recently, the role of ethnic Chinese business networks (Chinese diaspora) has increasingly become an important integrative driving force in promoting regional economic integration, both as a major source of inward investment to China, but also as important network connector, which links the Chinese market with the rest of the region.

These firms from advanced countries in the region use China as a low-cost manufacturing and export base, establishing production sites in China. At the same time, they have brought capital, technology and know-how into China. Xing and Zhang call it ‘regional network-based Chinese capitalism’, which has created hundreds of successful ethnic Chinese family businesses and networks interlocking medium-sized businesses in many countries in the region by the turn of the century. Thus contributing to the rise of China and her evolving “unavoidable” position in the regional GVCs and strengthening the Chinese economy (Xing, Zhang, 2009). This new pattern of regional integration is referred to in academic literature or economic journals as “Bamboo capitalism”, where the stages of the manufacturing process are carried out in various parts of the region before reaching their final assembly stage in China.

China’s emergence to the position of the world’s manufacturing base in the 21st century, was accompanied by the surging demand for industrial equipment. In China, operational stock of industrial robots has grown from less than 1,000 in 2000 to almost 650,000 in 2018, making the country home to an estimated one-quarter of the world’s robots and suggesting that China, as a manufacturing base, cannot be replaced in the short-term. The service network of major equipment manufacturers in China have a minimum of 100 branches, some up to 500 branches with 10,000 employees in aftersales service, to cover their installed base (McKinsey, 2020).

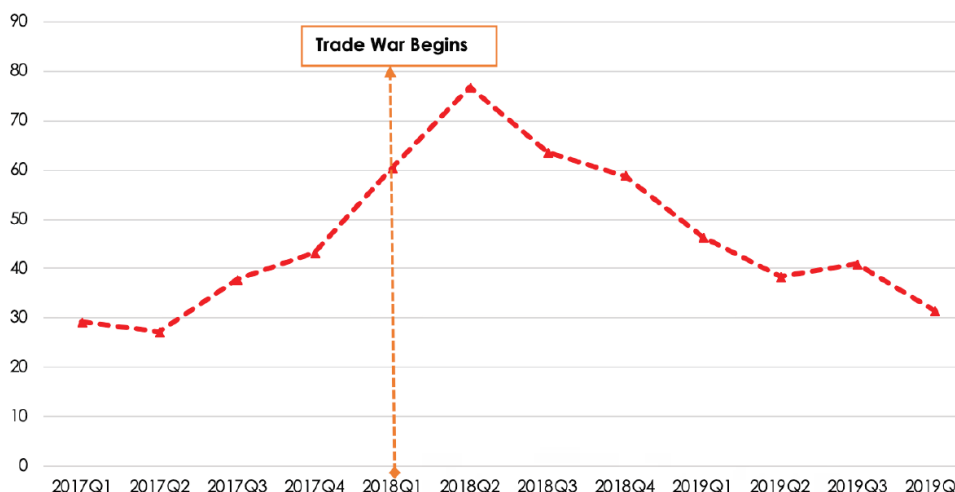
Figure 6
China’s operational stock of multipurpose industrial robots in 2000-2018¹⁵





Trade tensions between the US and China evolving from early 2018, have had a drastic impact on global trade growth (WTO, 2019) and on FDI into East Asia too, due to increased economic uncertainty affecting business confidence and investment decisions.

Figure 7
Greenfield FDI inflows to East-Asia from 2017 Q1 till 2019 Q4 in USD billion¹⁶



Authors of the ASEAN Integration Report 2019 warned, that although trade tensions between the US and China in 2018 “have not discernibly dented trade flows to and from ASEAN, although a few AMS have been more affected. Moving forward, however, further escalation of trade tensions could undermine trade flows as well as business and consumer optimism, with repercussions on regional integration and real economic activity.” In mid-2019, Moody’s ranked Singapore as one of the most vulnerable Asia-Pacific countries together with Hong Kong due to slowdown of Chinese demand that was clearly seen in the Singaporean GDP figures of the first half of 2019, despite ASEAN taking over the position of China’s largest trading partner from the US for the first time since 1997. Some analysts and consultants argued that ASEAN countries may benefit from the US-China trade frictions, as an alternative manufacturing base to China, for which there is empirical evidence. In May 2019, The American Chamber of Commerce in China conducted a survey among member companies in China on the impacts of the tariff increase. The survey addressed the tariff hikes announced for May and June 2019 from both sides, and concluded that the tensions certainly negatively impact the competitiveness of American companies; 40% of the respondents from 250 companies were considering or had already moved manufacturing out from China. A quarter of them considered Southeast Asia and 10.5% viewed Mexico as alternative location. Less than 6% considered moving manufacturing back to the US. (AmCham China, 2019). The rise in Chinese wages has seen low-value and labour-intensive tasks

in clothing, footwear and low-cost electronic parts manufacturing starting to move from China to Vietnam and Cambodia from 2015. Primarily, Vietnam has been seen as a possible alternative for relocation. As Vietnam cannot keep up with the giant size of the manufacturing base, India is positioning itself, with its Make in India campaign, for this role too. Nevertheless, nearly 40% of all green-field FDI into East Asia went to China in the 2017-2019 period as well, however, 15% of investments went to Vietnam in the same period. Research, based on microdata from the FT FDI Database between October 2018 and December 2019, identified 22 investments relocated from China that mostly went to Vietnam followed by Malaysia, Thailand and Cambodia (Gopalan (2020):19).

Even if the first phase agreement signed between the US and China on 15th January 2020 gave the first hope of easing the situation causing GVC disruptions, the outbreak of the Covid-19 epidemic in China and its turning into a global pandemic has brought a new shock for trade and investment activity within GVCs. In the electronic equipment segment, interwoven most strongly by supply chains with nodes in the epicentre of the Chinese epidemic outbreak as well, the impact was especially shocking. Relocation figures from China have still been relatively low, but the trend will certainly continue caused by the uncertainties attributable to Covid-19. Global companies are expected to diversify, for the long run, their supplier base and reduce their overdependence on China's manufacturing base. While it is widely known that Apple's huge assembly activity is taking place in the Chinese subsidiaries of the Taiwanese Foxconn, it is less known that 2/3 of their top ten suppliers are also located in East Asia. Disruption of supply chains due to border closures and lockdowns to contain the virus as well as falling demand in the globally uncertain situation still cast a dark shadow on East Asian economies where GVCs play a decisive role in their economic progress. The WTO confirmed 1.8% drop in total trade for 2019 in ASEAN and forecasts a drop of 13-32% in global trade across regions and a 40% drop in global FDI for 2020.(ASEAN Policy Brief No.3/July 2020). In the Joint Declaration of the Special ASEAN Summit on COVID-19 issued on April 14, 2020, ASEAN Leaders committed to keep markets open for trade and investment as well as strengthen ASEAN Economic Cooperation and Supply Chain Connectivity.

Conclusion

Where is the way forward from the two "black swan" events of the past 2.5 years that are still around reinforcing each other with major uncertainties? Is there a "New Normal" to come in East Asia? Sasidaran Gopalan, senior researcher of NTU CEM Singapore, claims that East Asian countries should learn to adapt to the partly de-globalized new realities, which will stay at least in the mid-term, while they should take advantage of new emerging opportunities. Hoe Ee Khor, chief economist of the ASEAN+3 Macroeconomic Research Office, established in Singapore in 2011, forecasts that the region realises the need to achieve compatibility between regional integration and globalisation. He believes that globalisation is here to stay – and Asia will remain one of the strongest advocates.



Looking at the developments from outside the continent, ASEAN member countries and businesses in their territory will certainly seek for more resilience, while still remaining closely connected to GVCs.

On the macro level:

- greater preparedness is needed for unexpected events and greater adaptability encouraged by policies
- according to capabilities and endowments, AMS countries should intend to move up the value chain by upgrading technology and human capital
- diversification shall be pursued in the economy e.g. best practice examples of Singapore advancing from electronics to biomedical research and biotechnology. Both sectors have shown robust growth in the first half of 2020; upgrading public health service after lessons from SARS in 2003 or, in the case of Malaysia, specializing in PPE manufacturing with great demand in the time of Covid-19 (Malaysia had 14.2% world market share in PPE production in 2018)
- stronger focus on institutionalization of integration and positioning ASEAN as a common investment platform with different merits in different tasks and functions in order to benefit from the shortening of supply chains with more regional scope

On the micro-level:

- companies started to realise the risks associated with the utmost fragmented production processes and extreme globalisation. Consultancy firms strongly promote this approach
- contingency plans are prepared for corporations to focus on more resilience including multiple suppliers for key components to enable shift if necessary
- overdependence on Chinese manufacturing is being reduced by diverting new investments of foreign and Chinese producers to alternative locations, mainly in ASEAN, to still service the growing Asian market
- shorter and more localised supply chains will hopefully lead to closer cooperation between state governance and foreign and local firms in considering the social component in order to avoid the circumstances for migrant workers which surfaced in Singapore with Covid-19

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Endnotes

Endnotes

- 1 Global strategy advisor and Senior Research Fellow, Lee Kuan Yew School of Public Policy, National University of Singapore, member of the World Economic Forum's Global Agenda Council on Geoeconomics. Khanna held a lecture on 16.3.2017 at Corvinus University of Budapest, as well, at the invitation of the PAGEO Foundation.

- 2 In the paper, East Asia is applied to East- and Southeast Asia together
- 3 Refers to the Agreement signed by US, Japan, Germany, UK and France in New York Plaza Hotel to offset trade surpluses in Japan and Europe against US, causing JPY's 50% appreciation against USD and DM
- 4 Some believed that Surin Pitsuwan had a chance to be elected as General Secretary of the UN, against Ban ki-Moon, but since another party than his came to power in Thailand, he was not nominated. The author participated in the conference on 31.3.2016 at IFAT Budapest and took precise notes of the lecture.
- 5 Founding members of ASEAN: Indonesia, Malaysia, Phillipines, Singapore, Thailand. Brunei joined in 1984
- 6 Source: ASEAN Statistical Yearbook 2012. Graphic 5.1. p. 62.
- 7 Source: ASEAN Statistical Yearbook 2012. Graphic 5.5. p. 64.
- 8 From 2010, the product group is specified with the HS code 85: Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles acknowledging the cross-border fragmentation of the manufacturing processes worldwide
- 9 Source: author's calculations based on various tables from ASEAN Statistical Yearbook 2001, 2012, 2019
- 10 Source: author's calculations based on ASEAN FDI Database, ASEAN Statistical Yearbook 2001, 2019
- 11 Source: author's calculations based on ASEAN FDI Database, ASEAN Statistical Yearbook 2001, 2019
- 12 Source: Gopalan S. NTU CEM (2020) p. 7. Figure 5. (based pm UNCTAD Eora Database)
- 13 Source: Global Value Chain Development Report. WTO 2019 p.22. Figure 1.11
- 14 Source: Gopalan, S. NTU NCEM (2020) p. 23.
- 15 Source: Chesnais Th. & Wu, T. (2020), McKinsey & Company Article August 14th, 2020.



The EU-ASEAN Ties: A Strategic Partnership?

*Assessing the Development of Relations through
the Lens of Political and Economic Cooperation*

ZOLTÁN PÁLDI¹

Abstract: The European Union and the Association of Southeast Asian Nations are both fundamental international organizations in their respective geographical regions, striving to become key players in shaping the global political landscape, reaching out far beyond their borders. In light of this, one might think it was already timely to raise the two blocs' partnership to the strategic level. Analysing official documents, and drawing upon previous researches in the field and a number of in-depth interviews with stakeholders from both sides of the EU-ASEAN ties, this article has given an outline on the development of relations between the two entities, with a particular focus on the political and economic domains. Highlighting the efforts made to pursue the elevation of ties to a Strategic Partnership, it concluded that ASEAN still primarily regards the EU as a trading partner with limited weight as a political and security actor. Protracted bilateral disputes between the EU and certain ASEAN member states also hindered the upgrade of relations for some time. The article argued that even though much has been done lately to approximate the two organisations' viewpoints, and the long-awaited official announcement of the EU-ASEAN Strategic Partnership that finally happened in December 2020 was beyond doubt an important milestone, there is still work to do to further streamline the ties.

Keywords: ASEAN, European Union, strategic partnership, regionalism, multilateralism

Introduction

Since its founding in 1967, the economic and political role of the Association of Southeast Asian Nations (ASEAN) has increased immensely both within its region and beyond, and the number of its member states doubled from the initial five². The global significance of the European Union (EU) is also unquestionable, especially in the economic domain. Being two of the world's most advanced regional groupings, ASEAN and the EU are both fundamental international organizations in their respective geographical regions, striving to become key players in shaping the global political landscape, reaching out far beyond their borders. In light of this, one might think it was already timely and obvious to raise the EU-ASEAN partnership to a strategic level. However, due to certain

asymmetries in their relations and a number of ongoing disputes and tensions between the EU and some of the ASEAN member states, this is by no means as straightforward as it may first seem.

The main guiding principle throughout this paper is to point out the way that led to the formalization of the ASEAN-EU Strategic Partnership in December 2020, a goal that the EU had been particularly keen to realize, at least in the last couple of years. Analysing official documents, and drawing upon previous research in the field and a number of in-depth interviews with stakeholders from both sides of the EU-ASEAN ties, this article aims to give an outline regarding the nature of relations between the two entities. Following a brief comparison of ASEAN and the EU, and an overview of the development of ties between the two institutions, the article attempts to shed light on the possible benefits of a strategic partnership between the blocs. It highlights the shifts in the EU's attitude towards ASEAN in the pursuit to be recognised as a Strategic Partner of the Southeast Asian grouping, arguing that the formal elevation of ties may increase the EU's recognition as a key political and security actor not only in the Indo-Pacific region but also in the global arena. In the subsequent section of the paper, economic ties are discussed, with a special focus on some of the main trade-related issues between the EU and certain ASEAN countries, such as the (planned) withdrawal of benefits granted to Cambodia and Myanmar under the Everything But Arms scheme or the so-called "palm oil case" that has been souring the EU's relations with Indonesia and Malaysia over the recent years. The last section concludes the paper and places its findings into a wider context.

Comparing the Main Characteristics of ASEAN and the EU

Originally, both ASEAN and the European Economic Community (EEC), the EU's predecessor, were established with the aim of enhancing stability and economic development in their respective regions. It is also worth noting that both organizations were accorded legal personality around the same time, via the ASEAN Charter in 2008 and the Lisbon Treaty in 2009, respectively. Certain institutional similarities can also be found between ASEAN and the European Union – take for instance the EU's Foreign Affairs Council and the ASEAN Foreign Ministers' Meeting, or the European Council and the ASEAN Summit, although the latter sits less frequently and has no legislative function. Upon having a closer look at their structure, however, one may conclude that the two represent different types of integration. While the EU is a supranational entity, ASEAN is a much looser, intergovernmental organization (ASEAN Secretariat [ASEC], 2008). Also, there is no institution resembling the European Parliament in ASEAN.

Apart from these, there are a number of other significant differences, too. Unlike the strict bureaucratic structure of the EU, the Association of Southeast Asian Nations operates via an extensive network of working groups and meetings of a more informal nature, guided by the so-called "ASEAN Way". This encompasses principles such as



non-interference into each other's interior affairs and a soft diplomacy approach where decisions are made with consensus reached via long consultations in a non-confrontational, informal manner, often referred to as “*musjawarat-mufakat*” in the Malay culture. No final decision is taken without the consent of all the member states, and the lengthy negotiations conducted in a conflict-avoiding manner provide delegates the opportunity to deepen their relations with each other, which helps fortify unity within ASEAN (Barbi, 1982). This method has not changed since the establishment of the organization, moreover, this unique system of soft institutions arguably proved to be the secret of ASEAN's stability throughout its existence of more than fifty years. At the same time, this time-consuming process of decision-making may result in limited effectiveness in certain situations that require prompt actions (Páldi, 2019).

Another important difference is the depth of integration. With the single market and the free movement of goods, services, capital and persons, the EU is currently the most integrated economic community in the world where the same trade policies and regulations apply to all member states, in almost every sectors. ASEAN, on the other hand, is still a long way from becoming a unified market even though the establishment of the ASEAN Economic Community (AEC) at the end of 2015 was an important milestone towards this way, and the ASEAN Economic Community Blueprint 2025 sets out even more ambitious goals. ASEAN member states favour upholding their sovereign trade policies and this is unlikely to change anytime soon. Nine out of the ten ASEAN countries (with Thailand being the only exception) are former colonial states who regained independence not long before the organization was established, hence keeping their political and economic sovereignty is of utmost significance to them even if this means that regional integration has to happen at a slower pace.

Despite differing in structure and approach, ASEAN and the EU still share similar core values. Over their decades of existence, both of them grew out to be fundamental organizations in their respective geographical regions, striving to become key players in shaping the global political landscape, reaching out far beyond their geographic borders. In light of this, one might think that the EU and ASEAN would make natural allies.

A Brief Overview of the History of the EU-ASEAN Partnership

The relations between ASEAN and the EU look back on a history spanning over almost half a century. The first ministerial level contact between ASEAN and the EEC took place in 1972, subsequently, ties formalized in 1977 when the EEC became ASEAN's Dialogue Partner (European External Action Service [EEAS], 2020). The year 1978 saw the first-ever ASEAN-EEC Ministerial Meeting and in 1980, a commercial-, economic- and development-focused Cooperation Agreement was signed providing legal framework for regular Ministerial Meetings and Joint Cooperation Committee (JCC) sittings between the two entities (EEC, 1980).

The changing geopolitical landscape with the end of the Cold War, and the impressive economic growth realised by the ASEAN states created the need to step up cooperation and review the framework of relations (European Commission [EC], 1996). Besides the economic achievements, the political weight of ASEAN also grew with the 1994 establishment of the ASEAN Regional Forum (ARF), the first region-wide Asia-Pacific multilateral platform for fostering consultation on political and security issues. Initially, the ten ASEAN member states and Dialogue Partners (including the EU) were granted membership to ARF and over the years, the number of members rose to 27.³

ASEAN's increasingly important role further added to the EU's motivation to strengthen political dialogue, although this intention was not always reciprocal. While the EU has been participating at ARF since the forum's inaugural sitting in 1994, this is not the case with the East Asia Summit (EAS) which was formed in 2005 by the ten ASEAN member states plus Australia, China, India, Japan, New Zealand and South Korea. Aiming to provide leaders a forum for strategic dialogue and cooperation regarding the East Asian region's key challenges, EAS is akin to ARF in many ways, though contrary to the ministerial-level ARF, EAS is conducted at the highest level with the participation of heads of government from respective member states hence its relevance is also significantly higher. Although the EU has been signaling its interest to engage with the EAS since as early as 2007 (EC, 2007), its admission still hasn't been considered yet. Russia and the United States however, managed to gain membership in the meantime in 2011. This implies that, as opposed to the above two powers, the EU is considered a less significant actor in the region from a political and security point of view.

In order to change this, the EU decided to step up efforts and in the EC's Communication titled "A new partnership with South East Asia", expressed its endeavor to revitalize relations with the region (EC, 2004). The initiative found welcoming ears in ASEAN, and in 2007, at their 16th Ministerial Meeting in Nuremberg, the two organizations accepted the Declaration on an EU-ASEAN Enhanced Partnership (EC, 2007a). The parties also agreed to work out a Plan of Action for the period of 2007-2012 to realize the enhancement of cooperation in the fields of political, economic and socio-cultural cooperation along the guidelines set by the Nuremberg Declaration (ASEC, 2007). Further ambitious steps along the way for the following five years were enshrined in the Bandar Seri Begawan Plan of Action to Strengthen the ASEAN-EU Enhanced Partnership (2013-2017) in 2012.

In summary, four decades after the first contact and 35 years after formalizing the ties, relations between the two organisations had evolved to a strengthened and enhanced status. As a next step, at the 20th EU-ASEAN Ministerial Meeting in 2014, held under the theme "Towards Strategic Partnership for Peace, Stability and Prosperity", the EU proposed to upgrade further the ties and elevate them to the highest level, declaring a strategic partnership. ASEAN, while not openly rejecting the idea, opined there is still work to do in this domain and the instant elevation of the status of relations eventually did not happen. Instead, as stated in the Co-Chairs' Statement issued after the Meeting, the sides merely "agreed



to work towards the upgrading of the partnership to a strategic one" (Council of the European Union, 2014). Similarly, the next Ministerial Meeting in 2016 in Bangkok did not produce spectacular results either with the parties only resolving to "accelerate efforts in working towards a strategic partnership" (ASEC, 2016).

