Economic Integration in Asia and Europe: Lessons and Policies

Edited by
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Regional economic integration is an effective approach for regional economic and political stability with the potential for poverty alleviation and the promotion of inclusive and sustainable development. Economic integration improves economic opportunities and growth because it increases both market and production bases, which enhance the availability of goods and services, leading to a reduction in the costs of trade and an increase in efficiencies that lead to greater purchasing power (Taghizadeh-Hesary et al. 2020).

According to Balassa (1961), regional economic integration is a process in which the differences and discriminations among national economies are gradually eliminated. Munakata (2006) points out that regionalism is institutional, whereas regionalization, the process of regional economic integration, occurred by way of market development. Regional economic integration should, therefore, be examined in a broader perspective to represent all the economic, political, and legal dimensions.

Economic integration has become a global trend since World War II. It has generated not only economic growth in different regions but also contributed to establishing security and peace. The European Union (EU) has developed a high level of economic integration as an economic union. At the same time, it represents one of the best models, guiding other regions and groupings such as the Association of Southeast Asian Nations (ASEAN) and the North America Free Trade Agreement (NAFTA), which was modernized to the United States, Mexico, and Canada Agreement (USMCA) in 2019.

Asian subregions exist at various degrees and levels of economic integration, compared to Europe. Each Asian entity applies its own economic and political agendas. Apart from ASEAN, which has created a common market, the third level of economic integration, Asian economies are in a loose cooperation scheme based on free trade agreements. In contrast, Europe has nearly achieved complete political union with the European Union (EU) and its single currency.

European integration is conceptually based on a comprehensive approach focusing on cultural, economic, legal, political, security, and social integration. The integration in the EU expanded from six member
nations in 1957 to 27 member nations in 2020, despite the exit of the United Kingdom (UK) at the end of 2019. The EU became the largest market in the world in 2017, implying its significance as one of the three major economic blocs in the world along with East Asia and the USMCA. It has also created the longest period of peace in the region since World War II, demonstrating how economic integration can contribute to comprehensively and sustainable regional development.

The Asian subregions can learn from the European experience to increase levels of regional economic integration in support of higher endogenous growth. The EU represents the outcome of European integration, while the Asian approach leans towards regional or international standardization and benchmarks. The former is led by an institutionalization approach and the latter focuses on a non-institutionalization approach that is regarded as a dynamic approach in the real economy.

This book provides comparisons of economic integration between Asia and Europe as practical lessons for economic integration in the Asian subregions and other parts of the world. Notably, there is no one-size-fits-all strategy—each region and subregion should tailor its strategy subject to their social, cultural, political, geopolitical, and economic differences. It further explores how the European approach can be adopted as a guide or appropriate model for the Asian approach to further develop its regional economic integration. It is worth noting that the two regions have experienced different development paths in their history with different economic, social and cultural backgrounds.

This book consists of 27 chapters categorized into six main parts: (I) perspectives and approaches, (II) fiscal and monetary integration and safety nets, (III) disintegration, (IV) regional initiatives and case studies, (V) energy and the environment, and (VI) financial inclusion and legal approaches.

Part I deals with the perspectives and approaches of economic integration in Asia and Europe in four chapters. It begins with a chapter by Dieter Eissel on the EU’s role in regional social and economic integration. It highlights the importance of convergence and competitiveness in the EU’s economic integration process. The regional policy of the EU and its financial execution surely help to improve the social situation in many of the poorer economies of the EU. Since the Lisbon Process, the EU changed its function from a mere economic common market toward being a social union. The Europe 2020 strategy adopted new targets with concrete objectives to fight climate change and to achieve higher employment rates.

Chapter 2 is on cultural heterogeneity and political distance in the process of the economic integration of Asia and Europe by
Muthurangam Subramaniam, Natarajan Panchanatham, and Alan Myrold. This chapter identifies and discusses the issues of cultural heterogeneity and political distance in the process of economic integration. It compares the European model of economic integration regarding cultural issues and political distance with that of Asia. The comparison aims to evaluate Asia’s capacity to take on the lessons learned from the European model to develop new policies and achieve enhanced economic integration.

In Chapter 3, Richard Pomfret discusses the different paths to economic integration in Europe and Asia, with the regions having followed very different paths after 1945. By 2021, the EU has become closely linked in an economic union with the free movement of goods and factors of production and a common currency. Meanwhile, Asia still lacks effective economic integration agreements, although countries in East Asia and Southeast Asia are becoming more highly integrated into global value chains (GVCs). The chapter discusses that the EU’s external trade policy and many Asian countries’ policies are converging toward the model of liberal trade regimes plus collaboration in establishing common norms in other areas that are important to GVC operations (so-called WTO+ issues).

Chapter 4, by Muthurangam Subramanian, Farhad Taghizadeh-Hesary, and Natarajan Panchanatham, compares the perspectives of regional economic integration in Asia and Europe. The chapter explains regional economic integration in the context of “why did Asia and Europe embark on regional economic integration?” and “what is the difference between the approaches adopted for the accomplishment of regional economic integration in Asia and Europe?” The chapter provides a conclusion and recommendations on whether Asia should follow Europe or create its own model for regional economic integration.

Section II presents theoretical concepts and empirical evidence on the development of fiscal and monetary integration and regional safety nets as a part of regional economic integration. The section consists of six chapters.

In Chapter 5, Muhammad Ayub Mehar examines the roles of financial support and the development of the sovereign bonds market on the development of economic corridors to boost the level of economic integration in Central Asia Regional Economic Cooperation (CAREC) member countries. The magnitudes and modes of financing usually determine the provision of logistic services and transport-related infrastructure, as covered in this chapter. The chapter suggests causal relations between trade and transport-related infrastructure and GDP growth in the CAREC region.

Chapter 6, by Danupon Ariyasajjakorn, Pitchaya Sirivunnabood, and Matteo Molineris, describes the evolution of financial integration in
selected sectors in ASEAN and compares it with the EU case. Since the Asian financial crisis of 1997–1998, ASEAN has continuously worked on financial integration and made tremendous efforts to ensure financial stability and financial inclusion in the region. The chapter examines and compares the effectiveness of the initiatives agreed upon and implemented by ASEAN against the EU’s success story as an institutional benchmark. A set of conclusions and policy recommendations are derived for ASEAN member states.

In Chapter 7, Muthurangam Subramanian, Farhad Taghizadeh-Hesary, and Chul Ju Kim review the creation and evolution of the European Economic Monetary Union (EEMU) and discuss the key lessons for Asian economic integration following an extensive literature review. The EEMU was created as a replacement for the European Monetary System (EMS) to implement a common monetary and economic policy for the EU. Given fundamental and cultural differences, Asia may not strictly follow the path of Europe’s integration. However, several key lessons, including the integration process of the EU and the experiences from the establishment of the EEMU, can be adapted to create an exclusive model for the full benefits of Asian economic integration.

Chapter 8, by Frank Rövekamp, examines the evolution of the European Stability Mechanism (ESM) in the context of lessons for Asian integration. The ESM is a permanent institution for maintaining financial stability in the eurozone. The Chiang Mai Initiative (CMI) was created as the regional financial stability mechanism for the ASEAN+3 countries\(^1\) after the Asian financial crisis. While the CMI has strengthened its operations, there remain areas for further enhancement. An insufficient funding base and a lack of capabilities to provide reform programs and surveillance for crisis countries can challenge its effectiveness. The chapter provides policy recommendations for increasing the effectiveness of the CMI as a component for improving regional financial stability in Asia based on European experiences.

In Chapter 9, Gong Cheng explains the development of European Regional Financing Arrangements and the role of these financial backstops in resolving the recent eurozone crisis. Based on the European experience, the chapter aims at identifying some potential lessons for other Regional Financing Arrangements, especially for the Chiang Mai Initiative Multilateralisation of East Asia and Southeast Asia. The chapter suggests that the European experience could be useful for the further development of the Chiang Mai Initiative Multilateralisation in the ASEAN+3 countries.

\(^1\) The 10 ASEAN countries plus Japan, the Republic of Korea, and the People’s Republic of China.
In Chapter 10, Gong Cheng and Kari Korhonen provide an overview of the recent steps made in the EU toward enhancing fiscal policy coordination and integration. They especially highlight the key challenges and strategies that must be considered for further fiscal integration in the monetary union. The outcomes of this chapter can help Asian counterparts when they consider strengthening fiscal integration in their region.

Part III examines different perspectives on disintegration, especially the Brexit phenomena and its consequences. This part consists of three chapters.

In Chapter 11, Donghyun Park, Cynthia Castillejos-Petalcorin, and Jungsuk Kim analyze the causes and results of Brexit and provide policy lessons for Asian integration. The chapter examines the EU's past success and current problems from the perspective of Asian countries. The analysis is linked to the ASEAN+3 context in the selected areas of integration. It is important to note that both past success and the current problems of the EU hold valuable lessons for ASEAN+3 countries as they chart their course toward regional integration.

Chapter 12 by Golam Robbani explores disintegration in the EU and provides lessons for Asia. The chapter shares the reasons behind Brexit and what lessons can be learned from Brexit for other integration arrangements around the world—especially in Asia. The chapter recommends policy makers take extra caution in expanding integration too far and too fast. The suggestion emphasizes adequate public awareness to educate citizens about the costs and benefits of regional integration.

In Chapter 13, Hooman Peimani studies the disintegration of the EU and its implications for ASEAN. The chapter discusses possible scenarios for disintegration, including the degeneration of the EU into a loose regional grouping of convenience. Under this scenario, the members can take advantage of its benefits while pursuing their national interests and following the EU’s rules only when they serve their interests. It concludes that if the EU, despite 70 years of planned integration with a significant degree of success, is not immune to disintegration, ASEAN with its still insignificant degree of integration is surely vulnerable to such possibility unless it seriously initiates a process to address its root causes before it is too late.

Part IV deals with regional initiatives for economic integration and case studies in Asia and Europe in nine chapters.

It begins with Chapter 14 by Sang Chul Park on Swedish economic integration to the EU as a “latecomer.” The chapter focuses on the Swedish dualistic approach of membership to the EU and non-membership to the eurozone, which has contributed to generating national economic growth. The analysis indicates which actors have
been the greatest winners and losers from full accession to the EU. Additionally, the chapter identifies challenges and prospects for the Swedish economy in the near future.

Chapter 15 by Kijin Kim and Paul Mariano analyzes the trade impact of reducing time and costs at borders in the CAREC region. Simulation results show that trade facilitation only at borders may not be a sufficient factor that could lead to broader economic impacts in the CAREC region. Therefore, holistic approaches both at and behind borders are needed.

In Chapter 16, Saeed Qadir and Karlo Fermin Adriano explore the regional economic integration in the CAREC region. The authors attempt to measure the degree of integration in CAREC in the overall regional economy.

In Chapter 17, Ulviyye Aydin expands her research on economic integration to cover the Caspian Sea countries. In particular, she focuses on barriers and solutions for economic integration in the region. The findings show that existing bilateral and trilateral agreements can be classified by the number of parties and subjects. Therefore, the degree and level of integration can be properly chosen among countries in the region depending on their interests.

Chapter 18, by Upalat Korwatanasakul, presents lessons from revisiting Asian economic integration. The chapter comprehensively reviews the true progress of Asian economic integration in comparison with the EU and at the same time examines the factors contributing to integration. The results show that comprehensive, continent-wide economic integration in Asia is not likely to take place in the near future because integration is mainly confined to East Asia and Southeast Asia, while other Asian subregions are much less integrated and less globalized.

Uwe Wissenbach focuses on the financial crisis in Europe and East Asia in Chapter 19. The chapter examines the different responses to the crisis in the two regions. The author finds that the EU strengthened its integration during and after the crisis, oscillating between the intergovernmental and supranational institutions. Although this finding cannot be explained by rational models of step-wise integration, it is eminently political. In contrast, East Asian countries, such as the People’s Republic of China, Japan, and the Republic of Korea, have handled the crisis more successfully in the short term, but their policies have been largely nationalist, with very limited multilateral coordination, let alone integration between them.

Falendra Kumar Sudan discusses regional institutions in Europe and Southeast Asia to provide lessons for economic integration in South Asia in Chapter 20. The findings suggest abysmal performance
in intra-regional trade among South Asian economies while bilateral trade is throttled between India and Pakistan, compared to regional trade in Southeast Asia. Therefore, there is a need to strengthen regional cooperation in South Asia through promoting regional institutions by learning from the experiences of the EU and ASEAN as well as addressing challenges and possible solutions.

In Chapter 21, Werner Pascha touches upon the dynamics of infrastructure connectivity initiatives in the People’s Republic of China and Japan and the EU’s responses. The chapter argues that East Asia has set the pace for regional and inter-regional integrations by such as the People’s Republic of China’s Belt and Road Initiative and Japan’s Partnership for Quality Infrastructure, while the EU recently launched the Connecting Europe and Asia: Building Blocks for an EU Strategy. Policy recommendations are proposed for all actors.