The year 2017 marked the first-ever, and so far the only, formal summit at leaders' level⁴ in the joint history of the two blocks. During the event entitled "ASEAN-EU Commemorative Summit on the Occasion of the 40th Anniversary of the Establishment of ASEAN-EU Dialogue Relations", the leaders welcomed the adoption of the new ASEAN-EU Plan of Action 2018-2022 and once again reiterated their intention to achieve strategic partnership (ASEC, 2017).

The Summit apparently gave a new momentum to the ties and ASEAN finally seemed to give in, its leaders agreeing upon giving their consent to the long-awaited strategic partnership, which was supposed to be announced at the 22nd EU-ASEAN Ministerial Meeting on January 21, 2019 in Brussels. However, in the last minute, Indonesia and Malaysia vetoed the deal as a de facto retaliatory measure against the recast of the EU's renewable energy directive (RED II) which in their view takes discriminative measures against palm oil, one of the main export commodities of the two countries. As a result, on the Ministerial Meeting, the sides only agreed "in principle to upgrade EU-ASEAN relations to a Strategic Partnership, subject to details and timing to be worked out" (ASEC, 2019a). So, following years of reluctance, this time, bilateral trade-related issues between the EU and certain ASEAN member states turned out to be the showstopper that stalled the planned elevation of ties.

This stalemate lasted for almost two years, with Indonesia and Malaysia seeming quite rigid regarding their standpoint. Still, despite the less than favorable outlook, a historical breakthrough was reached at the next, 23rd ASEAN-EU Ministerial Meeting on December 1, 2020. The parties agreed on conducting the inaugural session of the joint working group on vegetable oils in early 2021, a platform on which the EU and relevant ASEAN member states can hopefully work their way towards resolving the palm oil issue, and simultaneously, the formal upgrade of ties to a Strategic Partnership did also eventually take place. It is important to point out, however, that oddly, the official five-page long communique of the 23rd ASEAN-EU Ministerial Meeting touches upon this important milestone in a rather brief manner, merely informing that the parties "elevated the ASEAN-EU Dialogue Partnership to a Strategic Partnership" (ASEC, 2020a). On the other hand, the texts goes unusual lengths to commend the EU's contribution to help ASEAN mitigate the effects of the Covid-19 pandemic and to highlight the "robust economic cooperation" between the two entities. In light of the above, one may conclude that the elevation of ties happened not necessarily as a result of the ripeness of relations between the two organisations, but rather because of the stakeholders' necessity to put aside their assertiveness in favor of the post-pandemic economic recovery against the background of a changing global landscape. How the parties will fill the freshly elevated cooperation with actual content remains to be seen.

The Benefits of a Strategic Partnership

Even before becoming officially announced strategic partners, the two entities already shared an extensive set of platforms for consultation such as the ASEAN-EU Ministerial Meeting, the ASEAN-EU Senior Officials' Meeting, the ASEAN-EU Joint Cooperation Committee, or even ARF and the Asia-Europe Meeting (ASEM), among others. All these are regularly convening forums. Besides, a senior official at the Ministry of Foreign Affairs and International Cooperation of Cambodia pointed out, the so-called Guidelines for ASEAN's External Relations, an internal document adopted at the 47th ASEAN Foreign Ministers' Meeting in 2014, do not provide definitions of any kind regarding strategic partnership. The Guidelines list the different categories of engagement with external partners, namely Dialogue Partnership, Sectoral Dialogue Partnership, Development Partnership, and statuses such as Special Observer and Guest⁵ but there is no mention regarding enhanced, comprehensive or strategic partnerships (Sok, 2020). In light of this, the question may rightfully arise: what would be the actual benefits of a strategic partnership, and what is in it for the EU that was worth long years of pursuing?

Based on the dynamics of relations between ASEAN and its other strategic partners, the much-discussed elevation of partnership with the EU would bring about only one tangible difference, namely the possibility to hold summits regularly, typically at a biannual basis. While it does not sound much at first, the idea of regular ASEAN-EU Summits is not something to belittle; much more weight could be put behind the talks if there are regular high-level interactions between the sides, and it would naturally deepen political ties. On top of this, the formal establishment of strategic partnership could also serve as a steppingstone for the EU to achieve some long-standing political goals in the region like gaining admission to other ASEAN-led platforms such as the EAS or the ASEAN Defence Ministers' Meeting Plus⁶ formation.

ASEAN currently has ten Dialogue Partners, of which eight had already been granted strategic status before the EU. The EU-ASEAN Dialogue Partnership commenced in 1977 and it took more than four decades for the ties to reach the level of Strategic Partnership. China, in comparison, became ASEAN's first strategic partner in 2003, even though the status of ties between the two sides only emerged to a full Dialogue Partnership in 1996 (ASEC, 2020b). The latest addition to the list of strategic partners before the EU was Russia in 2018, with whom official dialogues formalized in 1996, similar to China (ASEC, 2019b).

The above once again indicates that the EU, despite being an important economic partner, is still not significant enough as a political and security actor in the eyes of ASEAN. This is a bitter pill to swallow for the EU, who is striving to increase its role as a global security provider and, in general, to create a 'stronger Europe' as set out in its 2016 global strategy (EEAS, 2016). In the wake of Brexit, and with Euroscepticism on the rise, these goals gain even more importance. Herein lies the real benefit: the recent recognition of the EU as ASEAN's strategic partner is expected to contribute to solidifying EU's image both in the Indo-Pacific region and at the global table.



Still, in the Co-Chairs' Press Release of the 23rd ASEAN-EU Ministerial Meeting, the official communique of the event, there is no hint yet to the EU's planned accession to important ASEAN-led platforms such as the EAS or the ADMM Plus, neither there is a mention of any specific tangible goals that may directly stem from the long-awaited upgrade of relations. Even though strategic partnership is an existing and frequently used phrase in the dictionary of ASEAN, it still lacks clear definition (Sok, 2020), so now that the EU-ASEAN ties have officially been elevated to the highest level, the main question is how to fill them with content.

Shifts in Attitude

In recent years, the EU put great efforts into deepening its ties with ASEAN. However, this had not always been the case. In the first three decades of the Dialogue Partnership, the central focus was mainly on the development of economic relations (Camroux, 2008) while, from a political point of view, the EU did not attribute much attention to the region and adopted a somewhat condescending attitude (Xuechen, 2018). Over concerns for human rights issues, the EU even suspended the meetings with ASEAN after the 1997 accession of Myanmar for a period of almost three years. This underlines that in their relations with ASEAN, the EU traditionally perceived itself as a role model, and felt obliged to promote its views in the region on human rights and democracy. The EU's norm-exporting attempts were met with the ASEAN member states' resentment as they deemed such actions as a violation of their basic principle of non-interference. However, even though political talks were on hold, trade and dialogue in the field of common economic interests did not cease between the two blocks (de Flers, 2010).

After the turn of the millennium, parallel to ASEAN's increasingly impressive economic growth and rising interregional political significance, the EU changed its approach as it gradually started to comprehend the nature of Southeast Asian integration and its main guiding principles, and dampened its norm-setting attitude (Xuechen, 2018). While the 2007 Nuremberg Declaration and its message to enhance the EU-ASEAN partnership was an important milestone exhibiting the will to start a new era in the relations, it was in 2012 when the EU started to noticeably put more political focus on Southeast Asia (Nuttin, 2017). Besides the ambitious Bandar Seri Begawan Plan of Action, in the same year, the EU also acceded to the Treaty of Amity and Cooperation in Southeast Asia (TAC), as the first regional organisation to do so. The TAC, originally a product of the first-ever ASEAN Summit in 1976, is an important cornerstone of ASEAN's philosophy, technically a peace treaty promoting non-use of force, non-interference, territorial integrity and equality.

Besides being a precondition for membership of the East Asia Summit, signing the TAC was also a gesture from the EU to acknowledge ASEAN's central role in the region and to express respect towards the fact that the Southeast Asian states chose a different path of integration than that of Europe. Since then, the EU has been actively emphasizing that they are 'natural partners' with ASEAN and theirs is a "partnership of equals", what is more, the EU's 2016 global strategy expresses

support for “an ASEAN-led regional security architecture” (EEAS, 2016). In 2015, to further demonstrate commitment, in addition to its already existing bilateral diplomatic missions in the region⁷, the EU launched a separate mission dedicated exclusively to oversee ASEAN affairs and to underline its ambition to elevate the ties to a strategic one (EEAS, n.d.).

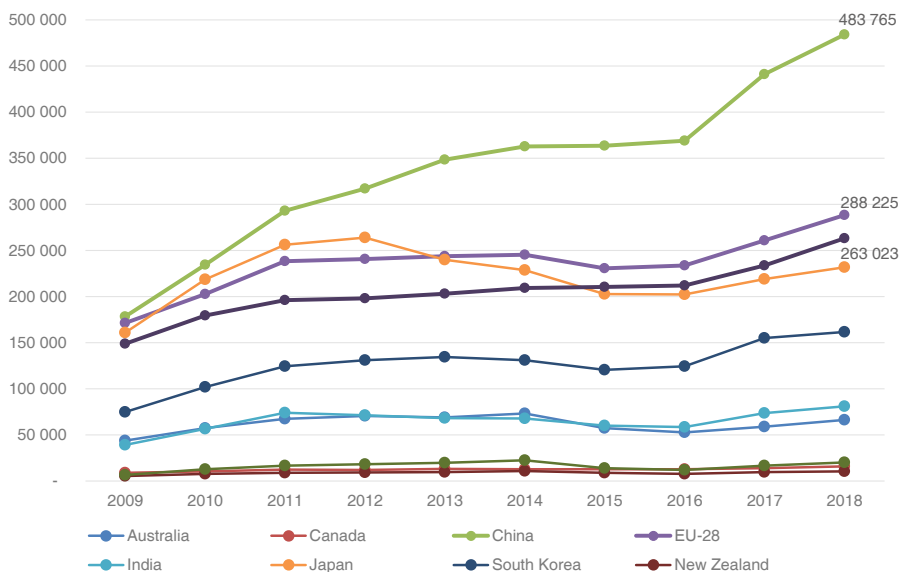
Although there is no universal definition to it, a partnership of strategic nature may imply a comprehensive approach in which participants share common goals and somewhat similar views, and conduct cooperation in a wide array of areas such as the trade, political and security dimensions, *inter alia* (Tyushka & Czechowska, 2019). Economic ties have always been strong between the EU and ASEAN. In the political dimension, too, despite some asymmetry, much has been achieved for the approximation of views and to better understand each other’s motives, especially in recent years. In the area of security dialogue, however, there is quite some disparity between the two organisations and still much room to grow. This is despite the EU engaging into cooperation with ASEAN in certain fields, such as maritime and non-traditional threats (e.g. cybercrime). ASEAN is already an accomplished actor even in the broader region, as it managed to balance between great powers such the US and China, and initiated and led pioneering platforms for regional political and security discussions in the Indo-Pacific. Whereas, to paraphrase the words of Belgium’s then-Minister of Foreign Affairs, Mark Eyskens from 1991, the EU, even though an economic giant, is still viewed as “a political dwarf and a military worm” in the Southeast Asian region. ASEAN and its member states still primarily regard the EU as a trade partner, with relatively marginal influence in the political and security domains.

Economic Ties and the State of Play of Free Trade Agreements

Throughout its history, economic ties have always been the strongest leg of the EU-ASEAN relations. Even the first-ever contact between the two entities, in June 1972, was economy-related in nature, when the Commission received an ASEAN delegation led by the Indonesian Minister of Trade, to discuss trade benefits (EC, 1996), and since then, trade has never stopped being the centrepiece of ties. There are a number of instruments and platforms in place to help further strengthen the economic cooperation and facilitate ASEAN-EU trade, such as the regular meetings between the ASEAN Economic Ministers and the EU Trade Commissioner or the ASEAN-EU Business Summit. As Diagram 1 shows, trade has been steadily growing between the two regions during the last decade as well. In 2018, the EU was ASEAN’s second largest trading partner, surpassing the US and preceded only by China, whereas ASEAN was the third most important trading partner for the EU, following the US and China, with the total EU-ASEAN trade in goods amounting to EUR 235 billion or USD 288 billion (ASEC, 2019c). This means that during the course of ten years, merchandise trade grew more than 70% between the two blocks, while trade in services more than doubled, from EUR 40 billion in 2007 reaching EUR 88.3 billion in 2017 (EEAS, 2020).

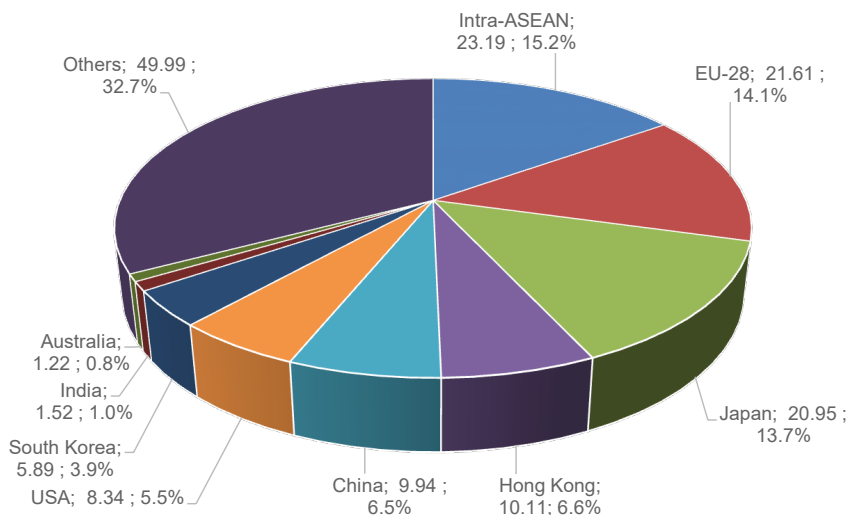


Diagram 1
ASEAN Trade in Goods by Most Significant Trading Partners
(2009-2018), in USD milion⁸



As seen on Diagram 2, with USD 21.61 billion, the EU was the biggest provider of foreign direct investment (FDI) in ASEAN in 2018 (not counting intra-ASEAN investments), providing 14.1% of the total FDI influx, followed by Japan (13.7%), Hong Kong (6.6%), China (6.5%) and the US (5.5%) (ASEC, 2019c).

Diagram 2
FDI in ASEAN in 2018 by Source Country in USD billion⁹



ASEAN has already signed free trade agreements with six¹⁰ out of its ten Dialogue Partners (or six out of its nine Strategic Partners, for that matter), namely Australia, China, India, Japan, South Korea and New Zealand (ASEC, n.d.). As for the European Union, the intention of establishing an ASEAN-EU Free Trade Agreement (FTA) was officially announced in 2006. Talks started in 2007 only to quickly come to a halt in 2009 due to a number of complications, mainly because the differences in the levels of development between ASEAN member states were too great and their diverging interests regarding the deal. Myanmar's position, then still boycotted by the EU over human rights issues, also hindered the progress (Cuyvers, Chen, Goethals & Ghislain, 2013). As a result, negotiations were reoriented towards bilateral trade agreements between the EU and certain ASEAN member states, with the idea that these pacts may function as building blocks for a future region-to-region FTA (EEAS, 2020).

The EU's two most important trading partners within the ASEAN are Singapore and Vietnam so it does not come as a surprise that agreements with them were the first to realise. With Singapore, negotiations started in 2009, finished in 2015, the FTA was signed in 2018, and entered into force on November 21, 2019. Talks concerning the trade agreement with Vietnam began in 2012, concluded in 2013, the signing took place in 2018, and August 1, 2020 marked its coming into force (EC, 2020a). The EU-Malaysia FTA negotiations were launched in 2010 but Malaysia requested to put them on hold in 2012 as they reached an impasse. In 2016-17, a stocktaking exercise was conducted to look into the possibilities of resumption. However, the "palm oil issue" that since emerged and related to the EU's RED II directive soured ties, making a resumption highly unlikely. For the same reason, talks over a comprehensive economic partnership agreement with Indonesia, the world's largest palm oil producer, slowed down significantly despite a promising start in 2016. With Thailand, negotiations about an FTA commenced in 2013 but halted the next year as the result of the military take-over. With an elected Thai government back in place, in 2019, the EU expressed its openness to resume talks. Regarding the trade and investment agreement with the Philippines, so far, two negotiating rounds took place in 2016 and 2017 but no date has been set yet for the next round. As per Myanmar, shortly after the country embarked on a process of democratic reform in 2011, the EU lifted its sanctions and in 2014, negotiations on an investment protection agreement commenced, though, due to the Rohingya crisis, its progress stopped in 2017. With Brunei, Cambodia and Laos, no negotiations have started yet (EEAS, 2020). Overall, in the last ten years, bilateral trade agreements were completed with only two countries in the region, and talks are currently ongoing with another two. That is not even half of the ASEAN member states, while negotiations with the rest of the members are on hold, or have yet to commence.

In 2017, after the US withdrew from the Transatlantic Trade and Investment Partnership, the EU and ASEAN rewarmed to the idea of their region-to-region trade pact and established a Joint Working Group to set out parameters for a possible future agreement (EC, 2020b). Until now, the group met three times, with February 2020 marking the latest sitting, however, the ambitious interregional FTA is not on the horizon yet, even though the Co-Chairs' Press Release of the 23rd ASEAN-EU



Ministerial Meeting on December 1, 2020 testifies about the two organisations' commitment to further efforts towards creating a practical framework for it. The realistic assessment is that sealing bilateral free trade deals with all ten ASEAN countries is nearly impossible as not all of them are ready yet to enter into such a pact with the EU. Not to mention that the EU is also reluctant to engage in talks with some of these countries over significantly conflicting views regarding certain core principles such as democracy or human rights. That said, pursuing the pipe dream of a region-to-region FTA still reflects genuine political will on both sides, and it is definitely a good-sounding motto that can be utilized to build momentum in the region towards integration and free trade, notions that are highly endorsed by the EU globally.

Economy-related Controversies

Though its member states are much more loosely integrated and are far from being as unified as the European single market, it does not mean ASEAN is not striving to step up its processes of integration, a venture the EU is happy to support while also promoting its own role as a "partner in integration" (EEAS, 2015). In order to underpin its purpose to scale up partnership, on top of the bilateral development support to the respective ASEAN member states totaling EUR 2 billion, the EU is also the biggest donor to the ASEAN Secretariat, providing EUR 200 million of grant funding in the 2014-2020 period to the ASEAN Secretariat (EEAS, 2019). This is more than double the amount of funds provided in the 2007-2013 cycle, and ten times as much as the ASEAN member states' accumulated annual contribution to ASEC of USD 2 million each. The EU development funds granted to the ASEAN Secretariat along with the EUR 94 million ARISE Plus¹¹ instrument is mainly used to enhance economic and trade connectivity within the block.

The generous support from the EU unquestionably contributes greatly to ASEAN's integration process. However, it may also come with some side effects as it may amplify the undesirable stereotype still prevailing in some ASEAN countries, namely that the ties between the two entities can be described merely as a top-down 'donor-recipient' relationship. This contradicts the EU's intention of diversifying and deepening the dimensions of cooperation. What is more, this is by no means the only thing that may come off controversially in the eyes of certain ASEAN member states.

Another example is the "Everything But Arms" (EBA) arrangement in regard to Cambodia and Myanmar. Under the EU's EBA initiative, as part of the Generalized Scheme of Preferences, products from states classified as Least Developed Countries¹² enjoy duty and quota free entry to the European single market as stipulated in the Regulation (EU) No 978/2012. However, in 2018, over concerns regarding political, labor and human rights in Cambodia and Myanmar, the EU stepped up its engagement and initiated investigations that could possibly result in the suspension of benefits granted to these countries under the EBA scheme. This is a serious threat, since the EU is one of the most important markets for both Cambodia and Myanmar, and thanks to EBA, export to the European Union grew immensely from both countries over the last couple of years.

An EC report from February 2020 states that since Myanmar had shown considerable progress in some key issues over the last two years, the EU would not yet exclude the country from the benefits of EBA, although it would continue its enhanced engagement and closely monitor the situation of human rights and other areas deemed problematic (EC, 2020c). The outcome in the case of Cambodia was less favorable: progress was assessed as insufficient and eventually, via a delegated regulation effective from August 12, 2020, the EBA benefits were partially withdrawn, affecting some one-fifth of the annually EUR 5 billion strong Cambodian export towards the EU (EC, 2020d). This may naturally disrupt ties, not to mention that the (partial) withdrawal of the EBA benefits, or even the threat of it (as was the case with Myanmar) might help push the affected countries onto China's lap. In addition, since decision-making in ASEAN works based on consensus, with every member states having the right to veto, tensions with Cambodia and Myanmar could potentially obstruct the EU in reaching its goals with the Southeast Asian bloc, despite the newly obtained strategic status.

In addition to the above, the issue that spurred the most tensions and drew the biggest media attention of late was the EU's RED II directive and its effects related to palm oil. The original Renewable Energy Directive (2009/28/EC) is set to expire at the end of 2020, and a recast had been in preparation since November 2016 and finally, the revised directive or RED II (2018/2001/EU) for the 2021-2030 period gained shape and entered into force in December 2018. As a major change compared to its predecessor, RED II classifies palm oil as a commodity with high indirect land-use change (ILUC) risk that technically means it is not sustainable and therefore it shall be gradually phased out of biofuels used in transport by 2030. Since this may potentially reduce the influx of palm oil to the EU, the directive sparked outrage in Indonesia and Malaysia, the two biggest palm oil producers in the world. The palm oil industry has extraordinarily big lobby power in both countries, so it is hardly surprising that as a de facto response to RED II, the brake was pulled on the announcement of the EU-ASEAN Strategic Partnership at the last minute and the official elevation of ties did not happen as originally planned in January 2019.

While the EU's main concerns regarding palm oil are related to the environmental damage the palm oil industry may cause, the standpoint of Indonesia and Malaysia is that the sector contributes to the Sustainable Development Goals (especially to SDG1 regarding poverty eradication) by providing livelihoods for millions of people in the two countries. They claim that RED II singles out palm oil of all the vegetable oils, and that the EU is running a discriminatory campaign against the commodity with the aim of replacing it in the single market with European-produced soybean and rapeseed oils.

The above standpoint is reflected in the joint letter of Indonesian President Joko Widodo and Malaysian Prime Minister Mahathir Mohamad dated April 5, 2019 addressed to Donald Tusk, President of the European Council and EC President Jean-Claude Juncker, following the 13 March 2019 adoption of the Delegated Regulation (EU) 2019/807 that lays out the implementation of RED II. In the document, the two Southeast Asian leaders express their disapproval as well as their readiness to take retaliatory measures if necessary. In their reply dated June 4, 2019, Tusk and Juncker reiterated that RED II may be reviewed in mid-2021 and that a palm oil working group is planned to be set up. Indeed, the Joint Statement of the 22nd EU-ASEAN Ministerial



Meeting from January 2019 states that the Foreign Ministers of ASEAN and EU Member States “welcome the establishment of a joint working group between the EU and relevant ASEAN Member States to address issues relating to palm oil”. However, progress regarding the realization of this vegetable oil working group had been slow until very recently and in the meantime, Indonesia filed a lawsuit at the WTO regarding palm oil on December 9, 2019, and Malaysia has also announced its readiness to follow.

Even though the pandemic-induced global recession forced stakeholders to adopt a somewhat more flexible approach within settling their disputes, and the Co-Chairs’ Press Release of the 23rd ASEAN-EU Ministerial Meeting in December 2020 hints that the inaugural session of the joint working group on vegetable oils may eventually take place in January 2021, the palm oil issue is still unlikely to come to a quick resolution. Also, having protracted tensions with Indonesia and Malaysia diminishes the EU’s chances of gaining the ASEAN member states’ full support in realizing the potential that lies within the freshly announced strategic partnership. Officially both ASEAN and the EU share the same view, namely that individual member states’ bilateral concerns with each other should not overshadow regional cooperation and the key achievements in the ASEAN-EU relations (“Sengketa Minyak Sawit”, 2019), the reality, however, looks a bit different. Although not all ASEAN member states are involved, Malaysian Minister of Primary Industries, Theresa Kok openly stated to the media that palm oil was the deal-breaker for the EU-ASEAN Strategic Partnership in January 2019, and the elevation of ties should not be possible until the dispute related to the commodity is settled (Valero, 2019).

To sum up, even though economic cooperation is a strong backbone to the ASEAN-EU partnership, at the end of the day it can be broken down to bilateral trade ties with the member states. This lowers the political price ASEAN has to pay when entering into a debate with the EU, since glitches in the relations at the EU-level do not (most of the time) disrupt the trade between the respective member states which overall puts the EU into a less favorable bargaining position. Besides, having less than ideal relations with approximately half of the ASEAN countries definitely won’t help the EU either in maximizing the advantages of its newly established strategic partnership with the Southeast Asian bloc. Especially given that the consensus-based decision making of ASEAN opens up the possibility for its members to leverage their national interests via the organisation, as we saw it happen at the 22nd EU-ASEAN Ministerial Meeting in January 2019, when the veto of Indonesia and Malaysia turned out to be a showstopper for almost two years, a period which could probably have lasted even longer were it not for Covid-19.

Conclusion and Outlook

Despite a number of similarities, the EU and ASEAN represent two relatively different ways of integration, the former being the most integrated economic community in the world with supranational characteristics, whereas the latter is

a much looser intergovernmental cooperation where non-interference and national sovereignty is vital. Still, both groupings are fundamental regional organisations seemingly eligible to be each other's natural allies, at least at first sight. Having a closer look, however, reveals that in the first couple of decades following the inception of ties between the two entities in the 1970s, the EU-ASEAN relations were not attributed much significance.

This changed after the turn of the millennium, when the EU, as a reaction to Southeast Asia's impressive economic growth and rising political significance (with the 2005 establishment of the ASEAN-led East Asia Summit being a particularly important milestone), started to look into strengthening cooperation with the bloc. To further step up the relations, since 2014, the EU had actively been seeking to elevate ties with ASEAN to the level of a Strategic Partnership, an upgrade that took six years to realize, much longer than first anticipated, mainly due to ASEAN's reluctance.

While one may argue that the cooperation between the two entities was already strategic in nature, the official announcement of the elevation of ties is still a significant achievement, as it can potentially strengthen the EU's position, recently weakened by Brexit and rising Euroscepticism, in both the Indo-Pacific region and in the global arena in general. After all, ASEAN was already in Strategic Partnership with technically all the major powers such as China, Russia, and the USA and the EU naturally did not want to be left out.

Although lacking any official definition, the term "Strategic Partnership" implies a multifaceted cooperation between the participating parties. Applying this to the EU-ASEAN relations would mean that ties are almost equally sound in the socio-cultural, political-security and economic-trade domains. This paper investigated the latter two and concluded that while economic ties have always been strong between the two organisations, in the field of political and security cooperation, certain asymmetries can be observed. ASEAN and its member states still primarily regard the EU as a trading partner, simply not significant enough as a political and security actor in the Indo-Pacific. Besides, some ASEAN member states still tend to view the EU as a condescending norm-exporter and development aid provider, despite its efforts to position itself in the region as an "equal partner" and a "partner in integration". This is further amplified via a number of bilateral issues between the EU and certain ASEAN countries, namely the (proposed) withdrawal of EBA benefits from Cambodia and Myanmar, and the RED II directive that, according to Indonesia and Malaysia, may negatively influence palm oil exports to Europe. The latter resulted in the veto on the formal inception of the EU-ASEAN Strategic Partnership in January 2019, creating an impasse that took the parties almost two years to overcome. Even though in the last couple of years ASEAN and the EU put in a great deal of effort to approximate their viewpoints and better understand each other, and the long-awaited official announcement of the EU-ASEAN Strategic Partnership that finally happened on December 1, 2020 was beyond doubt an important milestone, the above implies that there is still work to do to further streamline the ties.



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16 Source: Gopalan S, NTU CEM (2020) Figure 20. p. 18. (based on Financial

Endnotes

- 1 This article reflects the author's own findings and does not represent the standpoint of the Government of Hungary.
- 2 The founding members of ASEAN were Indonesia, Malaysia, the Philippines, Thailand and Singapore. Brunei joined in 1984, Vietnam in 1995, Laos and Myanmar in 1997, and Cambodia in 1999, respectively.
- 3 The current 27 members of ARF are the ten ASEAN member states, the ten ASEAN Dialogue Partners (Australia, Canada, China, the EU, India, Japan, New Zealand, Russia, South Korea and the United States of America), Bangladesh, Mongolia, North Korea, Pakistan, Sri Lanka, and Timor-Leste, and Papua New Guinea (as ASEAN observer).
- 4 At the Summit, the EU was represented by Donald Tusk, President of the European Council, who also got invited as a guest to the luncheon of EAS leaders.
- 5 Article 44 of the ASEAN Charter regarding the status of external parties lists the exact same categories.
- 6 The ASEAN Defence Ministers' Meeting (ADMM), established in 2006, is the organization's highest defense consultative and cooperative mechanism, while the ADMM Plus formation convenes with the participation of eight ASEAN Dialogue Partners, namely Australia, China, India, Japan, New Zealand, Russia, South Korea and the United States.
- 7 Currently, EEAS is present with bilateral diplomatic missions in nine out of ten ASEAN capitals, Brunei being the only exception. Overseeing relations with Brunei belong under the duties of the EU Delegation in Jakarta.
- 8 Source: ASEAN Secretariat, edited by the author.
- 9 Source: ASEAN Secretariat, edited by the author.
- 10 These countries are also in a strategic partnership with ASEAN. Together, they were the initial participants of the Regional Comprehensive Economic Agreement (RCEP) negotiations, though India pulled out in 2019.
- 11 The abbreviation is derived from 'Enhanced ASEAN Regional Support from the EU'.
- 12 The classification of Least Developed Countries is carried out by the United Nations.



ASEAN'S FTA Process and Prospects

TO MINH THU – HAN LAM GIANG

Abstract: Over the past three decades, regional economic integration has been a focus on the economic agenda of all ASEAN member states as well as of the group. The rapid increase in both the number and quality of RTAs/FTAs is an indication of the region's active trade policy. This paper examined ASEAN's FTA policy and process since the early 1990s and the factors that led to the conclusion of various trade pacts among the member states and also those with partners, as well as the prospects and challenges of future commitments. The paper considered both strategic and economic dimensions of the integration process. It argued that ASEAN's FTA policy was brought about by strategic calculation and political aspiration to create a single market and production base; a trade and production hub of the Asia-Pacific region. The economic impacts of these trade pacts have, so far however, varied greatly. ASEAN is now embarking on the new phase of its integration process with the coming conclusion of RCEP. The paper suggests that it is crucial for ASEAN to make RCEP effective as it would bring significant economic benefits to member states and help enhance ASEAN's economic and strategic centrality.

Keywords: ASEAN, Free Trade Agreement (FTA), economic integration, prospects

Introduction

The Association of Southeast Asian Nations (ASEAN) is a regional intergovernmental organisation comprising of ten Southeast Asian countries, that promotes the unity of Asian peoples as well as the economic, political, security, military, educational, socio-cultural integration, and cooperation amongst its members, with partner countries and globally. ASEAN was established on August 8, 1967 in Bangkok, Thailand. The five original founding members are Indonesia, Malaysia, the Philippines, Singapore, and Thailand. Brunei Darussalam joined the group on January 7, 1984. Vietnam's accession to ASEAN came later on July 28, 1995; Lao PDR and Myanmar on July 23, 1997; and finally, Cambodia on April 30, 1999, making up what is today the ten Member States of ASEAN. ASEAN covers a land area of 4.5 million square kilometers (3% of the total land area of Earth) and has a combined population in 2019 of approximately 650 million people (8.3% of the world's population) (The ASEAN Secretariat, 2019).

The Association's total combined nominal GDP in 2018 was more than USD 3 trillion, making it the fifth-largest economy in the world if ASEAN were a single entity (after the United States, China, Japan and Germany). In terms of

trade, ASEAN's total value of trade in goods and services reached more than USD 2.8 trillion and USD 778.6 billion, respectively, in 2018. Intra-ASEAN trade has continuously accounted for the largest share of ASEAN total trade. In 2018, intra-ASEAN stands at 23.0% of total trade in the region, with an intra-ASEAN market constituting 24.1% and 21.8% of ASEAN total merchandise exports and imports, respectively. China (17.1%), EU-28 (10.2%), and the USA (9.3%) are ASEAN's top three trading partners in 2018.

ASEAN's sustained economic growth was brought about by the efforts to keep regional and national economies open and connected to the world economy. The promotion of regional economic integration in general and regional trade agreements, in particular, has been a key policy in the region. ASEAN's economic integration started in the early 1970s and initially focused on industrial cooperation. After undergoing a post-crisis recovery period, regional economic integration intensified in the 1990s and achieved important progress with the establishment of the ASEAN Free Trade Area (AFTA) in 1992 and the signing of the ASEAN Framework Agreement on Services (AFAS) in 1995 with the aim of services liberalisation. After more than a decade of implementation, AFTA was further upgraded to the ASEAN Trade in Goods Agreement (ATIGA) in 2009 to cover a wider range of commitments in trade in goods and a reduction of non-tariff barriers. Financial integration started with the Chiang Mai Initiative to prepare ASEAN for the future financial crises and later the adoption of the ASEAN Financial Integration Framework (AFIF) in 2011. The intra-regional investment was boosted through the entry into force of the ASEAN Comprehensive Investment Agreement (ACIA) in 2012. The establishment of the ASEAN Economic Community (AEC) in December 2015 marked an important milestone in the process of promoting greater economic integration in the region (The ASEAN Secretariat, 2017).

Along with the trend of signing free trade agreements (FTA) in the world since the 1990s, ASEAN has been playing a major role in the dynamics of FTA development in Asia through various bilateral FTAs with their important partners in the Asia-Pacific, including five FTAs already in force with China, Japan, Korea, India, and Australia-New Zealand, one newly-signed FTA with Hong Kong, and the Regional Comprehensive Economic Partnership (RCEP) currently under negotiation. The FTAs have impacted not only ASEAN as a whole but also on each member. The purpose of this paper is to review the process and the effects of FTAs on economic and strategic issues in ASEAN, then suggest some directions and prospects of regional economic integration in the coming years.

ASEAN Trade and Cooperation

For several decades, ASEAN countries have been successful in sustaining high economic growth through the expansion of trade and the attraction of FDI. During the period 1965-1995, the original members of ASEAN recorded an average growth rate of more than 7%¹. Together with the fast-growing Northeast Asian economies, Singapore, Indonesia, Malaysia, and Thailand were named by the World Bank as



the high-performing Asian economies (HPAEs)². During the period 1998-2008, despite the impacts of the financial crisis, the average rate of economic growth of the group was 5.3%, which was significantly higher than the world average. In the same period, the average annual growth in exports was 14.2%, while imports increased at an average rate of 17.5% per annum. From 2008 to 2018, ASEAN continued to sustain its average annual GDP growth of above 5%. The newer members, including Cambodia, Laos, Myanmar, and Vietnam have especially achieved much higher growth rates from 6% to 8% annually³, thus, helping narrow the development gap between them and the more developed members.

Table 1 presents a breakdown of ASEAN's trade with its major partners. Intra-ASEAN trade accounts for about a quarter of regional trade. This means that about 75% of ASEAN trade is directed outside ASEAN. Adding three East Asian countries (China, Japan, and Korea), intra-regional trade increases to more than 50% in the last decade. These shares are below that of the European Union, which exceeds 60%, but higher than that of NAFTA, which peaked at 49% in 2001 (ASEAN, 2008).

Table 1
ASEAN trade by selected country/region⁴

Partner country/region	Share to total ASEAN Trade (%)			
	2000	2008	2013	2018
ASEAN	22.0	26.8	24.5	23.0
Japan	15.3	12.4	9.5	8.2
China	4.3	11.3	13.8	17.1
European Union (EU-25)	13.5	11.8	9.7*	10.2*
USA	16.1	10.6	8.1	9.3
Republic of Korea	3.9	4.4	5.3	5.7
Australia, New Zealand	2.6	3.4	3.1	2.7
India	1.3	2.8	2.7	2.9
Others	21.0	16.5	23.3	20.9
Total	100	100	100	100

Linkages in FDI are also strong in the region. During the period 2000-2008, ASEAN received about USD 342.7 billion in FDI inflows, of which 34.5% came from East Asia, 27.0% from EU countries, and 10.1% from the US. Many ASEAN and East Asian

countries are now specializing in large-scale production of manufactured products. The region has developed regional production sharing with Japan leading the chain (specializing in high-value and high-tech products), followed by Korea, Singapore, Malaysia, Thailand, Indonesia, and the Philippines. Recently, new members of ASEAN started to join the low-end of the chain in electronics assembly and other labor-intensive manufactures. These trade and investment linkages have been a major force driving economic cooperation in the region. In addition, the need for regional cooperation became more urgent after the 1997 economic crisis. East Asian countries realised that maintaining regional dynamism would require economic policy cooperation among themselves, in addition to policy efforts at the national level. The successful experience from European and North American economic integration also provides strong motivation for deeper regional cooperation. With the AFTA framework in the early 1990s, ASEAN became a catalyst for shared prosperity in the region. Since 2001, ASEAN has embarked on free trade agreements with major trading partners, including China, Japan, Korea, India, Australia, and New Zealand. These trading partners, whilst generally seen as competitors, recognise that there is a mutual interest that could be realized through cooperation with ASEAN.

ASEAN's FTA Policy and Process

Over the past three decades, the number of bilateral and plurilateral trade agreements that have been signed and ratified in ASEAN has been growing. Table 2 provides a list of FTAs which comprise all of the 10 members of ASEAN.

The AFTA agreement was signed in 1992. According to the Agreement, member countries would gradually reduce intraregional tariffs and remove non-tariff barriers (NTBs) over a 15-year period commencing on January 1, 1993. AFTA uses the Common Effective Preferential Tariff (CEPT) Scheme to decrease tariffs on all manufactured products and processed agricultural products to a range of 0–5% by 2008. In 1994, AFTA members agreed to shorten the time frame to 2003. In 1999 it was again shortened to 2002 (Pangestu, 2005).

ASEAN's ambition towards regional trade liberalisation was echoed by its partners. In November 2000, China proposed the idea of a free trade area between ASEAN and China. The negotiation did not take long and the framework agreement was signed on November 4, 2002. ACFTA requires that China and the 6 countries (Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand) would eliminate their tariffs on 90% of their products by 2010 and the 4 countries Cambodia, Lao PDR, Myanmar, Vietnam (often called the CMLV) engaged in the same policy on tariffs, with the same goal to achieve by 2015. In 2010, the ASEAN–China Free Trade Area became the largest free trade area in terms of population and third largest in terms of nominal GDP. It was also the third-largest trade volume after the European Economic Area and the North American Free Trade Area (Gooch, 2009). On January 1, 2010, the average tariff rate on Chinese goods sold in ASEAN countries decreased from 12.8 to 0.6% pending implementation of the free trade area by the remaining ASEAN members. Meanwhile, the average tariff rate on ASEAN goods sold in China decreased from 9.8 to 0.1%.



The second FTA of ASEAN with its dialogue partners is the ASEAN-Korea Trade in Goods Agreement, which was signed in 2006 and entered into force in 2007. It sets out the preferential trade arrangement in goods among the ASEAN Member States and South Korea, allowing 90% of the products being traded between ASEAN and Korea to enjoy duty-free treatment. The Agreement provides for progressive reduction and elimination of tariffs by each country on almost all products. Under the Trade in Goods Agreement, ASEAN-6, including Brunei Darussalam, and Korea eliminated more than 90% of tariffs by January 2010.