In Chapter 22, Zhihai Xie examines and compares the roles of institutions in regional economic integration between Asia and Europe. The findings are based on fundamental differences between the two parties’ economic integration. The core difference is the significance of institutionalization in economic integration. It plays a considerable role in Europe, while institutions certainly contribute to economic cooperation but are not the decisive driving force in Asia. The major Asian driving force is the development of the market and trade that has largely pushed Asian countries to cooperate.

Part V discusses the sectoral focuses on energy and environmental cooperation.

In Chapter 23, Ivan Diaz-Rainey, Daniel J. Tulloch, Iftekhar Ahmed, Matthew McCarten, and Farhad Taghizadeh-Hesary describe the possibility of a common energy policy in ASEAN. The chapter gathers lessons from the EU experience on energy integration, security, and decarbonization. The findings suggest that energy policy in ASEAN should explicitly pursue a dual transition pathway strategy to yield the best outcome by drawing on the EU’s experience.

Chapter 24, by Farhad Taghizadeh-Hesary, Tapan Sarker, Aline Mortha, and Chul Ju Kim, explores energy security and economic integration by using comparative analysis in Asia and Europe. Energy security in Asia and the Pacific is endangered by rapidly depleting resources and steadily increasing demand, with no legally binding framework to serve as a safety net in the region. Therefore, to increase its level of energy security, the chapter proposes that Asia and the Pacific region should shift its focus toward renewable energy while increasing its intra-regional energy trade. The chapter also argues that further integration in the EU is constrained by the desire for sovereignty of the member states in the area of energy.
In Chapter 25, Youngho Chang focuses on integrated energy markets in ASEAN. ASEAN has taken action to strengthen economic cooperation and energy development in the region. Initiatives like economic cooperation and energy development in the Greater Mekong Sub-region, the ASEAN Power Grid, and the Trans-ASEAN Gas Pipeline are some initial steps for launching an integrated energy market in the region. The chapter presents principles and explores the prospects for the ASEAN market by reviewing the lessons learned from economic and energy market integration in the EU. The findings suggest the possible success of an integrated energy market in ASEAN.

Part VI comprises two studies on other related sectors for further regional integration.

In Chapter 26, Ruixian Huang, Seenaiah Kale, Sudharshan Reddy Paramati, and Farhad Taghizadeh-Hesary discuss the role of financial inclusion and trade openness on economic development in the EU. The chapter aims to investigate the impact of financial inclusion and trade openness on economic development in the EU member states. It highlights the impact of financial inclusion on economic output, which is more significant in low-income and new-EU member countries than that of high-income and old-EU member countries.

Chapter 27, by Usanee Aimsiranun, presents a comparative study on the legal frameworks for a general, differentiated integration mechanism. The comparison covers the legal frameworks of three differentiated integration mechanisms, i.e., the EU’s enhanced cooperation, APEC’s pathfinder initiatives, and ASEAN minus X. The main conclusions lie in the effective implementation of the established initiatives and extensive participation with the ultimate objective of turning differentiated integration into common regional projects.

In summary, this book provides an extensive discussion on how regional economic integration has become a global trend and generated various benefits in trade, economic growth, regional development, and potential inclusiveness. However, in addition to these benefits, different forms of protectionism have also arisen, including the reversion of free trade agreements, global trade conflicts, and the phenomena of Brexit. Consequently, further efforts are needed to explore the way forward for regional economic integration.
References

Munakata, N. 2006. *Transforming East Asia: The Evolution of Regional Economic Integration*. Research Institute of Economy, Trade, and Industry (Japan) and Brookings Institution Press.
PART I
Perspectives and Approaches
1
The European Union’s Role in Regional, Social, and Economic Integration

Dieter Eissel

1.1 The Objectives of Convergence

Standards of living vary within the European Union (EU) and within each country. In some regions of the EU, the gross domestic product (GDP) per inhabitant in purchasing power parities is less than 50% of the EU average; in other regions, it is 40% to 50% above the EU average. The entry of the central and eastern member states has led to a dramatic increase in regional disparities in the GDP per inhabitant (Figure 1.1). The increased inequality in the enlarged EU has endangered social cohesion. That is why the EU amended its goals toward social policy (Eissel 2014). The EU often was understood as an organization following mere economic interests. The more it is highly regarded that the Lisbon Strategy, launched in March 2000 by the EU heads of state and governments, now has turned to a more complex approach and broader understanding of competitiveness.

To strengthen the social dimension, the new Social Agenda was adopted in February 2005. It contains a roadmap for European social policy up to 2010. This new impetus reflects the intentions of the EU’s draft constitutional treaty and “appears against the backdrop of existing EU policies which supplement Member States’ action in the employment and social field.” (Commission’s Directorate-General for Employment, Social Affairs and Equal Opportunities 2005, 7). Danuta Hübner, the commissioner responsible for regional policy of EU, pointed out that the traditional goal of the EU to favor competitiveness cannot be reached without cohesion: “Competitiveness and cohesion are complementary and, indeed, reinforcing each other. You cannot have sustainable cohesion without competitiveness. But a successful policy
for competitiveness depends on maintaining a high level of cohesion” (Hübner 2005). For the 2014–2020 period, the promotion of sustainable development in addition became higher importance. Thus, the cohesion fund in the period until 2020 could “also support projects related to energy or transport, as long as they clearly benefit the environment in terms of energy efficiency, use of renewable energy, developing rail transport, supporting intermodality, strengthening public transport, etc.” (European Commission 2018).

The EU uses over 35% of its budget to boost the economies of the less developed regions and in turn strengthen the EU as a whole. The Cohesion Policy focuses first on regions with a GDP per inhabitant below 75% of the EU average to achieve greater convergence while continuing to invest in the competitiveness of the other regions. It is up to the European Parliament and the Council of the European Union to define the tasks, the priority objectives, and the organization of the Structural Funds through the ordinary legislative procedure and consultation.

The regional funds helped, to a certain extent, to increase the GDP per head and thus contribute to better living conditions in the less developed regions (Table 1.1). Nevertheless, access to European funds alone cannot explain economic progress and coherence. EU funding is only one of the tools to support economic growth, fight unemployment, and minimize inequality among regions. We have to analyze the possible effects of national financial equalization programs and cultural factors too.
In many member states, the weaker regions are eligible for support through financial equalization to combat regional disparities. Of relatively high relevance here is the example of Germany. Germany’s constitution guarantees a system of financial equalization among the regional states, which reduces the differences in receipts among them. Poorer regional states receive adjustment payments. The wealthy states have to fund these payments. The system of financial equalization among the states thus ensures that fiscally weak states also have adequate financial resources to fulfil their tasks and develop their sovereignty. Aligning the revenue of the laender intends to create and maintain equal or comparable living conditions (Hauptstein 2007, Eissel 2013, Bundesministerium der Finanzen, Finanzbericht 2018). In contrast, there are other countries, like Italy and Spain, where some richer regions enjoy special rights concerning their tax income, which they must not share in solidarity with the financially weaker regions.

A further impact on economic success comes from the political culture and regional identity, as Keating, Loughlin, and Deschouwer

<table>
<thead>
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<th>2008</th>
<th>2018</th>
<th>2008</th>
<th>2018</th>
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</thead>
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<td>9.6</td>
<td>Luxembourg</td>
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<td>Latvia</td>
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<td>Lithuania</td>
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<td>Sweden</td>
<td>13.5</td>
<td>16.4</td>
<td>Bulgaria</td>
</tr>
<tr>
<td>Germany</td>
<td>15.2</td>
<td>16.0</td>
<td>Romania</td>
</tr>
</tbody>
</table>

* 2016, ** 2017.
(2003) showed in their research on eight different European regions. A comprehensive explanation for the factors behind the regional economic process and its failures and success stories does not exist; rather, there is a plethora of disparate approaches: agglomeration research, the theory of growth poles, the export basis concept, neoclassical approaches, free trade theory, and politico-economic approaches. However, it remains questionable whether and to what extent the less developed areas are able to mobilize the necessary resources politically to balance out their previous disadvantages as locations and why vice versa the richer regions are successful. A rather neglected aspect in this context is the impact of culture and historical identities on the management of the ongoing process of facing global competitive challenges. The more citizens develop a common regional identity and the more they act in a trustful cooperation—even between capital and labor—the better is the chance of developing their economic potential and making effective use of the available funds. Furthermore, Putnam (1993) assumed, having analyzed the case of Italian regions, that identity is an important vehicle in the shaping of images of a region and, more specifically, in applying the “logics” of regional economic positioning and regional governance. Processes of region building are legitimized on the basis of “objectified” notions of a community, common culture, shared values, and shared history and destiny, creating an illusion of an “objective” region (van Houtum 2003, Eissel and Grasse 2010).

For the period starting in 2010, the EU Social Agenda set a further priority of fighting against poverty and social exclusion, which the European Social Fund would mainly support (EU Commission 2010a, EU Social Agenda 2010). By most standards, Europe can be considered an affluent society. “More than 50 years of economic growth and inclusive social policies have brought about unprecedented levels of prosperity and comfort for its citizens. And yet as you read this, almost 80 million Europeans are struggling to make ends meet, to clothe and feed their children, to keep a roof over their heads. 17% of our fellow EU citizens currently live below the poverty threshold. The EU and its Member States are acutely aware of the iniquities of poverty and social exclusion and of how divisive they are to society. That is why they have chosen 2010 as a special year to raise awareness of these interrelated issues and to stimulate greater effort to combat the problems they cause” (Verrue 2010, 2). “Exclusion imposes unjustifiable and avoidable costs on society. The Lisbon strategy’s response – a European social agenda – is to provide basic skills for all, promote employment for those who are able to work and ensure adequate social protection for those who cannot. This approach recognizes the role of well-developed social protection systems in reducing poverty and promoting employment and
employability, as well as the need for such systems to be modernized to ensure their long-term sustainability in the face of an ageing population” (European Commission 2003). Poverty is mainly the consequence of unemployment and relatively low social transfers. The empirical data on unemployment and low income per head clearly indicate that the most serious problems arise in the peripheries of the EU. That is why, to fight poverty in the EU, it should first address the poorer societies in central, eastern, and southern countries, where over 20% of the population, even after social transfers, remain in poverty.

Having no hope for an improvement concerning their social situation in future, mainly the young, mobile, and better-trained members of the workforce leave their home countries in search of a better life in the wealthier states of the EU. Even though some countries and regions have gained better labor market conditions in recent years, there are still states and regions where they have deteriorated, like the Baltic states, Romania, and Bulgaria. Many countries are confronting long-term youth unemployment rates (Table 1.2), exceeding 50% in some regions, like the south of Italy (Eurostat 2018b).

### Table 1.2: Youth Unemployment Rate, 2005 and Sep 2019 (% share of the labor force aged under 25 years)

<table>
<thead>
<tr>
<th>Country</th>
<th>2005</th>
<th>Sep 2019</th>
<th>2005</th>
<th>Sep 2019</th>
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<td>12.9</td>
</tr>
<tr>
<td>Sweden</td>
<td>10.4</td>
<td>19.8</td>
<td>11.8</td>
<td>12.1</td>
</tr>
<tr>
<td>Austria</td>
<td>10.1</td>
<td>8.8</td>
<td>18.4</td>
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<tr>
<td>Germany</td>
<td>13.8</td>
<td>5.9</td>
<td>17.1</td>
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</tr>
<tr>
<td>Malta</td>
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<td>9.4</td>
<td>13.2</td>
<td>19.1</td>
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<tr>
<td>Denmark</td>
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<td>9.9</td>
<td>20.2</td>
<td>17.0</td>
</tr>
<tr>
<td>Slovenia</td>
<td>9.7</td>
<td>8.1</td>
<td>14.0</td>
<td>32.7</td>
</tr>
<tr>
<td>Czechia</td>
<td>16.9</td>
<td>4.9</td>
<td>17.9</td>
<td>17.2</td>
</tr>
<tr>
<td>Lithuania</td>
<td>10.7</td>
<td>12.3</td>
<td>18.4</td>
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<tr>
<td>Portugal</td>
<td>12.3</td>
<td>18.9</td>
<td>17.9</td>
<td>17.0</td>
</tr>
<tr>
<td>Finland</td>
<td>9.5</td>
<td>17.1</td>
<td>26.8</td>
<td>7.1</td>
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<tr>
<td>Estonia</td>
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<td>United Kingdom</td>
<td>8.9</td>
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<td>28.8</td>
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</table>

Fighting youth unemployment successfully furthermore gives the hope of minimizing unwanted harmful migration effects on both the poor regions through depopulation and the better-off regions through high agglomeration costs (more traffic problems and rising rental fees in the cities) at the same time. Depopulation has happened in Germany since the reunification. In the period from 2001 to 2010, about 3 million Germans from the east moved to the west (Federal Statistical Office 2012), leaving many districts in eastern Germany without any medical care. Depopulation could leave the less developed regions without a sufficient number of skilled workers and adequate social services.

It is obvious, lacking a skilled workforce, that companies are not willing to locate their production in these regions. However, until now, the positive effects of the funds addressing employment have remained small and been unable to prevent ongoing emigration stemming from workers’ negative future outlook regarding finding a job in their home country. This is observed in Romania, Bulgaria, and Poland, and—with regard to youths—dramatically in Greece, Italy, and Spain, where in some regions, youth unemployment is over 50% (Eurostat 2018c).