Table 2
List of ASEAN's FTA⁵

Name	Members	Signed date	Effective date
ASEAN Free Trade Area (AFTA)	10 ASEAN countries	01/1992	1993
ASEAN-China Free Trade Agreements (ACFTA)	10 ASEAN countries and China	11/2002	
ASEAN-India Free Trade Area (AIFTA)	10 ASEAN countries and India	10/2003	
ASEAN-Republic of Korea Free Trade Area (AKFTA)	10 ASEAN countries and Korea	12/2005	06/2007
ASEAN-Japan Free Trade Area (AJCEP)	10 ASEAN countries and Japan	04/2008	12/2008
ASEAN-Australia-New Zealand Free Trade Area (AANZFTA)	10 ASEAN countries, Australia and New Zealand	02/2009	01/2010
ASEAN-Hong Kong, China Free Trade Area (AHKFTA)	10 ASEAN countries and Hong Kong	11/2017	06/2019
Regional Comprehensive Economic Partnership	10 ASEAN countries, China, Japan, Korea, Australia, and New Zealand	Expected to be signed in late 2020	

In December 2008, the ASEAN–Japan Comprehensive Economic Partnership (AJCEP) came into force, marking the completion FTA between the ASEAN with its Northeast Asian partners. The Agreement covers trade in goods, trade in services, investment, and economic cooperation. The FTA provides for the elimination of duties on 87% of all tariff lines and includes a dispute settlement mechanism. It also allows for back-to-back shipment of goods between member countries, third party

invoicing of goods, and ASEAN cumulation. Both ASEAN and Japan have also initiated several economic cooperation projects that include capacity building and technical assistance in areas of mutual interest. These areas include intellectual property rights, trade-related procedures, information and communications technology, human resources development, small and medium enterprises, tourism and hospitality, transportation, and logistics, among others.

The agreement establishing the ASEAN-Australia-New Zealand Free Trade Area (AANZFTA) was signed in February 2009 and entered into force in January 2010. At the time of signing, the FTA was the most comprehensive agreement covering a wide range of issues including trade in goods and services, investment, intellectual property, competition as well as economic cooperation. Since its inception, the AANZFTA has encouraged trade in goods and services by removing barriers and reducing transaction costs for companies wanting to do business in member countries. According to the agreement, 99% of the Australia-New Zealand trade in goods with Indonesia, Malaysia, the Philippines, and Vietnam will be duty-free by 2020. Upon full implementation in 2025, almost all trade between the member countries will be free of tariffs, helping businesses save millions of dollars in tariff duties each year.

Also in January 2010, the ASEAN-India Trade in Goods Agreement (AIFTA) entered into force. The signing of the agreement paved the way for the creation of one of the world's largest free trade area markets, creating opportunities for over 1.9 billion people in ASEAN and India with a combined GDP of USD 4.8 trillion. AIFTA creates a more liberal, facilitative market access, and an investment regime among the member countries. The agreement set tariff liberalisation of over 90% of products traded between the two dynamic regions. Accordingly, the tariffs on over 4,000 product lines were agreed to be eliminated by 2016, at the earliest.

The latest FTA partner of the ASEAN is Hong Kong. On November 12, 2017, the two sides signed a free trade and investment pact to strengthen economic cooperation and stimulate economic development. The two agreements, the ASEAN-Hong Kong, China Free Trade Agreement (AHKFTA), and the ASEAN-Hong Kong Investment Agreement (AHKIA), were signed at the 31st ASEAN Summit in Manila and will come into force on January 1, 2019. The agreement will offer four key advantages to stakeholders in the region, namely tariff reduction for trade in goods; better and fairer investment protection; fewer restrictions for trade in services; and a longer stay for business travelers.

Currently, ASEAN and 5 partners, namely China, Japan, Korea, Australia, and New Zealand are in the final stage of negotiating the Regional Comprehensive Economic Partnership (RCEP), which is considered as a regional mega FTA. Initially, India was a part of the negotiation but it withdrew from the FTA due to concerns of competition from other members. However, ASEAN and other partners are still open to India joining later. It is expected that RCEP will be concluded and signed in November 2020 (ASEAN, 2020).

The creation of FTA in general and in ASEAN, in particular, has been explained extensively in the literature from both economic and political aspects. From an economic perspective, FTAs offer a more flexible choice for countries to facilitate trade when the speed of multilateral trade negotiation has slowed. Countries that see the potential to increase trade and economic linkages can choose to reduce



tariffs among themselves. In addition, with fewer members, it is easier to negotiate the level and extent of free trade. This flexibility is the strength of FTAs over global trade negotiations. Indeed, after several decades of high-speed economic growth, the economies of ASEAN have been more diversified in their production structures and more complementary towards each other. During the 1980s, several ASEAN countries undertook comprehensive economic reform to liberalise trade and investment, engaging deeper into the global production network (Tongzon, 2002). The expansion of ASEAN to include less developed countries, namely Cambodia, Laos, Myanmar, and Vietnam, means that there is more room for trade creation as these untapped markets are liberalized for trade and investment. Apart from the internal market, as shown earlier, ASEAN's economies had been highly dependent on a few partners, especially East Asian economies. Thus it is natural for ASEAN to look for closer trade links with its major partners.

During the 1990s, ASEAN faced significant challenges, especially due to changes in politics and the economy at both regional and global levels. The slow progress of the global trade liberalisation frustrated private sectors and governments in these countries. At the same time, the success of regional trade liberalisation in the EU and North America acts as a facilitator for regionalism as it increases competitiveness from regionally linked markets and also as a model for future market expansion, enhancing trade and investment relations among countries in the same region. Under such circumstances, ASEAN has been focused on regional economic integration as well as trade liberalisation. The association's commitment to the liberalisation of trade is highlighted in its efforts to establish a regional trade bloc, ASEAN Free Trade Area (AFTA), officially announced in the 4th ASEAN Summit in Singapore in 1992. This successful step of regional economic integration illustrates the expectations of supporting local trade and manufacturing in all ASEAN nations, attracting foreign direct investments as well as increasing the ASEAN region's competitive edge as a production base in the world market (Malaysia's Ministry of International Trade and Industry).

The policy of ASEAN on negotiating and signing FTAs has been through a number of significant changes. From signing FTAs within the member states in the region, ASEAN has moved towards signing and negotiating FTAs with other regional groups like the EU. ASEAN also concentrated on proliferating free trade with external dialogue partners. Up till now, ASEAN has six bilateral free trade agreements signed and in effect with seven dialogue partners including Hong Kong (China), China, Japan, Republic of Korea, India, and Australia and New Zealand via the platform of ASEAN+1 (ASEAN Website). Commitments to FTAs have been greatly accelerated and deepened. The coverage of FTAs has been widened to include much more diverse products, especially those initially excluded. Also, the implementation content of some FTAs, for instance, the ASEAN-Australia-New Zealand Free Trade Area (AANZFTA), covers a wide range of issues from trade in goods and services, investment, intellectual property, and the competition to economic cooperation (Dezan Shira & Associates, 2017). This is regarded as the most comprehensive and highest quality FTA concluded by ASEAN (The FTA Joint Committee, 2017).

From a political stance, it was well understood that closer economic relations and trade ties would help reinforce political commitment and help ensure stable relations (Gowa, 1989; Gowa and Mansfield 1993). For small states, it would be much more

difficult or sometimes impossible to negotiate a trade deal with a bigger partner. Thus being a member of ASEAN and a negotiating member of a trade agreement would help enhance their role in the partner's trade and foreign policy. For the group as a whole, trade agreements are often viewed more as political instruments for magnifying their strategic importance.

In addition, in the case of the FTA with the northeast Asian partners, the complicated relations between China, Japan, and Korea led ASEAN to opt for three separate FTAs with each country, despite various studies showing that the gain from an ASEAN+3 FTA would largely outweigh those of the three ASEAN+1 FTA. Indeed, some scholars have argued that the proliferation of FTA among ASEAN and China, Japan, and Korea is a strategic response to power distribution. It has been argued that the contestation over regional leadership between China and Japan had propelled a series of economic projects for regional integration (Yoshimatsu, 2005; Dent, 2006b; Wong, 2007).

Domestic political factors also play an important role in defining the FTA policy in ASEAN. Political leaders' preferences have played a pivotal role in determining the formation and direction of the AFTA. Chiou (2010) argues that since ASEAN countries are not fully democratic, the role of leaders is critical and as political leaders seemed to enjoy a stable win-set domestically, the achievement of FTA is more likely.

Economic Impacts of ASEAN FTA

There is a large volume of research that assesses the economic impacts of ASEAN's FTAs. Studies by Imada, Montes, and Naya (1991), Felipe and Wescott (1992), Takeuchi (1993), Adams and Park (1995), Nadal (1995), and Park (2000) show limited economic impacts for AFTA. Recently, Calvo-Pardo, Freund, and Ornelas (2009) and Kalra (2010) investigate the trade effect of AFTA by using preferential tariffs on nonmember economies. The empirical findings on trade effects suggest a small but positive improvement of intra-ASEAN trade, with similar gains to income. The relatively insufficient gains from AFTA is attributed to several factors, mainly (i) the slow progress of past ASEAN economic cooperation, (ii) the current low volume of intra-ASEAN trade, (iii) competition among ASEAN member nations for the same export markets (Japanese and U.S. market), (iv) relatively similar production and trade structures (light manufactured products and natural-resource-oriented products) in each member nation, (v) the very different tariff structures among member nations, and (vi) the negative effects on excluding the Northeast Asian neighbors (China, Japan, and Korea) will cause AFTA to fail (Park, 2011).

Comparing the impacts of different FTA arrangements using the same model, it is commonly agreed that the larger the size of the FTA, the more benefits it brings to the member economies, but also the higher the cost for non-members. These findings are to be expected because the benefits from improvements in resource allocation tend to increase with the size of the grouping without trade barriers. Lee, Choi, and Park (2003), Tsutsumi and Kiyota, (2000) find welfare gains for ASEAN increase significantly in ASEAN+3, compared with AFTA.



Kawai and Wignajawa (2007) provide the income effects for almost every individual economy in East Asia for ASEAN+1, ASEAN+3 and ASEAN+6, and find that the gains for member countries increase with the number of countries in the FTAs. The income effects for ASEAN improve from 3.72% in an ASEAN-China FTA⁶ to 5.23% in ASEAN+3, and to 5.66% in ASEAN+6. Effects on Northeast Asia rise from less than 0.3% in all ASEAN+1 FTAs to 1.85% in ASEAN+3 and 1.93% in ASEAN+6 FTA.

In sum, the evaluation of various FTA scenarios using different methods shows that economic gains for ASEAN countries in AFTA are quite limited. In other FTAs with partners, it would be more beneficial for ASEAN to reach a region-wide FTA, including all possible partners. Thus, economic motivation for AFTA and ASEAN+1 FTA is not the main driver for ASEAN to follow its past FTA policy. Instead, the political and strategic calculation could help shed light on the puzzling question of why ASEAN followed its current economic integration path.

ASEAN's New Phase of Economic Integration

As mentioned above, FTAs have brought about positive impacts on trade creation and trade diversion as well as serving for strategic goals. However, from the viewpoint of global value chains, ASEAN countries are still at the lower level of the chains. Although the regional FTAs offer high potentials for cooperation, the implementation has not been commensurated and is still limited compared with other high-quality FTAs in the world. Besides, the cooperation in various sectors other than trade in goods, such as trade in services, investment, labors, or environmental issues, is still at a low speed. Therefore, there are huge potentials that can be explored and those regional FTAs must be strengthened.

Due to its position as one of the most dynamic regions as well as its geostrategic location, ASEAN is in a good position to follow its integration path. Over the years, with the gradual opening up of its economies, increasing demographic importance, low labor costs, and steady growth, ASEAN has emerged as one of the most attractive foreign capital destinations in Asia. From the region's financial services capital in Singapore to its low-cost manufacturing hubs in Myanmar, the ASEAN region offers numerous opportunities for businesses interested in establishing operations or trading in Asia. In terms of low-cost manufacturing, besides Vietnam's already-firmed position, Myanmar, Cambodia, Lao PDR, and the Philippines have shown significant potential and development in their manufacturing activities and attracting investment in this sector. In addition, foreign businesses planning to set up operations in ASEAN also benefit from numerous tax incentives and fiscal benefits.

Furthermore, ASEAN is proven as a potential market of more than 600 million people. Also, the establishment and development of the ASEAN Economic Community (AEC) offers a possible avenue for businesses to capitalize on the region's dynamism. Exporters can tap into areas of strong consumer demand, a wide range of products eligible for preferential treatment, improved customs clearance times, and less complicated trade procedures (Dezan Shira and Associates, 2017). Moreover, due to the reality that ASEAN's intra-regional commodity production

structure is relatively similar, access to the external market is essential and a central priority. In addition, ASEAN is experiencing advantages in the current process of global and regional supply and value chain transition under the impact of the US-China trade war. Thus, the ASEAN's continued signing of FTAs as a single market also greatly supports member countries in the process of attracting FDI for socio-economic development towards modern and sustainable directions. This is especially so when the new-generation FTAs will require higher standards and cover wider issues that some members cannot meet if negotiating separately. Currently, the Regional Comprehensive Economic Partnership (RCEP) is the most prioritized FTA of ASEAN. RCEP, when signed and enforced, will create the largest free trade area in the world, and, at the same time, create a new driving force for development. The RCEP, initiated by ASEAN at the 21st ASEAN Summit in Phnom Penh, Cambodia in November 2012, is a proposed free trade agreement among 10 ASEAN member states and FTA partners are China, Japan, Korea, Australia, New Zealand, and India. The goal of launching RCEP negotiation is to achieve a modern, comprehensive, high-quality, and mutually beneficial economic partnership agreement among ASEAN member states and ASEAN's FTA partners. In other words, the RCEP was built upon the existing ASEAN+1 FTAs with the spirit to strengthen economic linkages and to enhance trade and investment-related activities as well as to contribute to minimizing the development gap among the parties (ASEAN, 2016). The RCEP negotiation currently covers a wide range of fields, namely trade in goods, trade in services, investment, economic and technical cooperation, intellectual property, competition, dispute settlement, e-commerce, small and medium enterprises (SMEs), and other issues. If the agreement was signed, confidence in the regional framework would have been further strengthened economically and politically, as well as in other areas. This will be the motivation to speed up the trade volume among participating countries, helping to rebuild the economies in the era of post-Covid-19.

Recently, India announced that it will withdraw from RCEP negotiation. The withdrawal of an important partner like India with a large market certainly makes RCEP less attractive. It is a clear symbol of how difficult it is to negotiate a mega-FTA and the determination of ASEAN to keep its economic integration policy forward. During the 36th ASEAN Summit, held via online format last June, ASEAN leaders applauded the progress made towards the full completion of the RCEP negotiations. The RCEP will send a clear signal that regional economic integration in Asia remains strong and vibrant, although protectionism and unilateralism are on the rise in the US and other regions. The challenges that lie ahead include how to convince people of the RCEP benefits and how to empower, allowing local citizens, small and medium enterprises to benefit from the regional trade agreement.

Many other scholars⁷ also agree on the importance of RCEP in the current context. The RCEP will be one of the most important regional free trade agreements in the world at this time. ASEAN leaders took a clear, unified stance against the policy of protectionism by moving forward, with deepening regional economic integration. Furthermore, it is important to build synergy between RCEP and other regional initiatives, to play a key role in enhancing development, and connecting regional infrastructure - key elements to support trade and investment attraction.



Another noticed trend is the birth of the so-called “new generation FTA”. This new kind has some different characteristics. Firstly, a new-generation FTA has higher standards and a broader scale. Compared to the previous FTAs, the new ones cover more fields such as the rule of origin, technical barriers, intellectual property rights, public procurement, growth models, labor unions, internal legislation, etc. Thus, new generation FTAs become more comprehensive and enhance standardisation levels at the same time. Secondly, the level of commitment to new generation FTAs is more extensive. This is shown in the process of negotiation and implementation where there have been no specific distinctions and preferences for any economy. Besides, the members also accept higher legal binding of the commitment. Thirdly, new generation FTAs care more about improving the mechanism of dispute resolution which is the weak point of current FTAs. It is necessary because of the more frequent trade and interest conflicts in recent times. Fourthly, the new generation FTAs have openness to the issue of member and content expansion, even after taking effect. These are flexible responses to the changing international context of today. Finally, considering entrepreneurs are the main growth driven force, the signatories prioritize measures to facilitate them creating innovation and development space. Hence, the new generation FTAs are predicted to have significant impacts on international trade and the economic policy of almost all countries.

Prospect of an ASEAN-EU FTA

The ASEAN is listed as a priority for further engagement as part of the European Union’s recently adopted strategy on trade, which aims to aggressively pursue the lowering of barriers of its exports through signing FTA (European Union, 2016). The ASEAN has been continuously growing in importance for European entrepreneurs as an attractive regional alternative or complement to business activities in China and India. The EU is the largest investor in the ASEAN region with the FDI stocks into ASEAN accounted for EUR 337 billion. ASEAN investment in Europe has also been growing steadily and impressively to a total stock of over EUR 141 billion in 2017. The EU is also the ASEAN’s second trading partner and the ASEAN represents the EU’s 3rd largest trading partner, with total trade in goods at EUR 237.3 billion in 2018 (European Commission, 2020). A free trade agreement between the two regions is expected to have a profound impact on trade and FDI between ASEAN and the EU. Negotiations for a region-to-region FTA between the EU and ASEAN were launched in 2007 and stalled in 2009 for political reasons. Nevertheless, the increasingly volatile international economic environment has pushed Europe towards Southeast Asia. In 2017, the EU re-started FTA negotiation with the ASEAN after the US pulled out of the transatlantic trade and investment partnership agreement (Hung, 2020a).

The proposed Free Trade Agreement (FTA) will take the form of a new generation of competitiveness-driven bilateral trade agreement that goes beyond traditional market access. Since the EU-ASEAN FTA negotiation was postponed in 2009, several bilateral FTA negotiations have been initiated which are conceived

as building blocks towards a future region-to-region agreement. Vietnam's parliament's ratification of the FTA between Vietnam and the European Union (EVFTA) in August 2020 can be seen as a positive sign. Previously, the EU also successfully signed an FTA with Singapore. In fact, Singapore and Vietnam are the EU's largest trading partners in the region. These two countries account for about 45% of the total EU's trade with ASEAN. These FTAs are expected to benefit inter-regional trade and employment. For European companies, the FTAs provide the opportunity to gain access to the potential ASEAN telecommunications, finance, and information technology markets. Singaporean companies at the forefront of the Industrial Revolution 4.0, will enjoy unlimited access to European digital markets. The Vietnamese government estimates that exports to the EU will increase by up to 20% under the EVFTA, adding 3% to the total domestic product by 2023 (Hung, 2020a). Therefore, the FTA between Singapore and Vietnam and the EU is expected to serve as a model for an ASEAN-EU multilateral FTA.

However, considering the current complicated context, the EU-ASEAN FTA will face a long path before reaching an agreement. The EU is struggling to find a way out for the deadlock in search of a post-Brexit trade deal with the UK. It is worth considering the trend of FTA negotiation between the Europeans and the ASEAN in the future, under the changing political and economic context. Firstly, Brexit has an impact on the way the EU negotiates bilateral FTAs with the rest of the ASEAN member states, so it definitely affects the FTA with ASEAN. Secondly, Brexit leads to the UK being out of any future EU FTAs, thus forcing the country to seek FTAs with ASEAN member states (Hung, 2020a). At the same time, the US-China trade war, as well as the US-EU trade tension, has not shown many positive signals. Along with that, the impact of the Covid-19 shock has caused certain adjustments to the directions and priorities of both sides. While there will be considerable economic value in securing duty-free trade with Indonesia, Malaysia, Thailand, and the Philippines, the EU still has disagreements over an FTA with the ASEAN bloc. For instance, the dispute between the major EU and ASEAN palm oil producers has also increased in 2019. Lawsuits over these disputes may take several years to settle and will likely dampen EU enthusiasm for duty-free trade with both of these countries.

With such barriers to a multilateral approach, the EU is likely to continue with bilateral negotiations with ASEAN members. On the basis of FTAs with Singapore and Vietnam becoming a foundation for strengthening confidence, Thailand can become a third country in ASEAN that can successfully negotiate an FTA with the EU. Indeed, the EU and Thailand initiated negotiations on an FTA in 2013, but stalled a year later, when Thailand's political situation changed. In 2017, the EU laid out the conditions for the resumption of negotiations (Rödl & Partner, 2018). The EU also expressed its goodwill to resume FTA negotiations with Indonesia and the Philippines. However, it seems that the EU is not ready to negotiate a separate FTA with countries such as Cambodia, Myanmar or Laos, nor apply tax exemption to these countries under the ASEAN hat. Therefore, from the perspective of economic dynamics, the prospects for an FTA between the two regions will be rather blurred.



Conclusion

In sum, although a latecomer, the economically important ASEAN has emerged at the forefront of global free trade agreement activity. There have been concerns raised about the negative effects of ASEAN FTAs, including the “noodle bowl” problem. The focus for policymakers should then be how best to minimise the costs of FTAs while maximizing their benefits. In fact, FTAs have brought many positive effects for ASEAN as a whole as well as for each member, both in terms of economic and strategic aspects. This continues one of the priorities of the ASEAN in the coming years. Especially, in the quickly changing world, negotiating and signing new FTAs along with effectively implementing the existing FTAs may play a crucial role in creating a new driving force for the development of the region. In which, RCEP is considered to be the most important one. Besides, the prospect of other new generation FTAs such as a FTA with the EU also opens many opportunities. However, the most important thing is the determination of the bloc to improve endogenous capacity to actively respond to the new shock, control the situation, and make good use of the advantages and chances.

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Endnotes

- 1 Except for the Philippines which suffered stagnation during the 1980s (Lau and Park, 2003).
- 2 The HPAEs are often referred to as the 8 high performing East Asian economies, namely Japan, Korea, Hong Kong, Taiwan, Singapore, Malaysia, Indonesia, and Thailand (World Bank, 1993).
- 3 According to ASEAN's Statistical Yearbook, various years.
- 4 Calculated from data in ASEAN Statistical Yearbook 2008, 2019. The statistics are of the European Union in 2013 and 2018 are those of EU-28.
- 5 ASEAN, Free Trade Agreements with Dialogue Partners
- 6 The effects on ASEAN+Japan and ASEAN+ Korea FTAs are 2.34% and 0.66% respectively.
- 7 E.g. Mey Kalyan - senior advisor to the Supreme National Economic Council of Cambodia, Joseph Matthews - senior professor at BELTEI International Univer-

Revamping Finance via Fintech: Promises, Perils, and Practices in ASEAN

KATIGBAK JOVITO JOSE

Abstract: Fintech presents opportunities for ASEAN, especially in realising its objectives of financial integration, stability, and inclusion en route to a highly integrated and cohesive economy by 2025. Cognizant of the cited development's tremendous potential, ASEAN Member States have outlined specific goals, policy actions, and timelines in the 2025 ASEAN Economic Community Blueprint and in the AEC Consolidated Strategic Action Plan. Despite these strides, fintech-related efforts within ASEAN can be aptly characterised as mainly state-driven, hence the proliferation of varying standards and regulations, the fintech adoption divide, and the low level of trust of consumers in fintech platforms and service providers. Thus, AMS may consider the following policy options: (i) formulation and implementation of a region-wide fintech-specific framework; (ii) underpin infrastructure sharing among telecommunications companies, especially those operating in remote, rural areas; (iii) development of industry sandboxes for start-ups and SMEs; (iv) increase funding for cybersecurity-related projects; and (v) participate in APEC's CBPR initiative.

Keywords: fintech, financial inclusion, ASEAN Economic Community, regional integration, regulatory coherence

Introduction

The Association of Southeast Asian Nations (ASEAN) continues to be a key growth engine for the global economy as it contributed USD 2.8 trillion in total trade and secured almost USD 155 billion worth of foreign direct investment (FDI) in 2018. Fuelled by a population of almost 650 million, ASEAN boasts the world's fifth largest economy with a combined gross domestic product (GDP) of USD 3 trillion (ASEAN Secretariat, 2019b). In addition, the said grouping officially charted in 2015 its course toward an ASEAN Economic Community (AEC) to foster closer cooperation among the ten member states as well as projecting a unified ASEAN to external partners. Indeed, the AEC has well-intentioned objectives but persistent challenges complicate the substantial realisation of a well-functioning economic community.

Specifically, the lack of access to finance, especially by lower-income groups, hinders households and small and medium-sized enterprises (SMEs) in fulfilling basic needs, investing in productive endeavours, enhancing skills, and scaling up



economic activities. ASEAN Member States (AMS) responded to this challenge by introducing novel, “targeted” financial offerings to certain groups but the emergence of financial technology (fintech) is viewed to thrust “open banking” into the mainstream as Internet-protocol-based financial transactions become more dominant. Since the 1950s, fintech has vastly evolved from merely supplementary instruments used by financial institutions to an entire industry characterised by mobile wallets, robo-advisors for wealth and retirement planning, payment apps, and crowdfunding and online lending platforms (Desai, 2015). Nevertheless, numerous impediments still exist such as access to government regulator data, outdated regulations, cybersecurity and data privacy, and lack of citizens’ trust towards fintech.

Given the novelty of such phenomenon, this article primarily aims to review and examine the opportunities, challenges, and application of fintech in ASEAN. It is divided into five sections. The first part presents a brief history and definition of fintech, as well as the ecosystem of this booming development. The second section tackles the projected gains brought by fintech along with the accompanying costs and risks. The third segment delves into the nature and present state of fintech adoption in ASEAN by identifying best practices and notable initiatives. The penultimate segment outlines policy options and considerations for ASEAN as it adapts to the fast-changing landscape of fintech. The concluding section provides a synthesis of the previous discussions and enumerates key insights for ASEAN amidst its regional integration project.

From Evolution to Revolution: A Review of Fintech’s Rise

Financial technology (fintech) can be characterised as the application of technologies to provide financial services. It was first coined in 1993 upon the creation of the Financial Services Technology Consortium by Citicorp (which later became Citigroup) (Hochstein, 2015). Further, Lee and Shin (2018) noted that this development began in the 1990s as the internet revolution took off. In particular, the easier, instantaneous financial transactions among individuals and organisations, enabled by the internet and the World Wide Web (www), gave birth to the electronic finance (e-finance) phenomena. E-finance models encompass all types of financial services such as online banking, stock trading, and insurance. Consequently, the smartphone boom in the mid-2000s augmented these channels by ushering in innovative services such as mobile banking and payment (Lee and Shin, 2008).

Notwithstanding the novel nature of today’s fintech, Arner et al. (2016) posit that the convergence of finance and technology initially occurred during the 19th century. They enumerated three main periods of the fintech evolution. The first phase (1886-1967) witnessed the transition from analogue to digital. It featured the following: (i) installation of the transatlantic telegraph cable; (ii) charge plates and credit coins as substitutes for credit cards; (iii) creation of the Fedwire Funds Service to link all Federal Reserve Banks through telegraph; (iv) modern-day credit cards; (v) global telex network; and (vi) automated teller machines (ATMs) (Zimmerman, 2016).

The second era (1967-2008) concentrated on the digitalisation of traditional financial services (Arner et al., 2016). Several financial institutions and mechanisms were introduced to facilitate cross-border transactions such as Clearing House Interbank Payment System, National Association of Securities Dealers Automated Quotations, and Society for Worldwide Interbank Financial Telecommunications. New e-finance schemes including online brokerage, banking, and shopping likewise emerged during this stage. In Europe, governments commenced the shift towards greater interconnection of their financial markets through key initiatives such as the Single European Act of 1986, financial liberalisation in the United Kingdom in 1986, and the Maastricht Treaty of 1992.

The latest period (2008-present) is essentially founded on the confluence of three factors, namely: (1) weakened trust of clients towards banks after the global financial crisis; (2) rise of smartphones; and (3) advanced application programming interfaces which allow the interoperability of different software and applications. Moreover, the distinguishing traits of today's fintech is the prominence of start-ups and technology firms in providing tailor-made services to a host of clients, as well as the velocity of change in many localities, especially in developing countries (Arner et al., 2016). As a result, individuals and organisations presently enjoy a multitude of digital financial services such as *"mobile wallets, payment apps, robo-advisors for wealth and retirement planning, equity crowdfunding platforms for access to private and alternative investment opportunities, and online lending platforms"* (Desai, 2015).

Notably, fintech's revolutionising force is projected to extensively affect the entire financial services sector (Heap and Pollari, 2015). At the institutional level, Schueffel (2016) underscored that *"operations, comprising middle and back-office client support, product servicing, and risk management functions will be affected and so will be distribution, encompassing online and physical channels, agents, financial advisers, and other third-parties"* (p. 33). It must similarly adapt to emerging market segments, dynamic customer expectations, and evolving competitive structure and ecosystems (Deloitte, 2016). In its effort to establish a common taxonomy of the most impactful innovations, the World Economic Forum (WEF) (2015) identified six core functions of the extant financial services. These are: (i) payments; (ii) insurance; (iii) deposits and lending; (iv) capital-raising; (v) investment management; and (vi) market provisioning.

Lee and Shin (2018) mentioned five primary actors in the fintech ecosystem. First, fintech start-ups provide niche services to customers and pioneer the innovations in several areas. Secondly, traditional financial institutions contribute in such setting by reinventing their business models and strategies and by entering into partnerships with emerging fintech companies. Thirdly, technology developers create online platforms for both start-ups and incumbents to deliver improved services via social media, mobile devices, cloud computing, and algorithmic trading tools, among others. Fourthly, customers who are younger, wealthier, urban-based, and tech-savvy, serve as one of the main revenue sources of fintech companies. Lastly, governments shape the ecosystem through regulations encompassing start-ups and traditional financial institutions.



Understanding the Promises and Perils of Fintech

Innovations in the financial sector are traditionally perceived as a conduit of economic development since the 19th century (Michalopoulos et al., 2011). They are also credited for a handful of finance-related improvements, such as better banking services (Merton, 1992; Berger, 2003), efficient capital allocation (Ross, 1976), complete markets (Grinblatt & Longstaff, 2000), and more risk-sharing opportunities (Allen & Gale, 1994). Beck et al. (2012) examined data from 32 high-income countries over the period 1996-2006, and found that a higher level of financial innovation is positively linked to a country's growth in capital and in gross domestic product (GDP) per capita.

Furthermore, fintech can substantially contribute in preserving financial stability through four main issue-areas, namely: (i) decentralisation and diversification; (ii) efficiency; (iii) transparency; and (iv) access to, and convenience of, financial services (Financial Stability Board, 2017). The first element pertains to the entry of new innovative players and models (e.g. big data processing in alternative lending, robo-advice in wealth management) which widens the range of services and options for customers. Accordingly, the emergence of fintech start-ups and service providers can lessen the adverse impact of financial shocks since the failure of a single institution does not result in a systemic shutdown.

The second dimension focuses on the efficiency gains brought by financial innovations. Specifically, the deployment of productivity-enhancing technologies by both incumbents and new entrants can lead to agile business models which ultimately benefit the economy as a whole. In the remittances sector, lower transactions costs and faster transaction execution due to fintech have resulted in declining fees for sending remittances and quicker flow of finance across borders.

The third facet refers to fintech's ability in promoting transparency through addressing information asymmetries and facilitating effective risk management and pricing. In particular, the use of technologies to collect, store, and analyse financial data at an unprecedented rate enables companies to instantly disseminate relevant information (e.g. fees and charges) to customers.

The last aspect may be regarded as the most important contribution of fintech from a development standpoint – financial inclusion. As previously discussed, the decentralisation and diversification of services have been instrumental in reducing the number of unbanked individuals and households, and in creating opportunities for the underserved and underbanked. Demirgüç-Kunt et al. (2018) posit that digitising payments of wages and government benefits can expand account ownership among the unbanked, as well as increase account utilisation among the banked. The adoption of fintech as an alternative to predominantly cash-based payments of utilities such as water and electricity may then stimulate the account utilisation rate among banked adults.

Conversely, the Financial Stability Board (FSB) (2017) identified two main categories of risks that fintech pose to the stability of the financial system. The first type refers to microfinancial risks which may emanate from either financial or operational sources.

Financial sources encompass maturity mismatch, liquidity mismatch, and leverage. The first scenario is common in lending platforms and arises when loans are extended for a longer duration, or when an investor opts to prematurely sell their loan before maturity thereby generating rollover risk. The second predicament can be observed in fintech credit platforms due to their non-performance of liquidity transformation. The last risk is usually associated with business and consumer lending or equity crowdfunding platforms and happens when they borrow funds to finance temporary holdings of equity issuance or bonds (FSB, 2017).

Vulnerabilities may also arise from the operations of fintech firms. These include poor governance or process control, reliance on third-parties for certain services, balance sheet losses incurred by critical FMI, cybersecurity and data privacy issues, and legal/regulatory challenges. The last two risks can be characterised as mainstream issues given their reach, impact, and policy implications. An instructive case of a devastating cyber-attack is the 2016 online heist incident, which resulted in a whopping USD 81 million loss for the central bank of Bangladesh (Quadir, 2019). Customers are also wary of misuse of personal data and electronic fraud (Cortina & Schmukler, 2018). Moreover, fintech-related regulations can be described as outdated, cumbersome, and even constraining to firms, especially start-ups, in many developing countries.

The second category pertains to macrofinancial risks, or system-wide vulnerabilities that may magnify shocks to the financial system therefore causing instability (FSB, 2017). Specific risks include contagion, procyclicality, excess volatility, and systematically-essential entities. The first predicament occurs when substantial losses incurred by a single fintech platform or sector spills over to other players or sectors. The second scenario is associated with availability of cheap debt and equity financing to start-ups and new entrants during an economic surge. The third risk stems from the use of algorithms and other technologies which amplifies the already volatile financial system. The last vulnerability relates to the displacement of traditional banks and the ascent of fintech firms as too-important-to-fail entities (FSB, 2017).

Fintech in ASEAN: Current State of Play and Notable Initiatives

Having the world's fifth largest economy and serving as home to around 650 million individuals in 2018, the Association of Southeast Asian Nations (ASEAN) has rightfully garnered the attention and interest of investors and fintech firms globally. To illustrate, ASEAN's fintech industry received USD 485 million worth of investments in 2018, which is over 140% bigger than the 2017 figure, according to CB Insights (2018). There are more than 600 fintech start-ups that operated in the region during the cited year. More importantly, the proliferation of fintech companies across ASEAN is viewed as a viable means in advancing financial inclusion, since over 50% of the adult population is unbanked and majority are poor and living in rural, far-flung areas (Demirgüç-Kunt et al., 2018).



The 2019 benchmarking study undertaken by the Cambridge Centre for Alternative Finance (CCAF), Asian Development Bank Institute (ADB), and FinTechSpace revealed key findings about the current fintech ecosystem in ASEAN. In terms of geographic breakdown, Singapore has the most number of fintech firms operating within the region (29% share of the total), followed by Indonesia (17%), Malaysia (11%), Thailand (10%), and the Philippines (7%). The remaining portion is composed of firms from Cambodia, Vietnam, Myanmar, and other enterprises that operate within ASEAN but are based elsewhere. Digital lending is the primary business model of fintech firms (32% share of the total), followed by digital payments (26%), crowdfunding (21%), enterprise technology for finance institutions (17%), and artificial intelligence (AI), machine learning (ML), big data (15%). Other types of business models include personal and enterprise financial management, trading capital markets, asset management, and Insure Technology (InsurTech).

The survey similarly showed that the primary customer of fintech start-ups and companies are individuals (42% of the total), but focus has been gradually shifting towards corporations (28%) and small and medium-sized enterprises (22%). Digital lending and digital payments platforms are the main transaction partners of individuals, while enterprise technology for financial institutions and AI/ML/big data are for large corporations and SMEs. In addition, ASEAN fintech firms retain their market share and expand their customer base by prioritising strategies encompassing ease of customer use, speed of service, product/service cost, interoperability, and user interface.

Furthermore, fintech firms expressed a generally positive reception toward regulations, albeit the need to secure specific licences for their different products and/or services (CCAF, ADB, FinTechSpace, 2019). Enterprises engaged in AI/ML/big data, digital payments, and digital lending are the most satisfied due to “adequate and appropriate” policies, while companies engaged in capital raising crowdfunding and enterprise technology for financial institutions are the least satisfied due to “excessive and too strict” regulations. Notably, fintech firms perceive cyber-attack and regulatory change as the top risks to their operations, followed by acquisition by incumbent or by competitor, increase in fraudulent activity across the ecosystem, shift in customer loyalty, and collapse due to malpractice.

As previously mentioned, regulatory agencies in ASEAN have developed and implemented frameworks and policies covering specific fintech sectors at the domestic level (CCAF, ADB, FinTechSpace, 2019). For instance, Indonesia has introduced tailor-made regulations for peer-to-peer (P2P) lending, while Thailand is closely following suit. There are no bespoke regulations for P2P lending in Philippines, Vietnam, and Singapore, thus firms are governed by existing laws such as securities and anti-money laundering requirements. Furthermore, both Malaysia and Indonesia have already issued specific regulations for equity crowdfunding, which is contrary to the situation in Laos, Myanmar, and Vietnam. Regulatory agencies in Singapore and Thailand are viewed as leaders in digital payments promotion, but there are still region-wide differences in qualification requirements, kinds of operational licences, and types of service providers. Other measures

implemented by financial authorities include favourable tax policies for fintech firms (e.g. Indonesia, Laos, Malaysia, Philippines) and co-working spaces among domestic firms (e.g. Malaysia, Philippines, Vietnam).

Regulatory agencies of AMS can then be credited for initiating a handful of regulatory innovations, namely: (i) establishment of innovation offices; (ii) regulatory technology (RegTech); and (iii) creation of regulatory sandboxes. First, several jurisdictions have formed innovation units to primarily cater to fintech development within their locality. They may perform a host of tasks such as overseeing innovation hubs and regulatory sandboxes, enforcing policy measures related to fintech innovation, and reviewing new offerings/services that fall outside of existing regulations (Alliance for Financial Inclusion, 2020). Innovation offices likewise act as liaison between regulatory agencies and fintech service providers.

Within the region and globally, the Monetary Authority of Singapore (MAS) is regarded as one of the first movers in fintech regulation. It established the FinTech and Innovation Group (FTIG) in 2015 which is tasked to develop regulatory policies and development strategies for technology and innovation, improve efficiency and risk-management, and advance competitiveness in the financial sector (MAS, n.d.). The FTIG is divided into three sub-offices namely, payments fintech, fintech infrastructure, and fintech ecosystem. Further, MAS institutionalised a Data Analytics Group (DAG) in 2017 to apply data analytics in strengthening the supervision of financial institutions and in enhancing organisational efficiency. DAG is composed of three sub-offices which are data governance and architecture, specialist analytics and visualisation, and supervisory technology. A Technology and Cyber Risk Supervision Department (TCRD) was also formed to develop technology risk management and cybersecurity strategy and policies for financial institutions and to undertake cyber-surveillance over the latest cyber threats (MAS, n.d.).

Another possible model is the Bank of Thailand's (BOT) Financial Technology (FinTech) Department, which is comprised of both information technology (IT) and policy experts (Alliance for Financial Inclusion, 2020). The Department is primarily responsible for managing the BOT's regulatory sandbox and attains this by working in coordination with other departments such as payments system policy, bank supervision, and technology risk supervision. The Bank has also created multiple cross-functional "squad" teams to keep track of recent fintech-related developments. Across Southeast Asia, Brunei, Indonesia, and Malaysia have their respective innovation offices which may function as an education centre, a one-stop-shop, or a policy-making body (CCAF, ADBI, FinTechSpace, 2019).

Next, AMS have rolled out regulatory technology (RegTech) to effectively monitor fintech firms' compliance with standards and measures, and vice-versa. The adoption of RegTech is projected to produce more evidence-based, data-driven policy decisions by finance authorities and augment operational efficiency (Perlman, 2019). Fintech firms may likewise benefit from such innovation as large swaths of data can be collected, stored, and analysed instantly and be made available for regulatory compliance purposes. To illustrate, the Autoriti Monetari of Brunei Darussalam have deployed RegTech in building a centralised statistical system of financial data from external parties, while the Bank Negara Malaysia has furthered



its open banking journey by promoting open application programming interface (API) covering motor insurance, credit cards, and SME financing. Singapore and Thailand have utilised RegTech for data governance and distributed ledger technology industry, respectively, while Philippines has begun exploring digital supervision technologies and techniques (CCAF, ADBI, FinTechSpace, 2019).