1.2 Goals of the European Union’s Regional Funding

Article 158 of the Treaty of Amsterdam, which entered into force on 1 May 1999 states that, “in order to strengthen its economic and social cohesion, the Community shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favored regions or islands, including rural areas.” The Summit of Lisbon (2000) indicated that the one-sided emphasis on the goals of the common market and deregulation were no longer the only goals. Since then, full employment and social cohesion have been at least equally entitled to be long-term goals for the European economy.

In addition, 2 years later, the Barcelona Spring Summit (2002) highlighted the Lisbon agenda, among others, as indicating an obligation to eradicate poverty and social exclusion by 2010. The most important regional funds to fight poverty and social exclusion and to achieve greater cohesion are the European Regional Development Fund (ERDF) and the European Social Fund.

The cohesion policy must be adapted to the particular needs and characteristics of individual regions in terms of the problems and opportunities that derive from their specific geographical situation. The territorial dimension includes the following themes:
• The contribution of cities (urban areas) to growth and jobs (to promote entrepreneurship, local employment, and community development, for example)
• Supporting the economic diversification of rural areas (e.g., the synergy between structural, employment, and rural development policies)
• Cross-border, transnational, and interregional cooperation focusing on the aims of growth and job creation (e.g., the Baltic Sea rim).


During the period 2007–2013, the EU invested a total of €347 billion in Europe’s regions. In this period, the cohesion policy focused on the following main objectives: convergence, solidarity among regions, regional competitiveness, employment, and European territorial cooperation (Cohesion Policy 2007–2013. http://ec.europa.eu/regional_policy/atlas2007/index_en.htm).

The funding helps, for example, to improve transport and internet links to remote regions, boost small and medium-sized enterprises (SMEs) in disadvantaged areas, invest in a cleaner environment, and improve education and skills. The EU also invests funding in innovation, developing new products and production methods, energy efficiency, and tackling climate change in so-called phasing-in regions. Member states where the GDP is lower than 90% of the EU average can also benefit from the Cohesion Fund but not by the same amount. A phasing-out system is available for member states that would have been eligible for the Cohesion Fund if the threshold had stayed at 90% of the GDP average of the EU of the former 15 member states. The highest sum, targeting convergence, was 82% of the total of €347 billion for the poorer regions with the objective of reducing regional disparities in terms of income, wealth, and opportunities. Primarily eligible to receive financial support through the important convergence objective during the coherence policy 2007–2013 concern the new (former socialist) member states in eastern and central Europe (the Baltic states, Poland, Czechia, Slovakia, Slovenia, Hungary, Croatia, Bulgaria,
and Romania) and southern regions in Portugal, Spain, Italy, Greece, Malta, and Cyprus.

With the challenges of climate change, the EU’s demographic changes, and the last economic crisis still very much in evidence, the EU changed its goals for regional support during the last program period from 2014 to 2020 (European Commission 2020). “The Europe 2020 strategy aims to ensure that the economic revival of the European Union (EU) following the economic and financial crisis is supported by a series of reforms in order to build solid foundations for growth and job creation by 2020. While addressing the structural weaknesses of the EU’s economy and economic and social issues, the strategy also takes account of the longer-term challenges of globalization, pressure on resources and ageing” (European Commission 2020).

Again, it ranked the regions and split them into three groups:

• Less developed regions (where the GDP per inhabitant was less than 75% of the average in all 27 member states).
• Transition regions (where the GDP per inhabitant was between 75% and 90% of the average in all member states).
• More developed regions (where the GDP per inhabitant was more than 90% of the average in all member states).

Because of concerns about climate change, the proposed ERDF would channel resources toward energy efficiency and renewable energy, innovation, and support for SMEs. The EU earmarked minimum amounts for investments in energy efficiency and renewable energy for all regions.

The scope of the Cohesion Fund will remain largely similar to the last period, with support for:

• investment to comply with environmental standards and energy projects, providing a clear benefit to the environment, for example by promoting energy efficiency and the use of renewable energy; and
• investment in trans-European transport networks as well as urban and low-carbon transport systems. For the first time, part of the Cohesion Fund will contribute to the Connecting Europe Facility for a competitive and sustainable European transport system.

The ERDF focuses its investments on several key priority areas:

• innovation and research;
• the digital agenda;
• support for SMEs; and
• the low-carbon economy.

This approach is called “thematic concentration”.

The resources that the ERDF allocates to these priorities will depend on the category of a region. In more developed regions, at least 80% of funds must focus on at least two of these priorities; in transition regions, this focus is for 60% of the funds; and it is 50% in less developed regions. The eligible regions where the GDP per inhabitant is below 75% remained nearly the same as in the last period, concentrating on the new member states. However, in comparison with the last funding period, the financial support was reduced due to the fact that the rich countries refused to enlarge their contributions to the funds.

1.3 Partnership as a Key Organizing Principle

“Historically the European Union has developed its regional policy activities and distributed cohesion policy funding through a partnership process, which includes significant input from the Member States. Partnership working covers the whole programming process, from the preparatory stage through to the implementation and assessment of results. This approach should lead to better program outcomes and help ensure that money from the European Structural and Investment Funds (ESIF) is spent efficiently” (European Commission 2008, Glossary). The EU introduced the “principle of partnership” in the funding period after 1988 and obliged the relevant social groups in the region—which are eligible to claim financial support—to collaborate on development strategies for their disadvantaged region. It based local and regional actions on three related dimensions:
• First, the EU recognized that the socioeconomic problems facing deprived areas were too complex and difficult for anyone organization or group working on its own to solve.
• Second, the increasing number of agencies and bodies involved has increased the need for different actors to work together and to coordinate their actions to avoid conflicts or duplication of work.
• Third, the emphasis is on social inclusion as a key goal of the development policy, which implies that bodies representing different groups and interests participate in the planning and implementation of local initiatives (European Commission 2010a).
For better regulation and acceptance of the designing of laws, regulations, and policies, it is necessary to consult a range of stakeholders. Broad consultations are the best way to ensure that they include all interests and a broad spectrum of society. The same method of cooperation supports the execution of EU programs. Due to the rising complexity and variety in the current political and societal system negotiations, corporations, networking, and market forces are participating as stakeholders in the decision-making process (Benz et al. 2007). Because of this enhanced participation, there is a perception that the spread of governance as a reaction to the functional demands of complex societies and to deficits in classical government in decision-making processes is a step toward more democracy. The European Commission established its own concept of governance in the “White Paper on European Governance” (European Commission 2001), in which the term “European governance” refers to the rules, processes, and behavior that affect the way in which entities exercise power at the European level, particularly as regards openness, participation, accountability, effectiveness, and coherence. These five “principles of good governance” reinforce those of subsidiarity and proportionality. The first steps toward this concept of governance are apparent in the “Open Method of Coordination” replacing in part the traditional way of law making, through directives and benchmarks, which include fewer or no sanctions in the case of failure to reach the goal. It leaves the transfer of objectives to practice to member states. In addition, the EU wants citizens and organizations of the civil society to engage in various fields of interest, in which their knowledge and competence are helpful in reaching tailored goals. Last but not least, to increase the transparency in decision-making, people perceive the influences of political and societal groups and the evidence-based effects of decisions as a new task for the European Commission. In this context, the European Commission has referred to “better regulation” and currently “smart regulation” to indicate the desired characteristics of new modes of governance (Chu and Eissel 2013).

So far, the EU has changed its way of making policies. Regions, towns, and citizens have gained a more important role when implementing the tailor-made strategies of the EU. They should mobilize a wide range of non-state actors, such as trade unions, interest groups, and nongovernment organizations, to try to shape policy decisions and execute them in the best way (Warleigh-Lack and Drachenberg 2009).

Furthermore, regional identity and joint projects can help to minimize conflicts within regional groups, like those between tradition and modernity, inward- and outward-looking economic development, and social cohesion. Even the creation of fundamentally constructive
collaboration aiming to achieve an advantage for the entire region cannot be guaranteed, it needs trust and reciprocity in negotiations to achieve greater success (Putnam 1993; van Houtum 2003; Keating, Loughlin, and Deschouwer 2003).

All in all, the regional policy aims to reduce the significant economic, social, and territorial disparities that still exist between Europe’s regions. Leaving these disparities in place would undermine some of the cornerstones of the EU, including its large single market and its currency, the euro. The question remains of whether the regional funds have reached their objectives.

1.4 Results of Cohesion Policy

When we compare the GDP per head within the last decade, we notice a general trend: all of the poorest regions of the EU have improved their economic situation, while many rich regions have reduced their distance to the average GDP (Table 1.3).

So far, greater convergence is observable. Nevertheless, without the neoliberal reaction to the financial crisis followed by a budget crisis in nearly all member states, the effect could have been better.

Table 1.3: Regional GDP (PPS per inhabitant as a percentage of the EU-28 average) by NUTS 2 Regions (selection of the 32 poorest and 32 richest regions)

<table>
<thead>
<tr>
<th>Poorest Regions</th>
<th>2005</th>
<th>2018</th>
<th>Richest Regions</th>
<th>2005</th>
<th>2018</th>
</tr>
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<td>Mayotte</td>
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<td>Provincia Autonoma di Trento</td>
<td>IT</td>
<td>135</td>
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<td>Valle d’Aosta</td>
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<td>Lombardia</td>
<td>IT</td>
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<td>RO</td>
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<td>Zuid-Holland</td>
<td>NL</td>
<td>141</td>
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<td>Prov. Antwerpen</td>
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<td>Bolzano/Bozen</td>
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<td>Centru</td>
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<td>Outer London, West and North-West</td>
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<tr>
<th>Poorest Regions</th>
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<td>Rég. Bruxelles</td>
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</tbody>
</table>

AT = Austria, BE = Belgium, BG = Bulgaria, CZ = Czechia, DE = Germany, EU = European Union, FR = France, GDP = gross domestic product, HU = Hungary, IT = Italy, LV = Latvia, NL = Netherlands, NUTS = Nomenclature of Territorial Units for Statistics, PL = Poland, PPS = purchasing power parities, RO = Romania, SE = Sweden, SI = Slovenia, UK = United Kingdom.


### 1.5 Austerity Policy Counteracting Convergence Policy

Mainly because of bailouts for the banks that were negatively engaged in the financial crisis (Lehman Brothers 2007) and rising interest rates to rescue states’ budgets, many European countries like Greece, Italy, Spain, and Portugal, nearly became bankrupt. As their public debt reached levels that were not acceptable within the EU, a troika,
consisting of the European Central Bank, the European Commission, and the International Monetary Fund (IMF), forced these countries to execute harsh cuts in their expenditures (austerity policy) when accepting supporting credit. In the case of Greece, this policy led to the following cuts. By the end of 2014, Greece had dismissed at least 11,000 civil servants. Nearly 11 million Greeks paid a high price for the neoliberal shock treatment: domestic demand collapsed, and about 100,000 companies became bankrupt. The unemployment exploded to 27%, and about 1 million people lost their jobs (Eissel 2015). The troika forced the Greek government to reduce payments for public support, execute cuts in pensions, and even reduce payments for health care. The IMF (Roos 2015) demanded a cap on spending in the public health sector of a maximum of 6% of the GDP (the average in the EU is 8% and in Germany 10%). As a result, many people lost access to health services. Foreign aid organizations that originally supplied exclusively refugees now have to help large parts of the Greek population. Due to the radical spending limits on medicine, there was a lack of antibiotics and insulin (Kiziltepe, Paus, and Troost 2014). “Overall, the austerity had an impact on the Greek economy as a shock. (…) All these facts accelerated the recession and had a destabilizing effect on the political system. More than heated debates about the coverage of the financial deficit or the sustainability of public debt in 2020, the country needs investment to return to a growth path” (Troost 2014, 1).

Despite the promises, the austerity policy did not help to generate GDP growth again in all countries, and above all it enlarged the ongoing public indebtedness. Mainly Greece lost wealth, while most of the other countries, which the budget crisis strongly affected, recovered a little, with the exception of Ireland (Table 1.4). After years of the austerity

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<tr>
<td>Germany</td>
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<td>100</td>
<td>103.7</td>
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<td>Ireland</td>
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<td>105.3</td>
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<td>81.5</td>
<td>82.1</td>
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<td>81.7</td>
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<td>Spain</td>
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<td>99</td>
<td>96.1</td>
<td>94.5</td>
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<td>France</td>
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<td>98.1</td>
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<td>102.2</td>
<td>102.5</td>
<td>103.1</td>
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<td>105.2</td>
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<td>108.8</td>
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<tr>
<td>Italy</td>
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<td>98.3</td>
<td>100</td>
<td>100.6</td>
<td>97.7</td>
<td>96.1</td>
<td>96.2</td>
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<tr>
<td>Portugal</td>
<td>101.1</td>
<td>98.1</td>
<td>100</td>
<td>98.2</td>
<td>94.2</td>
<td>93.2</td>
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<td>95.7</td>
<td>97.5</td>
<td>100.3</td>
<td>113.7</td>
</tr>
</tbody>
</table>

GDP = gross domestic product.
policy, Europe will never be the same. Not only are the people in the affected southern EU countries distressed, but so are many economists in Europe and the United States (like Stiglitz and Krugman), who have vehemently criticized this austerity course. An interview in *Time* clearly stated their message: “Since it’s impossible to grow while both the private and public sector cut costs, deficit problems in southern Europe are getting worse, not better” (*Time* 2013, 26, 27). Examining the short-term effects of fiscal consolidation on economic activity, even researchers from the IMF could show that the changes in fiscal policy resulting from a desire to reduce the budget deficit and not as a response to prospective economic conditions had negative results (Table 1.5). They suggested that fiscal consolidation has contradictory effects on the private domestic demand and GDP (Guajardo, Leigh, and Pescatori 2011).