Lastly, financial authorities across ASEAN have implemented regulatory sandboxes to enable and encourage innovation within a well-defined environment. The CCAF, ADBI, and FinTechSpace define sandboxes as *“formal regulatory programs that allow market participants to test new financial services or business models with live customers, subject to certain safeguards and oversight”* (2019, p. 57). In the Philippines, the Bangko Sentral ng Pilipinas (BSP) is implementing a regulatory sandbox as part of its fintech roadmap. BSP Governor Benjamin Diokno highlighted five main steps under such a mechanism, otherwise known as test-and-learn approach:

- i) Allow for market to develop and innovations to take place;*
- ii) Proceed with flexibility yet with caution;*
- iii) Understand operating and business model;*
- iv) Adopt appropriate regulatory approach; and*
- v) Closely monitor developments and related issues”* (2019).

Singapore remains a leader with over 40 applications and 140 types of guidance provided to firms and individuals. Brunei, Malaysia, and Vietnam have their own regulatory sandboxes, while both Thailand and Indonesia operate two sandboxes currently.

At the regional level, the ASEAN Financial Innovation Network (AFIN), ASEAN Bankers Association, and the International Finance Corporation, launched the API Exchange (APIX) in 2019 to catalyse synergies between financial institutions and fintech firms within the region. The APIX is the world’s first cross-jurisdictional, open architecture API which acts as both a marketplace and a sandbox (AFIN, 2020). Using this platform, fintech firms can help financial institutions in addressing business problems through innovative solutions, and users can purchase APIs for various objectives. Benefits of joining APIX include greater visibility with investors, better market credibility, less costly prototype and proof of concepts (POF) development, and intellectual property protection. Over 50 financial institutions and more than 330 fintech firms have already tapped APIX to upgrade their innovation capabilities and to scale their unique products.

Advancing Fintech within AEC: Options and Considerations

Notwithstanding the aforementioned strides, AMS still face several challenges in improving fintech uptake across the region. Based on the ASEAN Economic Community (AEC) Blueprint 2025, fintech-related goals, efforts, and initiatives can

be found under section A.4. Financial Integration, Financial Inclusion, and Financial Stability of pillar A. A Highly Integrated and Cohesive Economy (ASEAN Secretariat, 2016). Thus, the succeeding paragraphs review the salient features of relevant ASEAN documents, along with the key issues confronting AMS and the regional bloc. Policy options and considerations at the regional level are similarly explored.

As stipulated in the AEC 2025 Consolidated Strategic Action Plan (CSAP), financial integration will be pursued through *“increasing the role of ASEAN indigenous banks, having more integrated insurance markets, and having more connected capital markets”* (ASEAN Secretariat, 2018). Key ASEAN frameworks related to this endeavour are the Banking Integration Framework (ABIF), Framework Agreement on Services (AFAS)/Trade in Services Agreement (ATISA), and Collective Investment Scheme (CIS) Framework. Different working committees at the regional level monitor the progress and milestones of the AMS toward financial integration.

In the field of payment and settlement systems, AMS have begun adopting ISO 20022, which lays out the international standard for data interchange among financial institutions. Brunei, Cambodia, Philippines, and Thailand have enacted measures in congruence with ISO 20022 for Real-Time Retail Payments, while only Brunei adopted ISO 20022 for Large Value Payment Systems as of 2018 (World Bank & ASEAN WC-FINC, 2019). More recently, an ASEAN Payments Policy Framework (APPF) was finalised which will link real-time retail payment infrastructures in AMS, hence making cross-border transactions somehow comparable to domestic payments. These initiatives are expected to support a freer flow of retail payments within Southeast Asia. There are also efforts focusing on remittances through formal channels and stronger consumer protection (ASEAN Secretariat, 2019a).

Financial stability is another issue-area covered by AEC 2025 CSAP. The ABIF seeks to attain this by raising the level of regulatory transparency, standards, and coherence, and by espousing cooperation on supervisory and crisis recovery, management, and resolution arrangements. In addition, the AEC 2025 SAP for Financial Integration 2016-2025 provides that financial market infrastructures (FMIs) within the region must comply with international standards such as the Principles for FMIs. It also cites the need to craft an appropriate regulatory framework for innovations to effectively address novel risks and vulnerabilities. Some of the ABIF's financial integration-related milestones include a regulatory scan of AMS, Guidelines for Monitoring and Reporting on the Progress of Agreements under ABIF, including monitoring templates, key performance indicators for banking, and oversight of intra-ASEAN indigenous banks and intra-ASEAN financing.

In spite of the comprehensive nature of both the abovementioned documents, the lack of harmonisation among regulatory initiatives continues to challenge ASEAN's march toward regional integration. This is evidenced by varying data protection standards in different jurisdictions, fragmented platforms and policies, specifically on cross-border payments, and a multitude of regulatory approaches on cryptocurrencies. The absence of formal industry organisations in many fintech sectors have also hampered the development of self-regulation/policing mechanisms, which may lessen the burden on regulatory agencies (CCAF, ADBI,



FinTechSpace, 2019). Moreover, overregulation of certain sectors such as equity crowdfunding and enterprise technology for financial institutions is a real concern since burdensome requirements and licences hinder firms from actually operating in a particular jurisdiction. The presence of different authorities such as financial, competition, telecommunication, and/or anti-money laundering simultaneously regulating a single digital financial services (DFS) provider or product have resulted in overlapping regulations and silos (World Bank & ASEAN WC-FINC, 2019).

Thus, AMS may consider the formulation and implementation of a region-wide fintech-specific framework to effectively steer the Association toward financial integration. Existing frameworks such as the APPF, AFAS/ATISA, and ABIF may serve as vital building blocks or guideposts in the development of an ASEAN Framework on Fintech/Digital Financial Services to ensure its alignment with the 2025 AEC CSAP and AEC SAP for Financial Integration 2016-2025. Working committees at the regional level will therefore play a critical role in determining the depth and pace of such undertaking. Subsequently, AMS may identify “champions” to effectively streamline the proposed Framework and to enhance its visibility and agenda importance at both the domestic and regional levels. Singapore and Malaysia seem to fit the description, and Thailand, Philippines, and Indonesia are quickly catching-up.

In terms of content, ASEAN Member States may include a commonly-agreed definition of fintech to establish a clear outline of the scope and parties covered in the Framework. They may likewise incorporate a provision on the establishment of a Working Committee on Fintech composed of regulatory authorities of AMS, which will be responsible for the development of fintech-related policies and activities, as well as the oversight of States’ progress in increasing fintech uptake among members of the ecosystem. The pooling of resources and manpower under a single regional body may lead to a deeper level of fintech adoption. Moreover, the Framework may encourage the greater participation (and even the creation) of formal industry organisations of different fintech sectors in region-wide initiatives to foster synergies between AMS and private sector partners.

Furthermore, Member States may look into the development of self-regulation mechanisms to reduce the burden on regulatory agencies’ capacity. It is crucial to emphasise that self-policing should not be perceived as an enabler of regulatory arbitrage or regulatory capture, but instead as a means to enhance compliance of firms due to peer-to-peer monitoring. This decentralised type of oversight is appropriate for fintech products/services due to their wide-ranging nature and peculiar dynamics.

Along with financial integration and financial stability, financial inclusion is the last component of section A.4. of the AEC Blueprint 2025. The Working Committee on Financial Inclusion (WC-FINC) is tasked to facilitate the attainment of such goal, and is guided by the ASEAN Financial Inclusion Framework. The Framework has four main objectives: *“(i) support national financial inclusion strategy and implementation plan; (ii) elevate capacity building of AMS to enhance financial inclusion ecosystem; (iii) promote innovative financial inclusion via digital platforms; and (iv) increase awareness on financial inclusion and consumer protection”*

(Bangko Sentral ng Pilipinas, 2015). The survey done by WC-FINC found that six AMS have Roadmaps or National Strategies for Financial Inclusion respectively, and three of them have Roadmaps or National Strategies for Financial Education. All ten AMS have instituted public credit registry or credit bureau, while seven Member States operate their respective credit guarantee institution (World Bank & ASEAN WC-FINC, 2019).

Key documents that enable the operationalisation of the ASEAN Financial Inclusion Framework include the Guidance Notes on National Financial Inclusion Strategies, Guidance Notes on Financial Education and Consumer Protection, Guidance Notes on Digital Financial Services (DFS), and Survey Report on Digital Financial Services in AMS (ASEAN Secretariat, 2019a). Member States are also in the process of creating Guidance Notes on Monitoring Financial Inclusion Toolkit. The ASEAN Insurance Regulators' Meeting (AIRM) is similarly working on a Framework for Microinsurance Product to expand the coverage of commercial and social insurance schemes within the region.

Consequently, these undertakings have led to a lower financial exclusion rate at around 37% in 2018, from 44% in 2016, according to the ASEAN Integration Report 2019. Readiness of financial inclusion infrastructure among Member States have likewise improved to 74% in 2018, from 70% in 2016. The surge in digital payments systems utilisation, diffusion of digital technology, and digital financial services innovations are cited as main drivers of financial inclusion in ASEAN.

Despite these accomplishments, the regional bloc's financial inclusion project is still plagued by two perennial issues, namely, digital divide, and low level of trust and confidence in fintech platforms and service providers. The first challenge can be observed in the disparity in number of fintech firms operating in the region. Particularly, Singaporean, Indonesian, Malaysian, Thai, and Philippines enterprises make up more than 70% of the total, while CLMV countries and other non-ASEAN firms comprise the remaining 26% (CCAF, ADBI, and FinTechSpace, 2019).

Further, ASEAN-5 countries (Singapore, Malaysia, Thailand, Indonesia, Philippines) have an average of almost 70% of the adult population with a bank account, which is far greater than the CLMV (Cambodia, Laos, Myanmar, Vietnam) average of 27% (Demirgüç-Kunt et al., 2018). The lack of fintech-related infrastructure, especially in rural, remote areas, in several localities within Southeast Asia is seen as another perpetuator of the lingering divide. With the exception of Singapore, fixed broadband speed in the region is also lagging, with Philippines, Brunei, Indonesia, Cambodia, and Myanmar falling outside the top 100 (The ASEAN Post, 2019a). Evidently, these factors substantially contribute to the impeded growth of fintech ecosystems across several jurisdictions in the region. Hence, ASEAN and its Member States may assess a couple of policy recommendations in addressing the digital divide.

A logical pathway is the promotion of infrastructure sharing among telecommunications companies to reach underserved and disconnected areas (Garcia & Kelly, 2016). It may be in the form of either mutualisation (i.e. a common facility operated by all market players) or a cooperative model (i.e. infrastructure is built with other linear infrastructures). The sharing of facilities (e.g. site, cell tower,



base station, network) is expected to raise the quality of internet service and speed as more resources can be allotted for research and development of companies. Ultimately, a competitive telecom industry benefits the society, as more citizens can enjoy a whole spectrum of services and products at fair market prices. However, implementing an effective infrastructure sharing mechanism entails the cooperation of various market participants with competing interests. ASEAN governments are hence given the unenviable task of bringing together all the concerned parties and guiding them towards the right direction. They must similarly assess and account for the economic and regulatory implications of adopting such setting.

To support fintech start-ups and even SMEs, AMS, with the help of AFIN, may mainstream the development of industry sandboxes for fintech firms (World Bank & ASEAN WC-FINC, 2019). This set up allows firms and industry players to collectively test proof concepts and new offerings in an environment without consumers. The industry sandboxes can simulate consumer behaviour to examine whether an application has met the functionality level aspired by the company. This policy option may fulfil two purposes: (1) nurture a culture of innovation through partnerships among ecosystem members; and (2) serve as a complementary to regulatory sandboxes. Member States may explore the possibility of providing fiscal incentives to fintech organisations and market participants that are actively engaged in industry sandboxes.

The last issue refers to the low level of confidence and trust of ASEAN citizens in fintech platforms and products/services. To illustrate, around 50-65% of digital buyers from the Philippines, Thailand, Indonesia, Vietnam, and Malaysia expressed their reluctance in sharing their financial information online (BBVA Research, 2017). The anxiety in disclosing personal data to companies, especially e-commerce firms, is fuelled by large-scale cyberattacks in Cambodia, Malaysia, Singapore, Thailand, and Philippines (ASEAN Today, 2018). The Asia Pacific Risk Centre estimates that data breaches globally cost around USD 2 trillion in 2019, and that hackers are 80% more likely to launch attacks against organisations in Asia (The ASEAN Post, 2019b). In the Global Cybersecurity Index 2018, Singapore remains to be a trailblazer in ASEAN (ranked 6th globally), followed by Malaysia (ranked 8th globally), Thailand (ranked 35th globally), Indonesia (ranked 41st globally), and Vietnam (58th globally). The Philippines, Laos, Myanmar, and Cambodia complete the list.

Notably, only Philippines, Singapore, and Thailand in the region have data protection laws and data privacy regulatory agencies. Thailand is set to join the group soon, while Indonesia is following suit. The adoption of the ASEAN Framework on Digital Data Governance to leaders in 2018 is a welcome development as the document aims to improve data management, advance harmonisation of data standards and regulations, and enhance intra-ASEAN data flows (Thomas, 2019). However, a lot of work still needs to be done. For instance, AMS may augment their expenditures on cybersecurity-related programs, as they spent only 0.06% of the region's GDP (USD 1.9 billion) in 2017. The allocation of more resources for a fortified cybersecurity system may create additional savings for the government, which can then be utilised for provision of public services or reinvested in cybersecurity-related efforts. Furthermore, Member States, except Singapore and Philippines, may

participate in the Asia-Pacific Economic Cooperation (APEC) Forum's Cross-Border Privacy Rules (CBPR) which is *"a government-backed data privacy certification (scheme) that companies can (voluntarily) join to demonstrate compliance with internationally-recognized data privacy protections"* (APEC, 2019) Evidently, AMS' involvement in the CBPR can be taken as a demonstration of their commitment to consumer protection and data privacy.

The Future of Fintech in ASEAN

Indeed, fintech presents opportunities for Southeast Asia, specifically in upholding financial stability and in advancing financial integration. More importantly, financial innovations have the potential to level the playing field for all players and empower the unreached and underserved portions of the population. Recognising the tremendous promise of such development, ASEAN has laid the groundwork by setting specific goals, which can be found in the 2025 AEC Blueprint and AEC CSAP, and by developing region-wide frameworks such as the APPF, AFAS/ATISA, and ABIF. Nevertheless, fintech-related efforts within ASEAN can be aptly characterised as mainly state-driven, hence the proliferation of varying standards and regulations, fintech adoption divide, and low level of trust of consumers in fintech platforms and service providers.

Accordingly, AMS may consider the following policy options: (i) formulation and implementation of a region-wide fintech-specific framework; (ii) underpin infrastructure sharing among telecommunications companies, especially those operating in remote, rural areas; (iii) development of industry sandboxes for start-ups and SMEs; (iv) increase funding for cybersecurity-related projects; and (v) participate in APEC's CBPR initiative. The role of proactive, innovation-friendly policies and regulatory agencies at the domestic level are paramount in realising these recommendations.

In the medium-run, fintech adoption among Member States appears to be on an upward trend amid the Fourth Industrial Revolution. This phenomenon has prompted governments, private sector, and consumers alike to adapt to unprecedented technologies and living standards and to creatively manage new risks and vulnerabilities. The current Covid-19 pandemic has also been a catalyst of greater fintech uptake, as firms and consumers are pushed towards digital platforms and tools in carrying out their operations and even mundane activities. Nevertheless, AMS should exercise due diligence and caution by establishing fintech-related safeguards and mechanisms against underlying risks and potential vulnerabilities.

In the long-run, it remains to be fully seen how the dynamics and politics of fintech will coexist with the ASEAN Way, which is characterised by incrementalism, consensus, and non-interference. The only obvious observation is that the complexity and cross-border nature of fintech processes and transactions entail deeper cooperation and agile synergies at the regional level, especially amid ASEAN's integration project.



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Monetary Policy in the Founder Countries of ASEAN

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Abstract: In this paper, we examined the monetary policy systems of the ASEAN-5 countries (Indonesia, Malaysia, Philippines, Singapore, and Thailand) in order to assess the countries' readiness for a higher level of integration, a monetary union. We found that these countries successfully adopted many of the best practices of the developed countries, especially transparency which is important in anchoring market expectations. Furthermore, we did not find any significant differences in the five countries regarding inflation volatility and level, which could have been explained by the different monetary policy regimes employed. On the monetary union prospects, we found that inflation rates and exchange rates in the five countries showed strong connections, which is necessary to avoid the need for nominal exchange rate adjustments. On the other hand, the economies are far from the required harmonization, which resulted in different monetary policy reactions to the same shocks. In addition, the independence of the monetary policy has not been achieved in most ASEAN-5 countries, which can become a huge obstacle in the establishment of a supranational authority conducting common monetary policy in a monetary union.

Keywords: ASEAN, monetary policy, monetary union

Introduction

Any economic integration can be described by its depth. The literature (e.g. Balassa, 2013) describes five different levels of integration: free trade, customs union, common market, economic union (or single market), and complete economic integration. Through the different levels of integration, more and more restrictions are lifted among the countries participating in the integration. From the abolishment of tariffs in free trade to complete economic integration where the unification of monetary, fiscal, social policies are achieved, with the establishment of a supra-national authority whose decisions overwrite those of the member states. However, even in this breakdown, each level can be divided into more stages as we can see in the case of the European Union or the Eurozone, where the monetary integration is almost finished, but the political, social, and fiscal integration are still in their earlier stages. The ASEAN (Association of Southeast Asian Nations) integration is still far from this point in the integration process. According to the



ASEAN Community Vision 2025, the advancement of the single market agenda is *“through enhanced commitments in trade in goods, and through an effective resolution of non-tariff barriers; deeper integration in trade in services; and a more seamless movement of investment, skilled labour, business persons, and capital”* (ASEAN Community Vision 2025, 2015), so a common market is still only in the goals of the integration.

Thus, it is clear that the ASEAN integration is still decades away from even an economic union, not to mention a complete economic integration. However, even at this level of integration, it is important to examine the readiness of the ASEAN countries (Indonesia, Malaysia, Philippines, Singapore, and Thailand) to deepen the integration. Before a monetary union is introduced, it is fundamental that the participating countries have a well-functioning monetary policy system because it can help the economic development through many channels. Moreover, the synchronization of the monetary policies can reduce the exchange rate volatility among member states, which, in return, helps to strengthen economic relations, thus, forwarding the economic integration without the need to give up the independent monetary policy – an important tool in any crisis management.

In the literature, Vatsa, Sharma, and Basnet (2010) researched the same issue, specifically focusing on currency exchange rate co-movements. According to the literature, highly correlated business cycles are one of the necessary conditions for a higher level of economic or monetary union. They found that – except for Indonesia – the other member states of ASEAN exhibit co-movement both in the long-run and in the short-run which indicates monetary policy coordination among these countries. The reason behind this is that the four countries demonstrated a very similar response to the examined crisis (Latin American and Asian Financial Crisis). Taylor, in his 2018 presentation, assessed the monetary policy and the development of interest rates in ASEAN countries since the Asian Financial Crisis (International Monetary Fund [IMF], 2016) and the exposure of their monetary policy to the decisions of other national banks, in particular the Federal Reserve (Fed). He concluded that with its interest rate decisions, the Fed has a significant impact on the economic performance of ASEAN countries, mainly through the exchange rate, so the decisions of the region’s national banks follow the Fed. Dau and Sethapramote (2019) reached the same result. They analysed the fiscal and monetary policy spillovers in ASEAN countries. The authors found that these spillovers are significant for all of the 5 countries, and in case of external spillovers, other East Asian countries have a greater effect on ASEAN countries than the advanced Western countries¹. Expansionary monetary spillovers have a negative effect on ASEAN countries’ real GDP, which implies that the exchange rate transmission channel is very important in the ASEAN economies. The authors concluded that the policy coordination among ASEAN countries as well as at the regional and global level is necessary and important.

In this paper, we focus on the monetary policy of the ASEAN-5 countries: we examine the possibility of a monetary union amongst them. In the existing literature, the focus was only on the exchange rates, while the evolution of the inflation was neglected, which is similarly important in the optimum currency area

(OCA) theory (Mongelli, 2008). To fill this gap, we conducted a compact analysis of the monetary policy of the ASEAN-5 countries to determine their readiness for a monetary union.

The paper is organized as follows: Section 2 describes the inflation-targeting systems, its requirements, and its advantages against other monetary policy regimes. Section 3 introduces the monetary policy systems in the ASEAN-5 countries with critical remarks in comparison with the developed countries' practice. Section 4 evaluates the monetary systems in the five countries, through the evolution of the base rate, the inflation rate, and the exchange rate. Finally, Section 5 concludes the paper.

Monetary Policy and Inflation Targeting

The most commonly used monetary policy system, also considered as best practice, is the inflation targeting strategy. According to Svensson (2010), it is the most flexible and resilient monetary policy regime, which was already tested in a crisis. The central banks realised a long time ago that the most effective way they can support sustainable long-term economic growth is through the stabilization of the price level. However, inflation targeting is more than just an announcement of the inflation target. Mishkin (2002) published a set of "rules" which must be followed for the effectiveness of the system:

1. Public announcement of a medium-term numerical target for inflation
2. Institutional commitment to price stability as the primary goal of monetary policy, to which other goals are subordinated
3. Information-inclusive strategy in which many variables are used for deciding the set of policy instruments
4. Increased transparency of the monetary policy strategy through communication
5. Increased accountability of the central bank for attaining its inflation objectives

However, studies show mixed results on the effectiveness of the inflation targeting system in comparison with other monetary regimes. de Carvalho Filho (2011), found that during the crisis of 2008, countries using the inflation targeting system performed better than those implying different regimes. They were able to lower nominal and real interest rates much faster, thus, they were less likely to experience deflation scares. In addition, their currencies experienced real depreciations without a rise in perception of risk by markets, which, in turn, may help to raise external demand. Other researchers (Mishkin and Schmmidt-Hebbel, 2007), found that the fall in inflation (both in level and volatility), interest rate, and output volatility was a worldwide trend and was not exclusive to inflation targeting countries. Furthermore, they found that inflation persistence is lower for inflation targeters, and, in their countries, inflation expectations are more anchored, thus they react less to shocks.



Other alternatives to the inflation targeting system are money growth targeting and exchange rate targeting systems. The main problem with the former is that there is no exact connection between money growth and inflation, thus the practical experiences show this cannot guarantee the stabilization of the inflation. While the exchange rate targeting system is exposed to speculative attacks and increased international capital flows (Svensson, 2010). However, even if a central bank does not use inflation targeting regime, the points set above in relation to the employed regime can help raise the effectiveness of the given system.

Monetary Policy Systems in the ASEAN-5 Countries

In this chapter, we examine monetary policy systems of the ASEAN-5 countries. We concentrate on the main objective of the central bank in each country, its main instruments, and its relationship to the government. In the case of each central bank, we evaluate monetary systems in relation to the points presented in the previous chapter. We used the publicly available information on each central bank's website, the acts governing them, and the monetary policy statements.

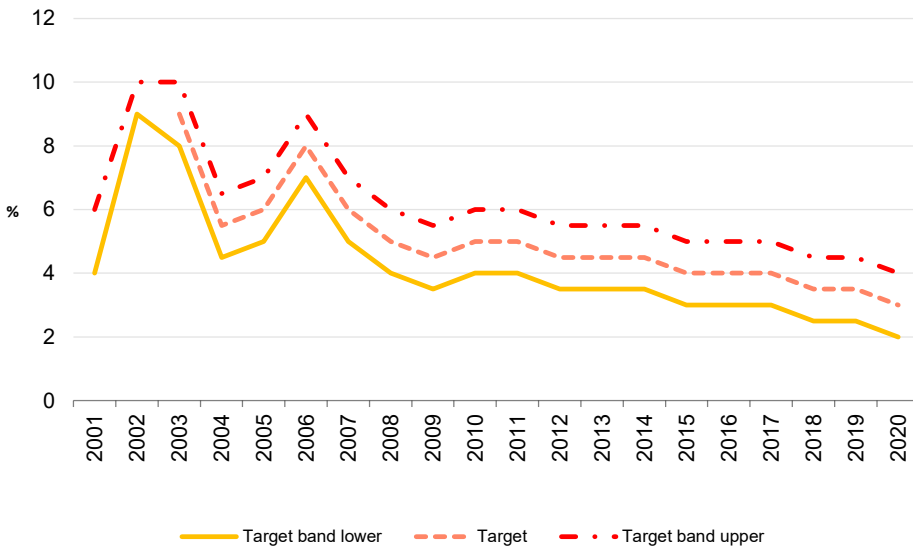
Indonesia

Bank Indonesia's (BI) goal is to achieve and maintain the stability of the local currency, the rupiah. The stability of the currency is defined by the stability of prices, thus the central bank adopted the inflation targeting framework in 2005. Furthermore, Bank Indonesia, although adhering to a free-floating exchange rate system, also operates exchange rate policy to minimise its volatility.

The inflation target in Indonesia is set by the Government with the Decree of the Minister of Finance for a 3-year period. This helps to anchor market actors' inflation expectations for the midterm. The current inflation target is 3% with a 2% wide symmetric target band. However, for the year 2021, there is not any established inflation target yet, which, considering the delayed-effect of any monetary policy action due to transmission, can significantly lower the effectiveness of the monetary policy in Indonesia.

In the past, the inflation target and the target band changed a lot, almost yearly. For the first two years (2001 and 2002), the BI set a band for the target which was changed for 2003 to a target point with a tolerance band. This system is active since then but the target was reduced significantly. From the continuous changes in the inflation target, one can assume that the decision-makers tried to set an achievable goal, instead of one that would help the economy in the long term and stick to it to anchor inflation expectations. This helped them to conduct a much more flexible monetary policy, while a stricter target would have needed a constantly strict monetary policy.

Figure 1²
Evolution of Bank Indonesia's inflation target and target band



The BI operates as an independent state institution, which guarantees its freedom from interference by any external party, including the Government. However, in article 7 of Act No. 3 of 2004 concerning Bank Indonesia (2009), it is stated that the central bank shall conduct monetary policy taking into account the general economic policies of the government. This somewhat contradicts the independence of the central bank in conducting monetary policy to achieve the inflation target. This stipulation appears in many other acts concerning central bank policy but mostly as a secondary goal, e.g. for the European Central Bank, clearly subordinated to inflation targeting.

The main monetary policy tool of Bank Indonesia is a 7-Day (Reverse) Repo Rate which was introduced in August 2016. Through this, the central bank can affect the interbank money market. Besides this, the BI employs standing facilities to limit the volatility of overnight interbank rates and provide or absorb liquidity if necessary. Furthermore, Bank Indonesia conducts open market operations to absorb or provide liquidity to the money market to maintain equilibrium.

Another important aspect of the monetary policy in Indonesia is the stance concerning fiscal policy. There are regular meetings between Bank Indonesia and the Government to coordinate policy actions. While this practice is common even in developed countries, Bank Indonesia, due to Covid-19, decided to purchase Government Securities in the primary market from June 2020. This is monetary financing which is forbidden in developed countries, and for a good reason.



Monetary financing reduces budgetary discipline and compromises the primary goal of the monetary policy, the achievement of price stability (Korencsi, Lakatos & Pulai, 2013). This is somewhat circumvented with the quantitative easing measures which are conducted on the secondary market, and the ECB uses restrictions on the purchases. However, in the case of BI, the purchases occur in the primary market, which can lower the credibility of the monetary policy in achieving its target.

Malaysia

The principal objective of the Bank Negara Malaysia (BNM) is to maintain monetary and financial stability to support the growth of the economy (Central Bank of Malaysia Act 2009). The role of the Bank is to formulate a monetary policy which, according to Article 22(1), “*serves the interests of the country with the primary objective of maintaining price stability giving due regard to the developments in the economy*”. In the case of financial stability, the central bank should pursue developing a sound, resilient, progressive, and diversified financial sector, which in return, can help the real economy. Although the BNM target is to maintain price stability, it does not employ an inflation targeting system, there is no stated inflation target in Malaysia.

The main instrument of Bank Negara Malaysia is the Overnight Policy Rate (OPR), which is the minimum interest rate in the interbank market charged amongst banks when they borrow liquidity from each other. Furthermore, the BNM operates standing facilities to minimise volatility in the interbank market, they are set 0.25 basis points above (lending) and below (deposit) the policy rate. However, the principal monetary instrument is the uncollateralised direct borrowing through open tender, the maturity of which can range from overnight to six months. Besides this, the BNM executes repo transactions – to absorb from and provide liquidity to banks for eligible securities up to one year – foreign currency (FX) swaps, and auctions of Monetary Notes and Interbank Bills.

Although the act behind Bank Negara Malaysia states that the bank shall formulate its monetary policy and actions autonomously and without external influence, the stated connection with the Malaysian Government contradicts this independence. According to the act, the Central Bank shall keep the Finance Minister informed of the conducted monetary policy relating to its principal objects. In case there is a difference of opinion between the Minister and the Bank relating to its principal objects, the Minister and the Bank shall endeavour to reach an agreement. If it is not possible, the Cabinet determines the policy to adopt by the Central Bank.

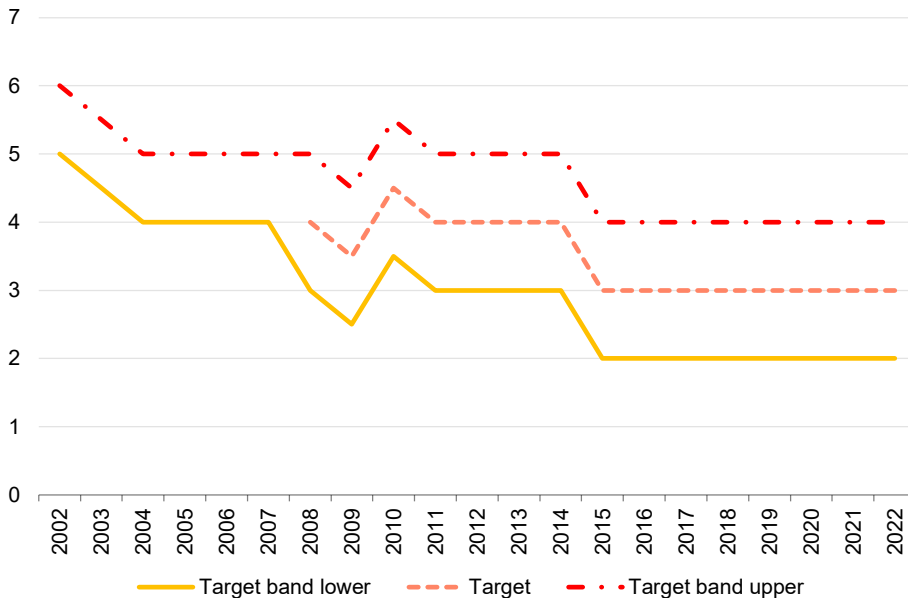
One more aspect of the act governing Bank Negara Malaysia is worth mentioning. The act allows monetary financing to the government, on market terms, if there are some temporary deficiencies of budget revenues. Although both the time and the value of this financing are capped in the act, this may undermine the independence and the credibility of the Central Bank in achieving its objective. However, this kind of safeguard is not unprecedented in developed countries. The Bank of England uses a similar system in the form of the Ways and Means (W&M) facility to smooth government cash flows in case of short-term disruption.

Philippines

The primary objective of Bangko Sentral ng Pilipinas (BSP) is to maintain price stability to achieve balanced and sustainable economic growth (Republic Act No. 7653 1993, 2019). To achieve this goal, the BSP has operated inflation targeting since 2002. One uniqueness of the system in the Philippines is that the inflation target is set by the Development Budget Coordination Committee (DBCC), a Governmental inter-agency together with the BSP. In contrast, ECB's or the Fed's target is set by the central bank itself.

The inflation targeting system has changed significantly since its introduction in 2002. Between 2002 and 2007, the BSP operated a 1% wide band target, which was replaced by a point target with a tolerance band in 2008, which is still in effect. The inflation target changed a lot, too. The target band in the first years of the system was gradually lowered but then, in 2009 and 2010, it was raised to ease the monetary policy's stand in response to the crisis. After that, the inflation target became stable. The only change occurred in 2015 when the government decided to lower the midpoint to 3% while keeping the 2% wide symmetrical band. Another difference in the BSP's inflation targeting system in comparison with the Bank Indonesia's is that the target is set for two years in advance. This can greatly help to anchor inflation expectations, thus helping the bank to achieve its target.

Figure 2³
Evolution of Central Bank of the Philippines' inflation target and target band⁴





The primary instrument of the BSP is the overnight reverse repurchase rate (RRP). Through the RRP, the BSP buys or sells government securities to banks to have an expansionary or contractionary effect on liquidity. In addition, the BSP operates overnight standing facilities to counter liquidity shortage and excess on an overnight basis. It also operates a term deposit facility (TDF) to absorb liquidity through deposit auction on 7, 14, and 28-day basis, and sets the reserve requirements for banks.

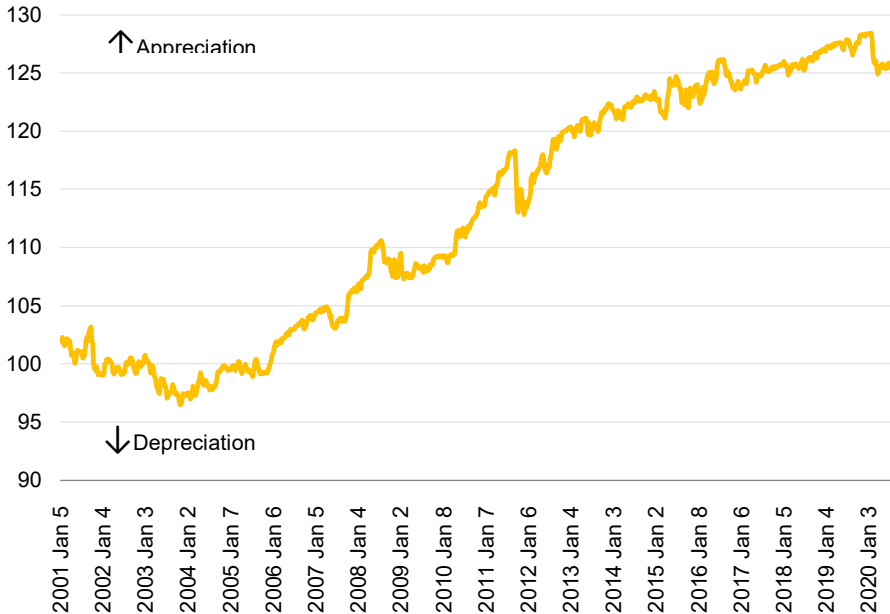
Although the act states that the BSP should operate as an independent and accountable institution, it is worth mentioning that one member of the seven in the Monetary Board is always a member of the Cabinet. However, in decision-making, majority rule is applied, meaning the Board can decide against the Cabinet member's decision therefore allowing independence in practice in the monetary policy.

Singapore

The monetary policy practice of the Monetary Authority of Singapore (MAS) greatly differs from those of the other four ASEAN countries. This is because it is centred on the exchange rate, instead of the inflation target. The final goal of the MAS is still price stability conducive to sustainable growth to the economy (Monetary Authority of Singapore Act 1999, 2018), but the central bank plans to achieve this through the stability of the Singapore dollar. The main reason behind the different monetary policy setting is that Singapore is an open economy where the value of the export and import together exceeds 310% of the GDP, while in the other two open ASEAN-5 countries (Malaysia and Thailand) it is only 123.1 and 110.3% respectively, according to the World Bank's data for 2019. Indonesia and the Philippines are considered relatively closed economies because their combined trade does not reach the value of the GDP (only 37.3 and 68.6% respectively). Because of this, the MAS can affect the economic process much more through the exchange rate than through interest rate policies. On the other hand, with exchange rate targeting, the MAS gives up direct control over domestic interest rates, which is determined by capital movements, and money supply.

Based on the applied monetary policy system, Singapore is the most prepared country of the five for a monetary union. This is because one of the last steps in the creation of a monetary union is the pegging of the exchange rate between the participating countries, through which they give up their independent monetary policy (see the ERM II system in the case of the Eurozone). However, the MAS's differs from other exchange rate targeting monetary regimes (like in Bulgaria) because the Singapore dollar is not pegged to a single currency but a trade-weighted basket of currencies (S\$NEER). While in the case of a monetary union, the Singapore dollar would be pegged to the other participating countries' currencies, meaning it would have to use a floating exchange rate system against the rest of the world.

Figure 3⁵
The evolution of the S\$NEER (Jan 1999=100)



However, the MAS does not set a point target but a policy band within, the exchange rate is allowed to fluctuate, which gives flexibility in conducting monetary policy. The bank announces the policy band to the market semi-annually, and reviews the composition of the basket. After each review (in April and October), a Monetary Policy Statement is released about the stance of the monetary policy in Singapore. However, this underlines the transparency of the monetary policy in Singapore as most central banks issue statements monthly or bimonthly to anchor market expectations and reduce uncertainty.

The main instrument of the MAS are the foreign exchange operations. With these operations the authority can keep the exchange rate in the policy band. At the same time, despite the exchange rate system, the MAS operates standing facilities to ease liquidity problems overnight, both in the Singapore dollar and the renminbi, and intraday in the Singapore dollar.

There is one more aspect in which the Monetary Authority of Singapore differs from the others presented above. The act governing the institution does not state that the MAS is independent, just that, according to Article 4(2), it “*acts as the central bank of Singapore, conduct monetary policy, issue currency, oversee payment systems and serve as banker to and financial agent of the Government*”.



Thailand

The Bank of Thailand (BOT) has employed a flexible inflation targeting system since 2000, with the main objective of maintaining price stability. The act controlling the monetary policy in Thailand (Bank of Thailand Act 1942, 2018) states, the BOT objectives consist of maintaining monetary stability, financial institution system stability, and payment systems stability. To achieve these objectives, the act states furthermore, that the Monetary Policy Board shall determine the targets of the monetary policy for every year with a corporative agreement from the Cabinet. This gives significant flexibility to the BOT to change the monetary policy system if the economic conditions require it. Despite this, the Bank of Thailand did not change the regime since the start of inflation targeting in 2000 but the target and target range change regularly.

In the first 9 years, the BOT determined a band for the core inflation⁶ between 0 and 3.5%. The use of core inflation is logical in the sense that it excludes products that are highly volatile, and thus, enables them to affect the underlying inflation process through the central bank's instruments. However, the lower band of the target range was 0, which is dangerous in the sense that undershooting the target would cause deflation which can be a self-stimulating process, and lead to a recession. To avoid the possibility of deflation, in 2009, the BOT narrowed the target band to 0.5–3.0%. The next change in the target came in 2015 when firstly, the target was changed to headline inflation instead of core inflation. Secondly, a new point target was set at 2.5% with a 3% symmetric band. The reason behind the change to the headline inflation was that it reflects the change in the cost of living much more. The BOT reasoned that setting a point target sends a clearer message to the economic actors and signals the monetary policy's stand better. The next change came in the target for 2020 when the point target was abolished and a 1–3% target band was established. These changes until 2020 can be seen as a learning curve to a developed inflation targeting system, but the regular changes can have an adverse effect on the economy through uncertainty which can undermine economic planning.

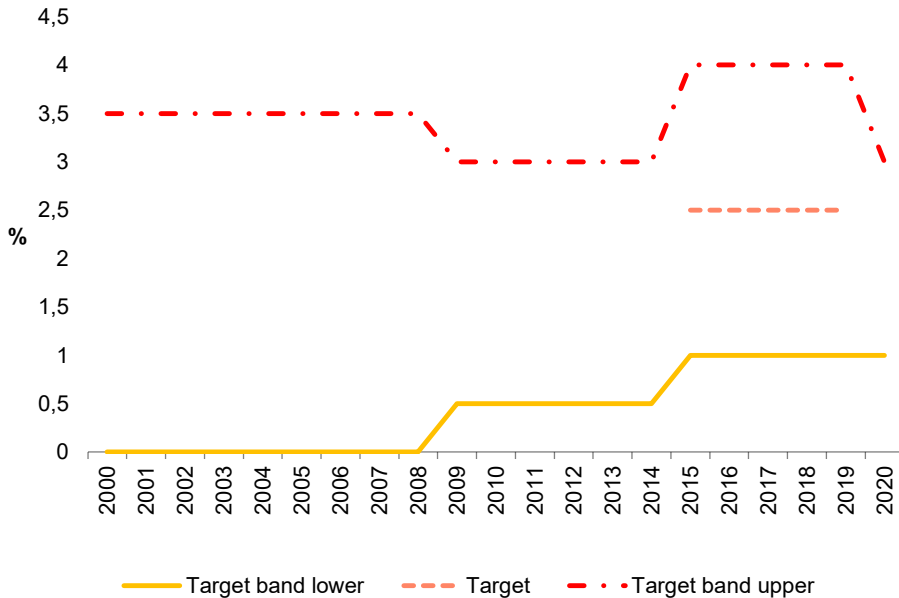
In addition, the Bank of Thailand adopted a managed-float exchange rate system, meaning the Thai baht is allowed to move through market forces, but in case of excess volatility, the BOT might intervene, which can become inconsistent with the inflation targeting system.