### Table 1.5: Development of Public Debt

<table>
<thead>
<tr>
<th>Country</th>
<th>Public Fiscal Balance as a Percentage of GDP</th>
<th>Public Debt as a Percentage of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2008</td>
<td>2010</td>
</tr>
<tr>
<td>Greece</td>
<td>–10.2</td>
<td>–11.2</td>
</tr>
<tr>
<td>Italy</td>
<td>–2.6</td>
<td>–4.2</td>
</tr>
<tr>
<td>Portugal</td>
<td>–3.8</td>
<td>–11.2</td>
</tr>
<tr>
<td>Ireland</td>
<td>–7.0</td>
<td>–32</td>
</tr>
<tr>
<td>France</td>
<td>–3.3</td>
<td>–6.9</td>
</tr>
<tr>
<td>Spain</td>
<td>–4.4</td>
<td>–9.4</td>
</tr>
</tbody>
</table>

GDP = gross domestic product  
Sources: Eurostat; Deutsche Bundesbank, monthly report (12/2019).

In the end, the austerity policy is economically a fiasco, a humanitarian catastrophe, and politically a danger for democracy. Instead of allowing the states to invest in capital and human infrastructure, which are preconditions for economic growth and recovery, states like Greece have lost their effective ability to restart economic growth.

Today we need the economic breathing room to recover and allow states like Greece to pay off a reduced burden of debt over a long period of time. Now is the time for a humane rethink of the punitive and failed program of the austerity policy within recent years to avoid counteracting the supportive strategies of the EU’s regional funds.
1.6 Conclusion

The regional policy of the EU and its execution through funding have clearly helped to improve the social situation in many poor regions of the EU. It was the right measure to address the financial support for the regional authorities directly, with the clear demand to engage the civil society in working on tailor-made projects. This first brought broader knowledge of the amount of funds that the EU offered and at the same time better control on the part of the EU and second could help to enlarge the steering capacity when engaging regional society in its own affairs.

Nevertheless, there are doubts about whether funding alone could lead to a better future. Several poor regions could improve their economic situation, indicating a rising GDP per head. Nevertheless, the regional funds could not prevent the ongoing emigration from poorer regions, mainly in the central and eastern member states. Following the data from the United Nations Population Prospects, the Baltic states and Bulgaria lost between 16% and 26% of their populations between 1991 and 2015, and this will continue in the future (UN Department of Economic and Social Affairs 2019). The permission for free movement of people in the EU has actively encouraged many citizens to look for opportunities in richer countries.

A change of these negative effects of depopulation and ongoing poverty in poorer regions can only be achieved if the members of the population face a positive outlook for their future. This is hardly attainable, but increased funds, supportive policies, and more engagement of the people in developing their own destiny would help to improve the situation. Investments in a future-oriented competitive economy plus more investments in infrastructure, education, and research and development are necessary. Building regional identity and a culture of cooperation in the region furthermore helps to mobilize endogenous potential.

Last but not least, increasing economic growth rates and higher employment rates are dependent on a large scale of factors encompassing competitiveness, a skilled workforce, enough demand, and so on. From the very beginning, the common currency favored those countries like Germany that were more competitive. Since the introduction of the euro, the weaker countries have no longer had the opportunity to compensate for their lower level of competitiveness with devaluation, as for example Italy did in 1993 by devaluing its lira by 25%. This helped at that time to make imports from Germany more expensive and thus minimized the negative trade exchange rates. Having introduced the euro, this classic method of protecting against stronger trade partners is
no longer available. Furthermore, the positive effects of regional funding and support for the poorer regions were counteracted by the austerity policy in the spirit of market dogmatism. Even before the financial crisis of 2007/08, the neoliberal strategy of the EU member states had increased the gap between rich and poor by downsizing the tax load on capital income, lowering wages and labor market regulations (Stiglitz 2010, Leaman 2013).

Nevertheless, the idea of leaving the eurozone would not help those member states that suffered heavily from the austerity policy, because the debt would be the same. Their chance of regaining a better economic situation is only dependent on higher growth rates introduced through investments in future technology and increasing the public and private demand. This strategy needs an investment program—like the European Recovery Program after the Second World War—as these states are unable to meet the challenges alone.
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2 Cultural Heterogeneity and Political Distance in the Process of Economic Integration of Asia and Europe

Muthurangam Subramanian, Natarajan Panchanatham, and Alan Myrold

2.1 Introduction

The present-day modern world is distinguished as the “era of migration,” which means a large number of people are basically “on the move.” Mobility is not a new phenomenon and has been an ongoing factor since early history. The change in labor migration has occurred due to natural calamities, epidemics, poverty, or major disasters. The main reason for the present mobility can undoubtedly be attributed to events like the global financial crisis, the crisis in the eurozone, or internal conflicts or civil wars in countries like Syria; the rapid increase in this mobility is considered much higher than in the past. This phenomenon is further fueled by the concept of globalization, the open economy, and the free movement of people as in the European Union (EU). As immigrants and refugees tend to bring along the traditions and customary practices of their native homes, labor migration has an impact on the cultural diversity of the destination country, which has a further impact on the economic performance of the destination country.

The influence of human capital resources on the economic growth and development of a country has been an important area of research in recent decades. There are many research reports, analyses, studies, and assessments published on the relationship between the quality of human resources and economic development, including the level of education (Jalil and Idrees 2013, Lu 2018, Ogundari and Awokuse 2018,
In general, it is hard to identify a correlation between educational attainment and income levels, although people in more affluent countries are generally considered more highly educated (Bacsi 2017). People in countries with high income levels have better education and people in poorer countries have enjoyed faster improvements than more prosperous countries. This is because of the long lags between increasing wealth and improved education outcomes resulting in a weak correlation (UNDP 2010).

Besides educational attainment, the roles of innovative capacity, talent, and creativity in enhancing economic performance have received increased attention. Research and investigation have been carried out on the contribution of these features to the financial results of organizations and the economic conditions of countries (Barnett and Kincaid 1983, Florida 2005, Adler 2008, Burger-Menzel and Syring 2013, Vollmer and Wolf 2015). A deeper analysis of these studies reveals that talent, skills, creativity, and capacity to innovate arise from heterogeneous human resources. By adopting appropriate human resource management practices, heterogeneous and diverse human resources can become a valuable asset for an organization. However, an organization that is unwilling or unable to communicate can lead to a lack of cooperation and eventually result in slow economic growth.

In the case of population groups with mixed cultures, the degree of creativity may be higher, mainly due to the range of their experiences, attitudes, creativity, and traditional backgrounds, which are crucial resources in a country’s economy (Yencken 1988, Florida 2005). Florida (2005) states that economic development is closely associated with human resources’ lifestyle factors such as endurance, cultural diversity, and infrastructure facilities for entertainment.

Economic development and regional economic integration are linked (Taghizadeh-Hesary et al. 2020). In order to make an assessment of countries according to their human resources potential and scope for economic integration, the method of clustering can be used effectively. The factors of clustering may include geographical location, the ethnic composition of people, cultural homogeneity, religions, attitudes, objectives, language proficiency, values, and personality traits (Gupta, Hanges, and Dorfman 2002; Ronen and Shenkar 1985; Vanderstraeten and Matthiessen 2008).

The grouping of countries into various clusters strongly depends on the selected cultural dimensions. Different dimensions may lead to a completely different country cluster. It is, therefore, essential to take necessary care in clustering, particularly for multicultural countries (Littrell 2012). Social and cultural heterogeneity has the following three theoretical consequences:
• It influences an individual's personal preferences, since individuals tend to have higher values for events that enhance the well-being of their cultural and social groups.
• It influences individual strategies since people, in general, have a preference for homogeneous work environments, as the environment’s transaction costs in such an environment are lower.
• Cultural heterogeneity may also have an influence on manufacturing activity due to variability, as well as the diverse pooling of skills.

Collier (2000) comments that fragmentation has adverse effects on growth and productivity in some regions. La Porta et al. (1999) and Alesina, Spolaore, and Wacziarg (2000) indicate that ethnically divided societies are correlated negatively with respect to the quality of infrastructure, literacy levels, and attainment in education, and the same is correlated positively with respect to infant mortality. However, correlations are found to be robust without taking into consideration per capita income. Alesina and La Ferrara (2005) conducted a survey of about 100 countries exploring the correlation between language proficiency, ethnic diversity, and per capita income growth. The study results reveal that ethnic fragmentation has a positive impact on developed and wealthy nations, but higher fragmentation has a correlation with lower growth of gross domestic product per capita (Bacsi 2017).

In a study conducted by Sparber (2007), the effects of cultural heterogeneity and racial diversity on the economies of cities in the United States (US) are investigated. Further, the study provides an in-depth insight into the relevant literature, emphasizing that, despite most literature agreeing on the harmful influence of ethnic fragmentation, there are some different outcomes and views. Taking US evidence, Putnam (2007) and Sparber (2007) explain that cultural heterogeneity and economic performance have a positive relationship. Their studies emphasize the value of cultural heterogeneity as a valuable asset to society. One essential finding of a study by Dohee and Gold (2014) is that cultural differences have a significant positive impact on regional economic integration. However, this is not prevalent in respect of all samples in Europe.

The above descriptions show that sociocultural factors, including social, cultural, ethnic, religious, and linguistic influences, have a complicated relationship with the development and growth of an economy and economic integration and a detailed analysis of this cannot be found in the literature. This chapter performs a comparative analysis of the role of cultural issues and political distance in Asian and European economic integration so as to assess whether Asia can take
some lessons from the European model with a view to increasing the level of economic integration.

1.2 Economy of Cultural Heterogeneity

The world was divided into various divisions and regions of special interest during the Cold War era, and it was not possible for individuals to change within the groups. Since the fall of the Soviet Union and with the US dominating as a giant capitalist country, the level of cultural diversity has significantly changed compared with the past.

In classical and general terms, the word “culture” is defined as the customary beliefs, social forms, and material traits of a racial, religious, or social group. But culture also includes more activities in broader terms, such as everyday work and routines like greeting, eating, loving, etc. Culture refers to the norms, moral values, conduct, behavior, material or immaterial products, and symbols relating to human beings of one culture that can be differentiated from human beings of another culture in one or several forms.

Cultural heterogeneity concerns the presence of many different cultures within a specific population. Culturally diverse population groups can include different characteristics, such as people belonging to different religions and with multiple ethnic backgrounds living in the same community, region, city, village, or area. In general, a mix of different components is considered heterogeneous. In recent decades, there has been a significant change in the cultural heterogeneity in European countries, leading to a remarkable increase in the cultural heterogeneity among the regional member states of the EU. An extensive review of the literature reveals that some research studies analyze the relationship between cultural issues and regional economic integration. However, when comparing regional economic integration, it is important to focus on innovative developments, gross domestic product per capita, and various other developments in the region. It can, therefore, be inferred that regions with a higher level of cultural diversity are more innovative, which results in better performance leading to higher growth and development.

Reviewing the last few decades of the European integration experience, an assessment can be made relating to the achievable level of integration among the member countries of Europe. The achievement of European integration is characterized by three different models or systems of regional integration: the dirigisme, which is a form of economic development that emphasizes the positive role of state intervention; the neoliberal model that integrates both political and

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economic and seeks to transfer control of economic aspects from the public sector to the private sector; and the structuralism model, which means that the elements of human culture must be understood in relation to their broader system. There is also a new form of integration known as “technical and substantial integration.” While the nature of technical integration is exogenous and explains the articles of integration, the nature of extensive integration is endogenous and refers to the contents of integration. Iliev and Ilieva (2014) focused on cultural diversity in the EU as a dimension of underlying extensive integration.

The obstacles or roadblocks to European integration are not attributed to culture. The lack of homogeneity of people in the region has never been a hindrance to European integration (Alesina, Tabellini, and Trebbi 2017). Alesina and his colleagues believe that European citizens are more similar to each other than they think they are. The critical issue for the future of European political integration is thus not cultural heterogeneity across EU members. This is one of the results highlighted by Alesina, Tabellini, and Trebbi (2017) in their study. They conducted a wide range of surveys among individuals belonging to the EU and found that the level of cultural and institutional heterogeneity has changed considerably.

Despite achieving a reasonable level of economic convergence and coordination among the member states in Europe, cultural or institutional convergence has not played a significant role in leading successful European economic integration. Comparing the heterogeneity among the EU member states, the level of cultural diversity across the EU members remains the same. The major obstacle to better political convergence cannot be attributed to cultural diversity but rather to other factors such as national identities. There are hard challenges faced by the EU. In the EU, a large number of Europeans do not trust the EU institutions and have less tolerance for supranational interference relating to domestic policies. Due to these issues, the European integration process is struggling at times and it has even taken a reverse direction with the Brexit crisis (Brexit is the withdrawal of the United Kingdom from the EU).

The review of the literature indicates that cultural differences may have an impact on the manufacturing function in an organization. Alesina, Spolaore, and Wacziarg (2000) adopted a Dixit–Stiglitz structure for manufacturing activity in which “intermediate inputs” are explained as multiple variations of individual traits and skills that eventually increase the total production output. However, this model cannot be a trade-off in manufacturing activity since it is always considered that a higher level of heterogeneity is better than a lower level. The cost of heterogeneity is outside the manufacturing activity.

Lazear (1999) explains how various skills in a manufacturing operation can boost the overall productivity of the unit. Lazear (1999)
points out that there is a trade-off between the diversity in manufacturing operation benefits and the anticipated costs that may be incurred due to communication difficulties among individuals of a different culture and speaking in different languages, etc. There exists an optimum heterogeneity level that is arrived at the optimum point of this trade-off under the nature of the manufacturing operation and its operating technology. Pratt (2002) indicates similar points in the context of “team theory.” In the case of teams, the jobs that are homogeneous in nature have a positive impact and vice versa. Ottaviano and Peri (2003) also explore the pros and cons of cultural differences in manufacturing activity. Cultural differences and related amenities affect the rental value of the land, which affects the manufacturing activity.

Further, while the demand for many goods and services has become more homogeneous across nations, cultural factors have also played a significant role in this change. In the present world of multiculturalism, cultural diversity will continue to be the strongest obstacle to globalization (Kale 1995). According to Belk (1996), the homogeneity of global markets such as the synchronization of American and European cultural models need not be the characteristic feature of globalization. Cultural factors can change globalization into an exclusive society with different interpretations. Cultures have the tendency to endure and be resilient similarly to the characteristic of multiculturalism as well as globalization. Manrai and Manrai (1996) argue that although cultural homogeneity may not be achieved by globalization, there can be a polarization of the concept and material differences.

Based on a broader and global perspective, traders can be viewed as geographic clusters of countries sharing the concept and/or different levels of material aspects of cultural factors (Malhotra, Baalbaki, and Agarwal 1998). However, based on the primary domestic perspectives, the entire world can be separated into two types of culture: Western and Eastern cultures. Eastern culture is characterized by a large distance in terms of power, collective groups, and a feministic nature. However, a short distance in terms of power, an individualistic and masculinist nature characterizes Western culture (Hofstede 1983, 1991). As an example, a comparison of Japan with Europe shows the differences in power distance, groups, and societies. Also, Western culture mostly tries to avoid the instability that can be seen in the long-term stability, closeness, and continuity of relationships (Van Den Bosch and Van Prooijen 1992).

Another significant and prominent cultural difference between Eastern and Western cultures is that of the high and low context level of the culture, respectively (Hall 1976). In the case of Eastern culture, the transactions based on social context are considered to be highly significant. According to Hall (1976), people of Eastern cultures perform
multitasks simultaneously (polychronic), while people of Western cultures perform each task separately at one time (monochronic).

In Western cultures, cultural differences exist within the major groups of countries. While countries such as the US, Canada, the United Kingdom, and some other European countries like Germany, Switzerland, and Austria, are highly masculinist, other countries, such as Norway, Denmark, and Sweden, are predominantly feminist in nature. Also, Manrai and Manrai (1995) comment that among Western culture-dominated countries, the US and Canada reflect a significant influence in terms of cultural aspects compared to western European countries. Based on the concept of the time continuum, it can, therefore, be concluded that the countries of East Asia belong to the polychronic category, the countries of western Europe belong to the monochronic category, and the countries of North America occupy the central status between monochronic and polychronic cultures, albeit being closer to the countries of western Europe (Malhotra, Baalbaki, and Agarwal 1998).

Further, there exist significant cultural differences among the three major global entity trading groups: the Association of Southeast Asian Nations (ASEAN), the European Union (EU), and the North American Free Trade Agreement (NAFTA). In view of the cultural diversity among these three large trade blocs, regionalization is encouraged as a better strategy than globalization (Morrison and Roth 1992). Further, regionalization may also boost the potential for large-scale globalization enabling these organizations to take advantage of the prevailing competencies. In general, culture is diffused and hard to come to grips with. Culture is treated as an independent variable that can be included in public policy and economic analysis. In the past, several authors (Kluckhohn and Strodtbeck 1961, Schwartz 1992, Trompenaars and Hampden-Turner 1997, Hofstede 2001, Hills 2002, House et al. 2004) have mentioned this aspect in their contributions relating to national cultures and integration theory. Schmitter (2005) also highlights the importance of cultural factors in his area of work.

1.3 Cultural Distances and Regional Economic Integration

It is important to assess whether regional economic integration can progress despite regional cultural differences. The term to indicate the cultural differences between countries is “cultural distances” (Colakoglu and Caligiuri 2008). A study conducted by Zuva and Worku (2016) investigates whether the cultural distances can be measured within regional economic integration and the possibility of the measure being
effectively utilized by governments and institutions. Hofstede’s cultural dimensions’ values were adopted for countries belonging to different regions in order to arrive at the cultural distances between countries and compute the average cultural distances within the regional group (Hofstede 1983).

According to Hofstede (1991), culture refers to a set of shared beliefs and value systems that distinguishes people belonging to one country with those from another. Hofstede classified culture into four important factors. The concept is to place the value of culture in these four factors relating to the culture. According to Hofstede, such causes are individualism or groups, power or its absence, masculine or feminine, and avoidance and non-avoidance of uncertainty. By adopting a survey methodology for IBM computers, Hofstede (1991) collected his research data on the cultural values of the countries around the world. He also developed a rating system using a scale of 1 to 120 (Wu 2006).

The survey results of the study were further interpreted on the basis of the stakeholders: the government, multinational companies, and human resource management of these organizations. The scored cultural values were computed for every country within the regional economic integration. A graphical display of the cultural value computation revealed those regions that have similar cultural values as well as the countries with a variety of diversified cultures. The research study by Hofstede proposes valuable recommendations for governments to use cultural values to make an assessment of whether or not regional economic integration can progress to the next higher level.

The cultural distances of member countries of the European Free Trade Association are shown in Figure 2.1.
The cultural distances of the North American Free Trade Agreement (NAFTA) member countries are shown in Figure 2.2.

![Figure 2.2: Cultural Distances of North American Free Trade Agreement (NAFTA) Member Countries](image)

US = United States.
Source: Depicted by the authors based on Zuva and Worku (2016).

### 2.4 Political Closeness for Economic Integration

The relationship between political distance and economic integration depends on international and domestic political and economic factors. The economic and political performance also play a role in connecting political and economic integration. As the success of economic integration depends on the interest shown by the member countries in the region in participating at a certain level of political integration, it is important to establish a strong relationship between political and economic integration. Political cooperation and political institutions are essential in establishing a common single market as well as a deeper level of economic integration (ADB 2010).

While European integration was possible through institutions, Asian integration and regionalization depend mostly on market considerations (Armstrong and Drysdale 2009, ADB 2010). Political cooperation in Europe led to regional economic integration. On the other hand, Asian economic integration is market driven despite political interferences without proper diplomatic cohesiveness. Market-led integration of the Asia and the Pacific region has been well detailed with the Asia-
Pacific Economic Cooperation (APEC) forum playing a significant role in terms of trade and investment liberalization and collaboration. Asian economic integration has the major benefit of APEC providing greater support for liberalization of trade and investment pursuits in the Asia and Pacific region.

In the process of Asian integration, the main reasons for the challenges relating to political issues are attributed to the weakness and poor performance of institutions. However, by reducing the barriers between borders, better trade prospects have been realized. This has also facilitated the recent establishment of production networks in different locations in the region. Despite the challenges, the political distance, multilateral trade connections, and foreign direct investments in the region play an important role in Asian economic integration. In the Asian region, East Asian economies face higher levels of political challenges and tension due to historical events than other countries in the region. As such, the political distance of foreign trade and investment between the economies in that region depends on the political distance between the regional economies.

A comparison of the trade and investment performance among different countries in the region can help evaluate the political distance. Here, APEC’s role should be considered significant. APEC should not be treated as an institution resulting from a trade and economic agreement among the economies of the Asian region. There are no preferential trade or other treaty agreements among the APEC members. It is structured based on the open regionalism and nondiscriminatory values and policies of the international economic trade and commerce.

APEC is structured based on the soft politics in regional economic integration as compared to hard politics involving many political and economic treaties and agreements (Armstrong and Drysdale 2009). It is important to assess the impact of APEC’s performance in terms of improving regional economic integration. It is essential to evaluate APEC’s performance in increasing the trade and investment in the region as well as to assess the impact of APEC in enhancing the relationship between the regions of Asia and the rest of the world.

In Europe, along with economic integration, international political integration has also occurred, where the member countries have enforced sovereignty limitations pertaining to policies like fiscal policy by delegating powers to the EU relating to some of the key areas such as trade and antitrust policies. However, these actions are being debated in the context of political integration.

In general, while economic experts have concentrated their focus on the growth and development of economic integration, there is a lack of awareness regarding the impact of cost and political integration aspects.
So, it is vital to analyze whether political integration affects economic growth. If this is the case, the aspects of the modus operandi need to be assessed. Another important aspect is to ascertain whether political integration is beneficial for the growth of globalized economic markets (Armstrong and Drysdale 2009).

The two functions of economic and political integration complement each other. When organizations get involved in both the economic and political markets, the productive activities of economic integration are hampered by the political integration. As organizations get involved in both the economic market, such as through market competition, and the political market, such as through government transfers, any changes in one market can have a tremendous influence over the other.

Severe competition for government transfers arises due to political integration. In order to maintain government transfers, organizations are required to exercise increased efforts in aspiring for rent. When there is a downward trend in political market gains, organizations have to depend more on the economic market for increasing their profits. Such a tendency creates increased competition in the economic market as well as an improvement in incentives for innovation. However, seeking higher rent can lead to increased costs and effectively force the establishments out of the market. This has a cascading effect of many establishments leaving the economic market and eventually reducing the incentives for innovation. Thus, there is no clarity relating to the impact of political integration on growth, innovative developments, and welfare prospects (Brou and Ruta 2007).

Both political and economic integration have similar implications. In general, economic integration in one market can have a positive effect on innovation and growth in that market. However, economic integration can generate a negative impact, reducing the number of firms in the other market. It can also lead to a negative effect on innovation and growth. Improvements in welfare or growth cannot be guaranteed by strengthening political integration only or by deepening economic integration alone. Thus, an amalgamation of economic and political integration can increase economic performance as well as the market competition in both the markets. Organizations get increased incentives to invest in innovation activities for sustaining their market share without seeking incentives for rent.

As countries develop both economic and political integration, there is an increase in the influence of growth, innovation, and welfare prospects. This is due to the creation of competition among economic and political markets without major changes in the incentives in the market. However, in reality, it is hard to have both economic and political integration going together strongly. An empirical study carried out by
Rodrik, Subramanian, and Trebbi (2004) indicates that there is a close association among better institutions under open economies. It can also be inferred that there is an increase in innovation, welfare, and growth prospects in open economies along with the development of efficient and effective institutions.

2.5 Conclusion and Policy Recommendations

European and Asian economic integration implies that the countries in these regions engage in economic cooperation to use their own resources more effectively. They also provide large markets for the countries of these two big continents. However, there are several inherent issues and challenges in the process of economic integration, including cultural heterogeneity and political distance. Cultural diversity and political distance are widespread in both regions. It is suggested that regional economic integration be combined with greater cultural heterogeneity and political integration.

Regional economic integration of countries that have similar cultural values can progress to the next higher levels on the scale. Cultural and political engagements of various Asian subregions create specific barriers in the process of economic integration. Political factors and government policies have a significant impact on the economic development of any region, which is planned to take place through the economic integration process. Sometimes, culturally motivated political interference affects various forms of government, political stability or instability, policy management, corruption, and commercial laws.

The degree of heterogeneity among the countries of a region is a vital factor to be considered in accomplishing the objectives of regional integration. It is, therefore, important for the economic and political institutions in a region to identify the various options for optimizing the cohesiveness that would develop a higher level of integration and agreement. As the advantages depend on the locations, it would be beneficial for regions to create institutional layers appropriately. Institutions in a region should also formulate rules and regulations for ensuring regional cooperation subsequent to the admission of a member country. Despite various differences, institutions can adopt the rules as a tool to join the cooperation and agreement among the groups of the regional member states, as noted from the European economic integration experience (ADB 2010).

Any proposal for moving regional economic integration to the next higher level should be based on a region’s cultural distance consideration. It is likely that a number of regions can be at the initial levels of regional economic integration, whereas others can progress
to the next higher levels on the scale. It is the responsibility of human resource management authorities to formulate new strategies in dealing with employees belonging to different countries in the regional economic integration process.

It is recommended that there be scope for undertaking further research to explore the statistical correlation between the cultural distances as well as the public economic performance among the countries in the regional economic integration process.

Further, based on the conclusions, the following suggestions are proposed relating to international commerce and trade, investment performance, and political relations:

- Multicultural international institutions must help to reduce the cultural, political, economic, and political distance between trading partners in promoting regional economic integration.
- Heterogeneity of income levels, differences in the level of development, and cultural distances in Asian subregions, if well managed, can be a valuable asset in raising the economic growth of all countries engaging in economic integration. Developed Asian economies such as Japan and the Republic of Korea can benefit from the spillover effect of investments in less developed Asian economies.
- For regional labor market integration, it is recommended that multilateral organizations and governments identify the cultural differences in their countries that are planning for regional economic integration. This will help to manage the workforce flow to fit well in the host country.
- The success of economic integration depends on the interest shown by the member countries in the region participating at a certain level of political integration. It is, therefore, important to establish a good relationship between political and economic integration.
References


3

Different Paths to Economic Integration in Europe and Asia

Richard Pomfret

3.1 Introduction

Regionalism in Europe and Asia moved in very different directions in the second half of the 20th century. By 2000, the European Union (EU) covered much of Europe, and in most of the EU physical border crossing points had disappeared and countries were adopting a common currency. In Asia, regional economic integration was negligible and the proposed regional trading arrangements were of limited economic relevance. In the final decades of the 20th century, Asia experienced some bottom-up economic integration as firms established supply chains that crossed borders.

In the 21st century, economic integration in Europe and Asia has similarities, as producers participate in regional supply chains with increasingly fine specialization across countries. A common pattern has involved the same sectors (cars, electronics, and clothing) leading the way, with the more economically developed countries and a few emerging economies among the dominant participants. The policy space has been similar, as countries have complemented low formal trade barriers with measures to reduce other costs of international trade. Within the closed regionalism of the EU, legislation enforced by the European Court is achieving policy integration, while, in Asia, treaty-based open regionalism is increasingly covering a mixture of bilateral, regional, and plurilateral arrangements.

Section 3.2 describes the different 20th-century paths and the progression of regional trade agreements from the customs union focus on tariffs and nontariff barriers to trade to deep integration arrangements that reduce trade costs and behind-the-border obstacles to specialization and trade. Section 3.3 analyzes the emergence of international supply chains (which people commonly refer to as global value chains, GVCs)
and their role in stimulating Asian trade agreements, which Section 3.4 examines. Section 3.5 describes the evolution of the EU’s external trade policies and shows how the European and Asian approaches converged in the 2010s. Section 3.6 compares the response of European and Asian policy makers to the withdrawal of the United States (US) from regional agreements and its threat to the operation of the multilateral trade system.

Section 3.7 concludes that the EU and a set of Asian economies have taken on the leadership of the global system by promoting trade agreements that extend beyond the existing world trade law and are open to other countries to join. Despite the difference in political integration, the interests of the countries involved in GVCs are strongly aligned. This position is firmly based on the mutual benefits from reducing trade costs and allowing specialization and trade along international value chains. Thus, there is a common purpose in resisting the threat to the multilateral system that the US has posed since 2017. Whether the Asian countries can achieve the degree of common purpose that the EU has, without the deeper institutional integration that Europe has developed over 70 years, remains unclear.

3.2 Regionalism in Europe and Asia after 1945

3.2.1 Contrasting Experiences during the Post-1950 Long Economic Boom

The end of the Second World War provided the opportunity for a fresh approach to the institutional structure of the global economy. Four of the five major allied powers (the US, Soviet Union, the United Kingdom [UK], and France) played a dominant role in the process and took the major decisions in Washington, Moscow, London, and Paris. The US and the UK led the initial steps—Bretton Woods in 1944, the United Nations Charter in 1945, and the General Agreement on Tariffs and Trade (GATT) in 1947. The Soviet Union initially participated in negotiations over the future world system but soon developed a separate system of planned economies. An iron curtain divided Europe.1 Crucially, apart

1 Winston Churchill described the situation in a speech on 5 March 1946: “From Stettin in the Baltic to Trieste in the Adriatic an iron curtain has descended across the Continent. Behind that line lie all the capitals of the ancient states of Central and Eastern Europe. Warsaw, Berlin, Prague, Vienna, Budapest, Belgrade, Bucharest and Sofia; all these famous cities and the populations around them lie in what I must call the Soviet sphere, and all are subject, in one form or another, not only to Soviet influence but to a very high and in some cases increasing measure of control from Moscow.”
from the Soviet Union, the largest European economies (the UK, France, the Federal Republic of Germany, Italy, and Spain) were all on the same side of the curtain.

The origins of European integration lie in the aftermath of three Franco–German wars (1870–1871, 1914–1918, and 1939–1945), each more disastrous than the previous one, and the decision of leading French statesmen (notably Jean Monnet and Robert Schuman) to prevent a new war through economic collaboration rather than vengeful peace. Key German (Adenauer) and Italian (de Gasperi) leaders, and crucially the US as the Cold War gathered intensity, supported them. The initial step, the creation of the European Coal and Steel Community in 1951, followed this vision by providing for a supranational authority to oversee the two industries that people then considered to be at the heart of a modern industrial postwar economy.

The aftermath of war was different in Asia. The Cold War split the two largest East Asian economies; the People’s Republic of China (PRC) allied itself with the Soviet Union in the 1950s and after the Sino–Soviet split became inward looking until the 1970s, while the US occupied Japan and then became strategically allied with it. Decolonization and nation building dominated South Asia and Southeast Asia in the late 1940s and 1950s. In Southeast Asia, this was associated with fractious relations, as the creation of Malaysia occurred in the face of Indonesian opposition and Singapore’s secession in 1965, and with escalating military struggles in mainland Southeast Asia. The non-Communist nations created the Association of Southeast Asian Nations (ASEAN) in 1967 as a strategic alliance, although it had little economic content before the end of the century.

Meanwhile, in Europe the six member countries of the European Coal and Steel Community (Belgium, France, the Federal Republic of Germany, Italy, Luxembourh, and the Netherlands) signed the Treaty of Rome in 1957, creating a customs union in the 1960s and committing to common policies in nuclear energy, transport, and agriculture as well as eventual free movement of labor and capital. The UK and six other countries that were suspicious of the supranational powers inherent in the Rome model formed the European Free Trade Association (EFTA) in 1960. By the early 1970s, the economic success of the six countries

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2 A customs union inevitably involved supranational powers to implement the common external trade policy and to manage the tariff revenues (it was unacceptable to allow the country of the port of entry to keep the revenues when Rotterdam was the port for many non-Dutch importers). Other common policies, such as the agricultural policy that countries negotiated and introduced in the late 1960s, involved higher levels of collaboration.
encouraged the UK, Denmark, and Ireland to abandon the EFTA in favor of the European customs union. The overthrowing of the Fascist regimes in Greece, Portugal, and Spain in the mid-1970s removed the obstacle to those countries’ accession to the European Community in the 1980s.

By the end of the long boom in 1972–1973, both Western Europe and much of East Asia and Southeast Asia had integrated their thriving regional economies into the global economy. Europe based its growth on strengthened intraregional specialization and trade within the customs union.³ In contrast, Japan and the newly industrialized economies of Hong Kong, China; the Republic of Korea; Singapore; and Taipei, China operated as spokes in a world economy centered on the high-income countries of North America and Western Europe. The Asian success stories were a result of the macroeconomic policies, labor markets, port infrastructure, and customs systems, and other features conducive to exporting manufactured goods according to the comparative advantage of each economy. Even in the globally depressed conditions in the decade after 1972, they continued to outpace the economic growth elsewhere so that the Asian region’s share of the world economy continued to increase.

In sum, while Western Europe had a functioning and expanding customs union, Asia, as an economic region, was fragmented, with most countries pursuing inward-oriented policies. While Western Europe was developing intraregional trading patterns, Japan and the newly industrialized economies of East Asia were part of a hub-and-spoke system of international trade in which they exported to markets outside Asia.

### 3.2.2 Deep Integration in Europe in the 1980s and 1990s and Its Absence in Asia

The 1980s and early 1990s were a period of challenge in the global economy, as the established major trading nations recovered from the stagflation of the 1970s only to face competition from the newly industrialized economies. A second generation of Asian high-performing economies—Malaysia, Thailand, Indonesia, and the PRC—

³ Surprisingly, rather than the anticipated inter-industry trade, much of the trade within the European customs union was intra-industry trade (IIT) (Grubel and Lloyd 1975). Some IIT was horizontal trade in differentiated products, spurring a “new trade theory” with imperfectly competitive markets, while other IIT was vertical trade of components, foreshadowing the identification of GVCs.
now joined Japan and the original Gang of Four. After initial flirtations with “new” protectionism, for example, measures such as voluntary export restraint agreements or orderly marketing arrangements, the leading trading nations reverted to liberal trade policies, concluding the Uruguay Round of multilateral trade negotiations, and establishing the World Trade Organization (WTO) in 1995. They also tried to strengthen their competitiveness by signing regional “deep integration” agreements, such as the 1983 Closer Economic Relations (CER) agreement between Australia and New Zealand and the 1994 North American Free Trade Agreement (NAFTA) between Canada, Mexico, and the US.

The clearest example of deep integration was the European countries’ program to complete the single market by 1992—a process that the 1993 Maastricht Treaty ratified and that included the adoption of the name the European Union (EU). Among the drivers of the 1992 program was a sense that the customs union completed in the 1960s was an unstable equilibrium. Like riding a bicycle, the process of regional integration had to move forward or be derailed. The potential sources of derailment were exchange rate fluctuations and nontariff barriers to internal trade.

At the time of the Rome Treaty, the Bretton Woods system pegged exchange rates, and no discussions took place on monetary arrangements. In 1969, differing economic pressures led to upward revaluation of the German currency and devaluation of the French currency, disrupting the prices of goods traded in the customs union. The Werner Committee in 1970 proposed a 10-year road map to a common currency, the implementation of which began in 1972. The timing was disastrous, as the Bretton Woods fixed exchange rate system collapsed and the world economy entered years of turmoil. Facing rapidly increasing prices of oil and other imports, the European countries pursued diverse monetary policies. Exchange rates became more volatile, and the abandonment of the Werner plan occurred in 1976. The striking sequel was that the leaders of France and the Federal Republic of Germany agreed in 1977–1978 to resuscitate the plan for a currency union. The establishment of the European Monetary System took place in 1979 and led, 2 decades later, to the introduction of the euro. A specific reason for this outcome was the recognition that monetary instability hampered the smooth functioning of a common market and that adopting common policies,

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such as an agricultural policy with agreed common prices, was virtually impossible with volatile bilateral exchange rates.\textsuperscript{5}

The process of European integration also faced challenges from a landmark legal case in 1979. The European Court found in favor of a French producer that could not sell its \textit{Cassis de Dijon} in the Federal Republic of Germany because its alcohol content was too high to be sold as wine but too low to be sold as spirits. The court concluded that, if the sale of a good was legal in a member country, then it should be legal throughout the common market. A central feature of the 1992 program was to establish common standards either through the mutual recognition principle, as in the \textit{Cassis de Dijon} case, or, when this was unacceptable, by harmonizing standards. Effectively, this program sought to add an economic space without non-tariff barriers to the tariff-free internal trade of the customs union. The EU had less success in the mutual recognition of many service activities that powerful professional associations provided, but it did make progress in labor and capital mobility and in removing physical border checks.\textsuperscript{6}

The deep integration process, which the internal dynamics of economic integration accentuated in Western Europe, was absent in Asia. The ASEAN countries tried a series of economic integration programs, notably the ASEAN Free Trade Area in the 1990s, but none had much impact. Elsewhere, there was even less movement toward formal regional integration. The economies that were most involved in global trade unilaterally reduced their trade barriers, in part within the open regionalism framework of the Asia-Pacific Economic Cooperation (APEC) forum, which was established in 1989.

APEC was a much weaker institution than regional trade agreements like the EU or even NAFTA or the CER. The concept of open regionalism meant that membership was open to any country in Asia and the Pacific

\textsuperscript{5} Pomfret (1991) and Basevi and Grassi (1993) documented the link between the Common Agricultural Policy and the speedy resuscitation of the monetary union in the late 1970s. The public finance transactions costs are why countries invariably have a single domestic currency (Pomfret 2005), and a common currency requires acceptance of a single monetary authority (Pomfret 2016).

\textsuperscript{6} The establishment of capital mobility in 1992 provided the currency union with a final push. The fixed exchange rates required for the smooth operation of the common market and the free movement of capital are incompatible with independent monetary policies (the “Impossible Trinity”). Without independent monetary policies, there was little point in maintaining national currencies. The EU members that were unwilling to give up their national currencies (Denmark, Sweden, and the UK) risked either being left outside the EU core if their currencies fluctuated or having a symbolic national currency with some nuisance value for no economic purpose if its value was pegged to the euro.
that adopted the fairly general principles. It was useful for countries that announced unilateral trade liberalization measures simultaneously and hence were able to appease domestic interest groups by suggesting that they were gaining access to foreign markets as well as opening up their own markets. However, any attempt to pressure countries to liberalize, as in APEC’s ill-fated 1997 voluntary sector liberalization program, faced robust resistance. APEC further lost momentum in the late 1990s due to the failure to muster a response to the 1997–1998 Asian financial crisis. However, APEC remains a forum for annual meetings of leaders in Asia and the Pacific.

The Asian countries involved in electronics value chains also signed the WTO’s 1997 Information Technology Agreement (ITA), the signatories of which guaranteed not to impose any tariffs or similar restrictions on imports of specified electronic goods. The ITA is a plurilateral agreement, meaning that it is not mandatory for WTO members. Signing the ITA provided lead firms in GVCs with a guarantee that components could move freely in and out of a country. Because signing the ITA was possible for all WTO members, it shared the key feature of open regionalism.

3.3 The Regional Basis of Global Value Chains

By the start of the 21st century, GVCs were a recognized dynamic feature of the world economy. Most GVC production was, in fact, happening along regional value chains, centered on North America, Europe, and East Asia (Johnson and Noguera 2012, 2017). Salient differences were that the management of North American GVCs was mostly mercantilist under NAFTA, European GVCs operated within a common market, and Asian GVCs were market driven without significant regional policy management.

Europe established the customs union in the 1960s, and the 1992 program, the establishment of the Schengen Area, which eliminated physical border barriers, and the creation of a common currency in the late 1990s further reduced the barriers to internal trade. The extent to which economics or a desire for ever-closer political union drove the deeper integration varied among the member states, but an economic consequence was the facilitation of cross-country supply chains in Europe. The process of creating value chains had received a boost from

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7 There is a large amount of literature on the evolution and analysis of GVCs, for example Pomfret (2014), Baldwin (2016), Inomata (2017), and UNIDO (2018).
the accession of poorer southern European countries in the 1980s and, even more so, from the end of Communism in Eastern Europe and the clear intention of new lower-wage countries to join the EU. In sum, the economic basis for European regional value chains was an integrated area of low trade costs due to the reduction of border-crossing costs and the currency union, and exogenous political drivers that increased the diversity of locations within the EU augmented the impact.8

The process of creating regional value chains in Asia was a bottom-up process, initially concentrating on the more open and business-friendly economies, with the cities of Singapore and Hong Kong, China playing key roles. As wages increased in the cities, their entrepreneurs offshored labor-intensive activities to neighboring areas: Johor in Malaysia and Riau in Indonesia for Singapore and Guangdong in the PRC for Hong Kong, China. External developments were also important. The rapid appreciation of the yen after 1985 encouraged Japanese carmakers to seek offshore locations for car assembly, and they found Thailand. Malaysia played an important role in electronics value chains. Following the opening of the PRC economy in 1979, entrepreneurs from the original newly industrialized economies started shifting labor-intensive production processes to the PRC in the 1980s and 1990s.9 In 2001, the PRC joined the WTO. With more formal incorporation into the global economy, the PRC’s centrality in Factory Asia increased.

The extent of GVCs is greatest in East Asia and focuses on a few participating countries. For example, using two indicators that Athukorala (2011) operationalized, the value and share in manufactured trade of parts and components and the concentration of trade in sectors in which GVCs are prominent, Pomfret and Sourdin (2018) found that

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8 McCallum (1995) demonstrated the importance of the border effect even when tariffs and traditional trade barriers had fallen to minimal levels. Anderson and van Wincoop (2004) pioneered the measurement of the costs of international trade. Sourdin and Pomfret (2012) defined and measured trade costs and analyzed policies for reducing trade costs, that is, trade facilitation.

9 The key intermediaries were in Hong Kong, China. In the mid-1980s, following currency appreciation and rising wages and land prices, Hong Kong, China became uncompetitive in labor-intensive manufactured goods, but entrepreneurs had management and export-marketing skills as well as a common language with neighboring Guangdong Province in the PRC, where low-wage labor was abundant and trade costs were low. By the end of the 1990s, Li and Fung was the lead company in the world’s jeans value chains. Companies from Taipei, China and the Republic of Korea that were offshoring to the PRC often used an intermediary from Hong Kong, China to minimize the political constraints.
the PRC; Hong Kong, China; the Republic of Korea; Singapore; Thailand; and Malaysia dominate GVC trade in Asian emerging economies and that the values are much larger than those for the leading EU emerging economy participants in GVCs (Table 3.1).10

Table 3.1: Measures of Global Value Chain Participation in Emerging Asia and Emerging Europe, 2012

(a) Exports and Imports of Parts and Components

<table>
<thead>
<tr>
<th>Emerging Asia</th>
<th>Emerging Europe</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value (X+M)</td>
<td>Imports (share)</td>
</tr>
<tr>
<td>PRC</td>
<td>590</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>248</td>
</tr>
<tr>
<td>Republic of Korea</td>
<td>154</td>
</tr>
<tr>
<td>Singapore</td>
<td>147</td>
</tr>
<tr>
<td>Thailand</td>
<td>96</td>
</tr>
<tr>
<td>Malaysia</td>
<td>90</td>
</tr>
<tr>
<td>India</td>
<td>56</td>
</tr>
<tr>
<td>Indonesia</td>
<td>38</td>
</tr>
<tr>
<td>Philippines</td>
<td>34</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>24</td>
</tr>
</tbody>
</table>

continued on next page

10 GVC participation is notoriously difficult to measure. The ideal measure would be derived from input–output tables, but the existing tables are insufficiently disaggregated to capture GVCs with precision. The Athukorala measures, intra-industry trade data, case studies, and casual observation all point in the same general direction, with GVCs being the most pronounced in motor vehicles, electronics, and apparel and increasingly visible in other sectors.
Before 2000, despite proliferation in other continents, regional trading arrangements were practically absent from Asia. Signed agreements typically had a limited impact. Exclusions that ensured that protected activities remained protected even in the free trade area, for example, effectively neutered ASEAN’s free trade area. Other would-

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11 Even in Latin America and Africa, where countries have signed many trade agreements, few preferential trading arrangements were effective in the 2000s. The WTO (2011) estimated that, counting the EU as a single unit, 84% of world merchandise trade took place on a most-favored nation basis in 2007. This is consistent with Vinerian customs union theory, in which preferential tariff reductions are inferior to most-favored nation tariff reductions for an importing country (Pomfret 2001) and with a view of the EU as a fundamentally political union.
be preferential trade agreements, such as the Economic Cooperation Organization, the South Asian Association for Regional Cooperation, or the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation, had even less effect.

After 2000, Asian countries led the way in signing trade agreements. By 2018, Singapore had 20 agreements in force, followed by the PRC, the Republic of Korea, Japan, Malaysia, and Thailand (Table 3.2). These agreements are not necessarily regional trade agreements; for example, the partners in Singapore’s agreements include Costa Rica, Jordan, Panama, Peru, Turkey, and the US. They are also clearly not traditional free trade agreements in the sense of removing tariffs on trade between the partners, because Singapore already has an effectively free trade regime and would have nothing to offer in a traditional agreement.

Table 3.2: Regional Trade Agreements Involving ASEAN+6 Countries

<table>
<thead>
<tr>
<th>Framework Agreement</th>
<th>Under Negotiation</th>
<th>Signed, but Not in Force</th>
<th>Signed and in Force</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brunei Darussalam</td>
<td>0</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Cambodia</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Indonesia</td>
<td>0</td>
<td>8</td>
<td>3</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Malaysia</td>
<td>1</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Myanmar</td>
<td>1</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Philippines</td>
<td>0</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Singapore</td>
<td>0</td>
<td>9</td>
<td>2</td>
</tr>
<tr>
<td>Thailand</td>
<td>1</td>
<td>8</td>
<td>1</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>0</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Australia</td>
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<td>7</td>
<td>3</td>
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<td>PRC</td>
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<tr>
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<td>New Zealand</td>
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<td>6</td>
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</tbody>
</table>

ASEAN+6 = Association of Southeast Asian Nations plus the PRC, India, Japan, Republic of Korea, Australian and New Zealand; Lao PDR = Lao People’s Democratic Republic; PRC = People’s Republic of China.

Source: Asia Regional Integration Center at https://aric.adb.org/fta, Table 6, FTA Status by Country /Economy 2017 (accessed 16 April 2019).
The 21st-century trade agreements typically cover trade facilitation and behind-the-border measures related to services trade, investment, intellectual property rights, and domestic regulation, often described as WTO+.\(^\text{12}\)

ASEAN progressed its economic integration after 2000, initially by strengthening the free trade area and then by deepening integration into the ASEAN Economic Community. A landmark step was Malaysia’s removal in 2005 of assembled and knocked-down automobiles from its list of excluded items, acknowledging that an integrated, and protected, car industry had become a poor substitute for trading components and cars along automobile GVCs.\(^\text{13}\) However, steps beyond trade in goods moved slowly in the consensus-driven ASEAN debates, and the ASEAN Economic Community remains far less integrated than the EU, with areas like borderless trade or a common currency not even appearing on the horizon.\(^\text{14}\)

The proliferation of bilateral, regional, and wider trade agreements in Asia in the 21st century is related to GVCs as both cause and effect. Tariffs and nontariff barriers are clearly inimical to the fragmentation of production across borders. Deep trade agreements further facilitate the flow of goods and services within GVCs, even though other factors, such as industry competitiveness, skills, and research and development intensity affect GVC integration. If a country wishes to be a GVC participant, the government will want to facilitate trade, and, once in GVCs, the government will face lobbies for further specific measures to facilitate trade or to make it easier to conduct business.

Bilateral agreements tend to be more limited and more easily negotiated and implemented than multilateral agreements. Although the items that an agreement includes will be of particular interest to the signatories, measures such as reducing paperwork at the border or removing regulatory barriers are intrinsically nondiscriminatory and hence unlikely to lead to the trade diversion associated with 20th-century trade agreements. The drawback of bilateral agreements is that they can

\(^\text{12}\) They can be specific troubleshooting exercises. The 2007 Japan–Thailand Economic Partnership Agreement reduced the obstacles that Japanese carmakers identified in importing components to their assembly plant in Thailand in return for providing better work permit conditions for Thai cooks in Japan.

\(^\text{13}\) Australia, whose government wound down assistance for the car industry, reached a similar decision, leading to the closure of all car assembly plants by 2017.

\(^\text{14}\) Even on accession decisions, in the 21st century, ASEAN seems inert compared with EU negotiations that are cumbersome and lengthy but have led to the accession not only of Eastern European countries but also of the small island economies of Cyprus and Malta. Timor-Leste’s request for ASEAN membership seems to be stuck in a non-transparent holding dock.
lead to the proliferation of regulations and standards that are confusing to traders and inconvenient for GVC coordination, the “noodle bowl” effect (Pomfret 2011). This was most apparent in ASEAN’s relations with its six Asian Economic Summit partners (the ASEAN+6 group). Not only did ASEAN’s agreements with the PRC, Japan, the Republic of Korea, India, Australia, and New Zealand have differing terms (e.g., the rules of origin for goods to qualify for preferential treatment vary considerably), but individual ASEAN countries had signed separate bilateral agreements with individual partners from the +6 group. To systematize these relationships, in 2012, ASEAN launched negotiations for a consistent Regional Comprehensive Economic Partnership (RCEP) agreement among the ASEAN+6 countries.

The Trans-Pacific Partnership (TPP) negotiations grew out of the 2005 P4 agreement that Brunei Darussalam, Chile, New Zealand, and Singapore signed. Beginning in 2008, additional countries joined the P4 in a discussion over a deep trade agreement, and 12 countries (the P4 plus Australia, Canada, Japan, Malaysia, Mexico, Peru, the US, and Viet Nam) signed the TPP on 4 February 2016.

In many respects, the TPP and the RCEP aimed to be similar deep integration agreements, albeit with the important difference of membership that the TPP excluded the PRC and the RCEP excluded the US. Nevertheless, there were hopes that the two agreements would be harbingers of a wider free trade area in Asia and the Pacific. An important aspect of mega-regional groups such as the TPP or the RCEP, with many participants and lengthy negotiations, is that they create common practices and rules. There is a trade-off between the difficulty of reaching agreement among many countries and the network benefits of common standards that become more useful as they cover more partners.

### 3.5 The European Union’s External Trade Policy

During the 1960s, 1970s, and 1980s, the EU’s trade policy focus was inward looking on creating the customs union and then completing the internal market. The six signatories of the Rome Treaty participated as a single unit in the Kennedy Round of multilateral trade negotiations, and the outcome of substantially lower tariffs helped to maintain US support for the customs union, since access for third countries’ goods was now substantially easier than under the previous French or Italian tariffs. In the 1960s’ competition with EFTA, the six countries signed association agreements with Greece in 1961 and with Turkey in 1963. This turned out to be the beginning of a strategy of using preferential trade agreements as an instrument of foreign policy.
By the early 1970s, the EU had created a pyramid of preferences (Pomfret 2001). After the first enlargement in 1973, a free trade area in manufactured goods was established with the remaining EFTA countries. The Global Mediterranean Policy consolidated the patchwork of agreements with Mediterranean neighbors in 1972 and offered free access to EU markets for manufacturers and some privileged treatment under the common agricultural policy. African, Caribbean, and Pacific former colonies were granted preferential treatment under the Yaoundé and Lomé Conventions, which were important for some products. Other developing countries qualified for the less generous Generalized System of Preferences (GSP) scheme. Imports from only seven trading partners (Australia; Canada; Japan; New Zealand; the Republic of Korea; Taipei, China; and the US) faced the most-favored nation (MFN) tariffs that were supposed to apply to all GATT signatories. Non-market economies faced stricter, often ad hoc, conditions.

The pyramid of preferences proved to be a blunt instrument of foreign policy. Countries often fretted about the better treatment that competitors received rather than appreciating the better-than-MFN treatment that the pyramid granted them. The substantial reductions in the common external tariff eroded the value of preferential tariffs and narrowed the scope for distinguishing between more and less preferred partners. The GSP came under criticism because upper limits applied to preferential treatment, so, if a poor country identified a successful export at the GSP tariff, it would revert to MFN treatment. Economies with exports that faced MFN tariffs resented the discriminatory treatment.

The EU’s external trade policy became more complex in the 1980s as an increasing number of producers demanded protection against the fast-growing imports from Asia. In contrast to the long-protected agriculture and textiles and clothing sectors, countries often viewed car and steel producers as national champions, and their well-organized labor unions were politically powerful. National governments introduced many of the new protectionist measures, especially in the car industry, which undermined the creation of a single market. By the late 1980s, the EU’s external trade policy was foundering under the complexity of hierarchical preferential tariffs and national restrictions on market access.

The 1990 GATT ministerial meeting in Montréal was a turning point, after which the EU committed to multilateralism through the conclusion of the Uruguay Round and the establishment of the WTO. This commitment involved the termination of one-way trade preferences and the reform of the common agricultural policy, decoupling rural support from the output or prices of farm goods. The agricultural reforms took time but were largely completed by 2003–2004 (Swinbank and Daugbjerg 2017).
However, agreement on a new strategy took until the 2015 *Trade for All* strategy document (EU 2015), which committed the EU to open multilateral trade aimed at promoting participation in global value chains. The EU was open to signing trade agreements, but there would be no one-way preferential agreements other than the GSP. The EU had tentatively embarked on WTO+ bilateral agreements with smaller trade partners, of which the EU–Republic of Korea agreement, signed in 2010 (and entered into force in 2015), was the most substantial, before initiating negotiations with larger trade partners. Negotiations with the US over a Transatlantic Trade and Investment Partnership (TTIP) commenced in 2013, and bilateral negotiations began with Canada in 2008 and with Japan in 2013.

In sum, the evolution of the EU’s common external trade policy was tortuous but eventually moved in the same direction as Asian regionalism. Countries that are intending to participate in global value chains must have efficient internal markets and minimal barriers to external trade so that producers can access their first choice of inputs and supply customers easily. The deep integration agreements also highlighted the need to move beyond the WTO Charter to cover areas either that the world trade law addresses inadequately or that did not exist in 1995, such as e-commerce and cross-border data movements.

### 3.6 Closed and Open Regionalism

Regionalism in Asia and Europe has followed different paths since 1945. In Europe, the process has been toward political and economic integration. This has caused tensions with countries that are less committed to political union (notably the UK) or unwilling to accept constraints on macroeconomic policy making within the common currency area (Italy in 2018) and disagreement over political norms that the majority (but not Hungary and Poland) believed to be “common.” Nevertheless, the processes of widening and deepening have progressed over the decades, albeit with hiccups that in the early 2020s have followed Brexit and talk of a multispeed EU. The geographical limits of “Europe” ensure that membership is not open to all.

In Asia, there has been no serious pressure to achieve political union or monetary integration. Nevertheless, a shared commitment to openness toward the global economy as well as regional economic networks has promoted regional economic cooperation and integration among a growing number of Asian countries. The number sharing the commitment has grown following the examples of Japan and the original new industrializing economies and of the PRC and the second generation of high-performing Asian economies. The driving
Economic Integration in Asia and Europe: Lessons and Policies

force is the desire to share those countries’ prosperity or not to fall behind rivals.

Beyond the differences, both European closed regionalism and Asian open regionalism have ended up with many countries’ commitment to globalization and GVC facilitation. This involves openness to the world economy and, because many GVCs have actually been regional value chains, continuous efforts to reduce the obstacles to regional economic cooperation. As GVCs become more truly global, it is desirable to situate regional economic cooperation within a set of global standards and regulations.

An unforeseen challenge to the broader objective was the transformation of US trade policy in 2017 in the direction of aggressive unilateralism. One of President Trump’s first steps after his inauguration in January 2017 was to announce the US’s withdrawal from the TPP agreement, which meant that a sufficient weighted majority could not ratify the TPP. It soon became clear that the new president did not feel bound by the existing trade agreements that he perceived to oppose US interests, including WTO commitments. Negotiations toward a TTIP between the US and the EU were halted. In 2018, an actual US–PRC trade war followed the threat of a trade war that the US government’s tariffs on steel and aluminum sparked in June. In both cases, the US’s explanations in terms of national security risks and the PRC’s theft of intellectual property and other malpractices took the disputes beyond normal challenges under world trade law. At the same time, by refusing to fill vacant positions on the WTO appellate board, the US threatened to vitiate complaints through normal dispute resolution mechanisms.

After the initial shock of the US’s withdrawal, the 11 remaining TPP nations negotiated a new trade agreement called the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), which incorporates most of the provisions of the TPP and which entered into force on 30 December 2018. The RCEP negotiations, which had proceeded slowly since 2012, appeared to accelerate in 2018. At the November 2019 RCEP summit, India withdrew from the RCEP, and the other 15 countries appeared to be ready to sign the agreement early in 2020. In sum, the more open Asian economies that participated in GVCs responded to the “Trump shock” by reaffirming their commitment to open regionalism with WTO+ content.

The breakdown of the TTIP negotiations encouraged the EU to complete and implement the WTO+ agreements with Canada (which it signed in 2014 and has applied since September 2017) and with Japan (signed in 2018) and to initiate similar negotiations with Australia and New Zealand in 2018. By the end of 2018, the EU, together with the other Group of Seven countries apart from the US (i.e., six of the
seven largest market-based economies), had signed deep integration agreements.

The CPTPP brought together Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Viet Nam. The RCEP included some of these countries plus Cambodia, the PRC, India, Indonesia, the Lao People’s Democratic Republic, Myanmar, the Philippines, the PRC, the Republic of Korea, and Thailand. The overlaps between the groups suggest strong incentives to ensure compatibility rather than creating idiosyncratic regulations, standards, and so on. Some of the RCEP countries (e.g., the Republic of Korea and Thailand) have expressed an interest in the CPTPP. In sum, the major Asian GVC participants and the EU have created a common trading environment that moves beyond WTO commitments to include areas on which it has proven difficult to achieve consensus at the WTO.

A major challenge for the 2020s is to create a legal and/or institutional framework in which GVCs can flourish. The first-best outcome would be agreements within the WTO to include issues that are important to GVCs. However, these are unlikely in view of the tortuous history of the Doha Development Round, which commenced in 2001 to include new areas and is still running with minimal achievements. The fundamental problem is the requirement for consensus and the contrary objectives of some members, especially those with little GVC participation.

A plurilateral agreement under the WTO may be more plausible and has the support of many countries involved in GVCs, including the EU, which proposes “that a subset of WTO members can advance on a given issue, while keeping the door open for interested WTO members to join at a later stage. This would allow for new plurilateral agreements under the WTO umbrella and would make it easier to anchor in the WTO those plurilateral agreements that are currently negotiated outside the organisation” (EU 2015, 28). The prime example of a WTO plurilateral agreement is the 1997 Information Technology Agreement in which the 82 participants agreed to maintain zero tariffs on goods listed under the agreement; a principal goal of the signatories is to signal to GVC lead firms a credible commitment not to impose import duties on the listed goods.

So far in the 21st century, however, there has been little new progress in this direction and considerable opposition. At the December 2018 Buenos Aires ministerial conference, 71 WTO members agreed on a proposal that could foreshadow the proposal of a plurilateral agreement on e-commerce at the 2021 ministerial conference in Geneva. A plurilateral agreement would avoid the need for consensus, but many WTO members oppose it on the grounds that it undermines the universality of WTO trade law.
Regional leadership is necessary because the lack of consensus, including several large trading nations adopting blocking positions, is stymying the extension of the WTO beyond its 20th-century coverage. Open regionalism is a second-best approach that is desirable in the absence of WTO progress, especially without regionally defined access to agreements. Several Asian countries have shown interest in joining the CPTPP, but even more interesting is the prospect of post-Brexit UK joining the CPTPP and establishing that its boundaries are not limited to Pacific nations. The EU’s external trade policy has already shown elements of open regionalism. The EU has signaled its receptiveness to more flexible approaches; the Trade for All strategy document (EU 2015, 5) acknowledged the EU–Asia link and the option of openness to other countries: “the strategy also opens the door to new initiatives, when the conditions are right—in the Asia-Pacific region, in particular, but also in Latin America and Africa.”

3.7 Conclusions and Policy Recommendations

In the second half of the 20th century, it was commonplace to contrast European regionalism with the lack of regionalism in Asia or with market-driven regionalization in East Asia. In the 21st century, the institutional environment for international trade has converged in the two areas around a model of reducing barriers to conducting business and trade both within the national and regional economies and as part of the engagement in the global economy. In this chapter, I have argued that the increasing fragmentation of production along regional and then global value chains has been a driver of this convergence.

In Asia, the CPTPP became effective at the end of 2018 and the RCEP negotiations approached conclusion in November 2019. Many chapters, especially in new areas, such as e-commerce and data flows, are similar, and a plausible follow-up would be to harmonize the two agreements. One suggestion is to combine the CPTPP and the RCEP into a Free Trade Area of Asia and the Pacific, although the Asia and the Pacific restriction is anachronistic, and a global “open regionalism” arrangement would be a preferable 21st-century arrangement.

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15 The EU Trade for All strategy (2015) stated that EU trade agreements should be open to all willing WTO members to join and gave the example of the FTA that the EU signed with Colombia and Peru in 2012 and to which Ecuador acceded as a result of negotiations concluded in July 2014. However, this set of agreements existed in a South American framework from the start.

In Europe, the 1992 program, the Schengen Area, and the euro have substantially reduced the barriers to internal market integration. Regional value chains were identifiable in earlier decades, but they have received a boost since the 1990s, when the process of incorporating Eastern European countries with different factor endowments and prices from the first 15 members into the EU began. Europe has abandoned external trade policies to create favored partners or to protect favored producers in support of an open trading regime. Bilateral agreements with major trading partners include areas and even language similar to that of the TPP, for example in the e-commerce chapter. Synchronizing the EU agreements with Asian open regionalism should not be difficult.

A global agreement on new issues would be desirable, but the WTO has been to some extent the victim of its own success. The conclusion of the Uruguay Round and the establishment of the WTO in 1995 were a massive achievement (Sampson 2018). With 164 members and 32 observers, the WTO is a truly global organization. However, the requirement for consensus to agree any changes to the rules has restricted its evolution since 1995. The value of the WTO, and the threats that it faces, became more apparent after January 2017 as a result of the disregard that President Trump showed for the organization. However, the “Trump shock” highlighted the need for other countries to step up and identify their commitment to reinforcing and expanding the multilateral trading system whether through the WTO or by other means.

Does this future signal the end of regionalism? The answer is yes, if we define regionalism narrowly in trade-related terms. However, regionalism can be about much more than trade alone, as the EU illustrates. In the ASEAN Community established in 2015, the economic pillar is only one of three pillars: the ASEAN Economic Community, the ASEAN Security Community, and the ASEAN Socio-cultural Community. Nevertheless, there is little appetite for political integration in most of Asia. By contrast, the debate in Europe is between those who value the EU as a vehicle for ever-closer political union and those, such as the Brexiteers in the UK, who oppose the erosion of national sovereignty.

What lessons does European integration hold for Asia? The historical evolution suggests that the answer may be not many, because Europe is engaged in a process of ever-closer political unification that most of the continent’s countries accept, while Asia appears to have little enthusiasm for closer political union. However, the embracing of GVCs and the reaction to the “Trump shock” have brought the EU and the dynamic East Asian countries together in support of the world trading system.
Beyond defense of the current system, the two groups have a common interest in reaching agreements in WTO+ areas that are important to GVC functioning, such as trade facilitation and e-commerce. For Asian countries, the priority is regional cooperation to avoid a noodle bowl of differentiated regulations. Such cooperation is happening in the CPTPP and the RCEP, but, beyond that, global agreement either within the WTO or, more likely, with the EU and its partners is desirable. While EU regionalism and East Asian regionalization have so far progressed independently, with GVCs becoming more global, the two will need to promote consistency in WTO+ areas.
References


4 Perspectives of Regional Economic Integration in Asia and Europe

Muthurangam Subramanian, Farhad Taghizadeh-Hesary, and Natarajan Panchanatham

4.1 Introduction

Regional economic integration is an effective strategy for promoting stable economic growth, resolving the numerous challenges and thereby improving the region’s economic growth and development pace (Taghizadeh-Hesary et al. 2020).

Asian economic disparities are more prominent compared with Europe, ranging from wealthy and modern to poor and conventional economies, but Europe is more politically homogeneous. The process of the European Union (EU) had a big effect on global stability while the