To achieve the monetary policy targets, the BOT sets reserve requirements, conducts open market operations (bilateral repurchases, issuance of bills and bonds, purchases/sales of public sector debt securities), and applies standing facilities (deposit and lending). In this instance, the practice of the Bank of Thailand does not differ from the one used in most central banks. The main policy rate refers to the conducted bilateral repurchase (repo) transactions from 1 day up to 6 months.

Similar to the MAS, the act governing the Bank of Thailand does not state that the institution is independent, only that it is a juristic person which is a state agency, and that the Governor shall be independent in the management and administration of the BOT. However, the Code of Conduct for Members of the Monetary Policy Committee states, in the first point, that they must act independently in expressing opinions and

making decisions, upholding the benefits to the overall economy. Despite this, the BOT in practice can work as an independent institution but the absence of this in the act is unusual, compared to developed central banks.

Figure 4
Evolution of Bank of Thailand's inflation target and target band⁷



Results of the Monetary Policy

In this chapter, we examine the monetary policy of the ASEAN-5 countries regarding three factors. Firstly, we overview the base rate of the countries to compare the reactions of the monetary policy to different shocks that occurred in recent years. Secondly, we analyse the inflation process as the main objective of each central bank, and thirdly, the evolution of the exchange rate. We will evaluate the data relative to each ASEAN-5 country and concerning the requirements of a monetary union.

Base rate

The policy rates or base rates differed significantly in the five countries in the examined period. The lowest rate was recorded in Singapore, which can be explained by the fundamentally different monetary policy system. As we explained earlier, the MAS does not control the interest rate in Singapore; it is determined by capital movements and money supply, thus it is more exposed to international shocks, which can be seen in the path of the repo rate. The rate was close to zero until around 2015 when

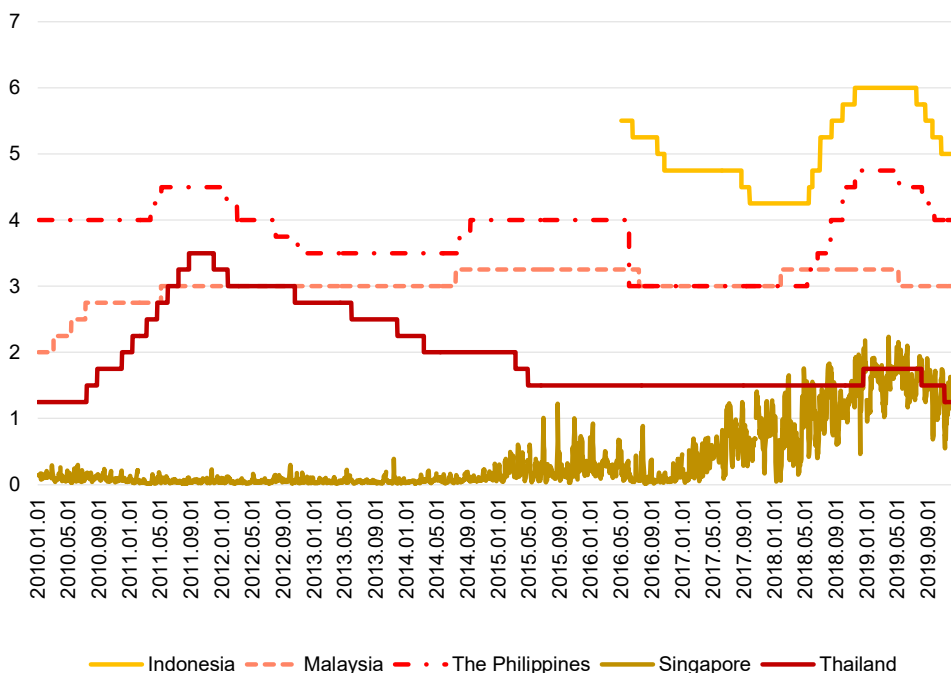


the Fed concluded its asset purchase program. However, the rate did not increase significantly until the middle of 2017 when the Fed announced its normalization plan to gradually reduce its securities holdings. The increase in interest rate ended in the second half of 2019 when the Federal Reserve ended its balance sheet wind down.⁸

In the case of Indonesia, the BI's 7-day (Reverse) Repo Rate was only introduced in 2016 to strengthen the monetary operations. After the introduction, Bank Indonesia was able to reduce its rate until 2018, despite the Fed's interest rate hikes and balance sheet normalization plans. However, in 2018, due to the Fed Fund Rate (FFR) hike and the increasing risk in the global financial market, Bank Indonesia had to raise significantly its interest rate. The central bank was able to reduce its rate and ease monetary conditions only in 2019, when the Fed decided to lower its policy rate.

In the last examined period (2018–2019), the Bangko Sentral ng Pilipinas conducted a similar monetary policy as Bank Indonesia. The BSP started to raise its interest rate in May 2018, a couple of days earlier than Bank Indonesia. The Monetary Board's statement explained the step with the inflationary processes and the normalization of the monetary policy in the advanced economies. After that, the BSP raised the interest rate roughly at the same time as Bank Indonesia, and overall to the same extent (175 basis points). In 2019, the BSP, earlier than Bank Indonesia, was able to reduce its policy rate, due to weaker global economic prospects. After that, the two central banks' policy rates were reduced similarly. This co-movement shows that the two economies had a similar reaction to the external shocks, which needed similar monetary policy actions.

Figure 5
Evolution of policy rates in the ASEAN-5 countries⁹



In the case of the Bank of Thailand and Bank Negara Malaysia, there was not such a big monetary policy action to the shocks of 2018. The BNM raised its interest rate only at the beginning of 2018, but it was a pre-emptive measure to normalize monetary conditions. After that, due to the resilience of the domestic financial markets, there was not any need to change the monetary conditions. The BOT only raised its policy rate at the end of 2018, as the need for accommodative monetary policy reduced. The BNM reduced its interest rate in 2019, roughly at the same time as the BSP. This was due to the downside risks to global growth, according to the MPC's statement. The BOT reduced its policy rate later, only in the second half of 2019. The explanation of the decision was that a more accommodative monetary policy would help economic growth and the rise of inflation toward the target. This shows that these two central banks reacted to the same shock as the BI and the BSP (albeit to a smaller extent).

In examining the whole period, we can see that the Bank Negara Malaysia and the Bangko Sentral ng Pilipinas reacted similarly to different shocks in more than one instance. Both raised the interest rate in the first half of 2011 and in the summer of 2014 due to inflation pressure from energy prices in both cases. In the case of the Bank of Thailand, in these instances, there was not any monetary decision that could be connected.

These small case studies show that, although in some instances the monetary policies of the ASEAN-5 countries react similarly to different external shocks, the economies are far from the necessary harmonization which is required for the unification of monetary policies in a monetary union.

Inflation

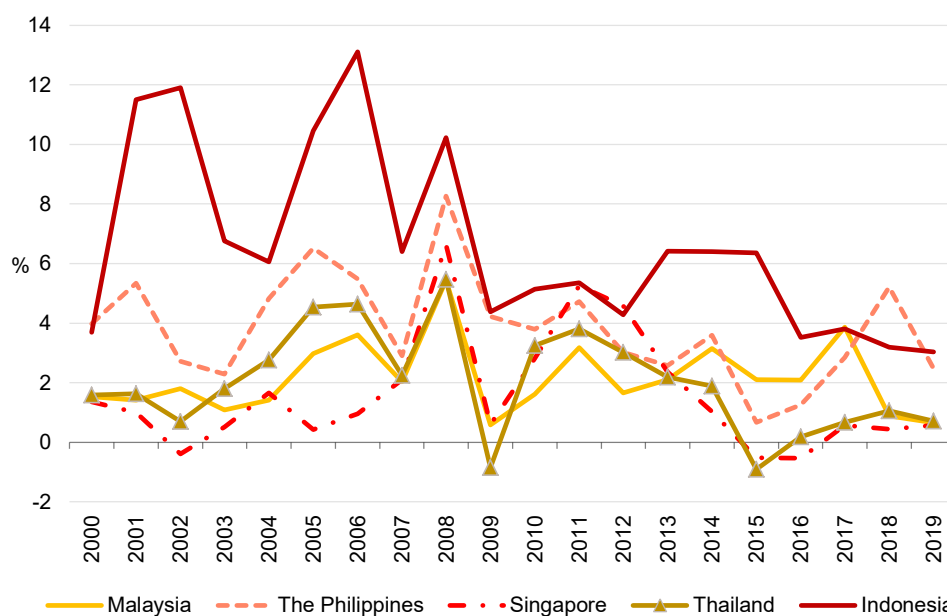
The inflation rate showed sizeable volatility in the ASEAN-5 countries in the last 20 years. Considering the whole period, the prices grew to the greatest extent in Indonesia, on average 6.6% per year, while the average inflation rate was only 1.6% in Singapore. This means the Monetary Authority of Singapore was able to achieve the lowest inflation rate, even with a greatly different monetary policy system. However, in Singapore, there were three years (2002, 2015, 2016) when they registered deflation, the decrease in prices, which can become a self-stimulating process and reduce growth. The only other country that faced deflation from the ASEAN-5 was Thailand in 2009 and 2015, which can be partly explained by the very low inflation target. The other three countries registered average inflation rate between Singapore's and Indonesia's: in the Philippines 3.8, in Malaysia 2.2, and in Thailand 2.0% on average. This, however, shows that the Central Bank of Malaysia, without an inflation targeting regime, was able to achieve similar inflation rates to their counterparts in the two countries. Another mentionable trend in the ASEAN-5 countries is that the inflation-targeting countries faced a decrease in inflation rates if we compare the data from 2000–2009 to 2010–2019. Meanwhile, Malaysia and Singapore achieved similar, low rates in the two periods. The explanation behind this can be twofold. On the one hand, it is possible that through the inflation targeting



system they were able to achieve low inflation levels. On the other hand, due to the effect of the crisis in 2008, the world-leading economies (the USA and European Union) faced lower levels of inflation rates, which, through trade, can affect the price process in the ASEAN countries.

The correlations between the different ASEAN-5 countries show a moderate positive connection (between 0.4 and 0.6). From this, there are only three outliers: the correlations between Thailand and the Philippines and between Thailand and Singapore show a strong positive connection (between 0.6 and 0.8), while the one between Indonesia and Singapore shows a very weak positive connection (between 0 and 0.2). Based on this, we can state that there are similar processes that affect the inflationary environment in ASEAN-5 countries. The similarities of inflation rates are an important factor for the establishment of a monetary union, according to Mongelli (2008), because it reduces the need for nominal exchange rate adjustments.

Figure 6
Inflation rate in the ASEAN-5 countries¹⁰



It is imperative to examine the inflation process of the inflation-targeting countries in relation to the announced inflation target for each year. In the case of the Philippines, the inflation rate was out of the central bank's target range in 10 years since 2002, the establishment of the inflation targeting system. The average difference (in absolute terms) from the mid-point of the target range was 2-4% points. Considering that after the first 6 years in the regime, the target band was widened from 1% to 2%, this difference is fairly significant.

In Thailand, the inflation rate was out of the target band in only 5 years from 2000 to 2019.¹¹ To compare this to the Philippines, one must consider that the target range in Thailand was always wider: 3.5% points between 2000 and 2008, 2.5% points between 2009 and 2014, and 3% points after 2015. The average difference from the mid-point of the target band was a little smaller than in the Philippines, at 2.2% points. Furthermore, four of the five deviations happened after the change of the policy target in 2015, meaning the BOT was much more successful in affecting the underlying, persistent inflation process (core inflation) than in the headline inflation.

Similar to the BSP, the inflation in Indonesia between 2001 and 2019 was only in the 2% wide target band for half the time. However, the absolute difference was the largest in Indonesia, on average 3.5% points, meaning a very volatile inflation process in the country and a less successful monetary stabilization policy.

Exchange Rate

In the evaluation of the monetary policy in the ASEAN-5 countries, it is worth examining the evolution of the exchange rate. Mostly because the MAS uses an exchange targeting system, but because an interest rate policy has a great effect on the exchange rate too, it is imperative to examine it in other regimes. To get comparable data, we used daily exchange rates for each ASEAN-5 countries against the dollar from the start of 2010 to the end of 2019. The use of the exchange rate against the dollar offers another advantage; the effect of different external shocks on the region can be measured as well.

Considering the whole examined period, the Indonesian rupiah depreciated the most against the dollar, by more than 47.3%, while the Malaysian ringgit depreciated by 19.5 and the Philippine peso by 9.6%. In contrast, the Thai baht and the Singapore dollar appreciated against the dollar by 10.7 and 4.1% respectively.

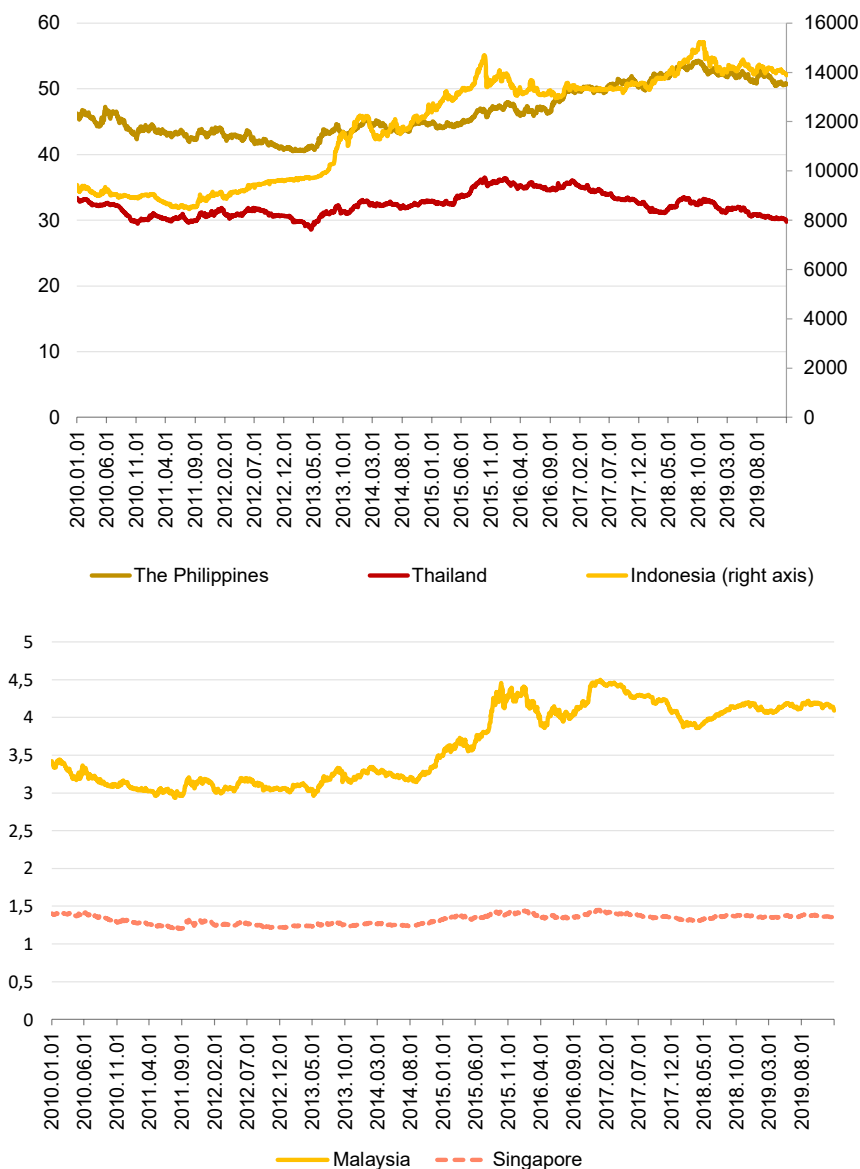
However, not only the path of the exchange rate matters but also its volatility. To get comparable data, we used the relative standard deviation (RSD) which measures the ratio of the standard deviation to the mean. From the five currencies, the Singapore dollar was the least volatile between 2010 and 2019, the value of the RSD was 4.7%. While for the second least volatile, the Thai baht, it was 5.5%. The Philippine peso has shown a bigger volatility, 8.1%, but it can still be considered somewhat stable. On the other hand, the Malaysian ringgit's 13.9% and the Indonesian rupiah's 17.9% relative standard deviation show a much more volatile path in the exchange rate. The stability of the Singapore dollar was expected, considering the exchange rate targeting monetary policy, but it is clear that, even with a different monetary system, similar stability can be achieved. At the same time, the relative stability of the Thai baht can be explained by the employed managed-float exchange rate regime.

The correlation between the exchange rates of the ASEAN-5 countries' currencies against the dollar shows a strong (between 0.6 and 0.8) or a very strong positive (above 0.8) connection in most cases. The only two exceptions



are between the Indonesian rupiah and the Thai baht (0.57), and between the Thai baht and the Philippine peso (0.36). This shows that external shocks have a similar effect on the ASEAN-5 countries. This is a good sign for the monetary union because if external shocks have a similar effect on the countries participating in it, then uniformization of the monetary policy would have a less unfavourable effect.

Figure 7
Evolution of the exchange rate against the dollar in ASEAN-5¹²



Conclusions

In examining the monetary policy practice of the ASEAN-5 countries, we found that they adopted many of the best practices of the developed countries. The central banks work transparently, which can help to anchor market expectations, thus strengthening the monetary policy to achieve its target. However, there are many differences in the monetary policies of the five countries. Only three of them (Indonesia, the Philippines, Thailand) adopted the inflation targeting system. The other two (Malaysia and Singapore), in the case of inflation volatility and level, achieved a similar result in the long run with a different monetary policy regime. There is only one aspect of the monetary policy which has a long way to go for the ASEAN-5 countries. That is, the basic requirement of the independence of their central banks is not yet achieved; the governments have the power by law to affect the monetary policy which can reduce its effectiveness.

Our main objective was to examine the readiness of the ASEAN-5 countries for a monetary union in regard to their monetary policy practice. In some aspects, the five countries are on the right path to establishing a monetary union: their inflation rates and exchange rates show a strong connection which is necessary to avoid the need for nominal exchange rate adjustments. On the other hand, the economies are far from the required harmonization. Thus, the monetary policy in each country must react differently to the same external shock. In addition, the lack of independence in the monetary policy poses a threat to the monetary union. In a monetary union, the leaders of the participating countries must agree on a supranational authority which must conduct monetary policy independently, and in the interests of the whole union. However, in the case of some ASEAN countries, the separation of the fiscal and monetary policy, which could raise the effectiveness of the latter, has not yet happened.

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Endnotes

- 1 Western countries included Australia, Euro Area, Japan, United Kingdom, and U.S.
- 2 Source: Bank Indonesia
- 3 Source: Central Bank of the Philippines
- 4 Source: Central Bank of the Philippines
- 5 Source: Monetary Authority of Singapore
- 6 Consumer price index (CPI) that excludes fresh food and energy prices
- 7 Source: Bank of Thailand
- 8 On the effect of the Fed's nonconventional monetary in Asia and the Pacific, see Punzi and Chantapacdepong (2019)
- 9 Source: Reuters Datastream. In the case of Singapore, the Singapore Dollar Domestic Interest Rate
- 10 Source: World Bank
- 11 Until 2015, we compared the target range to the core inflation.
- 12 Source: Reuters Datastream

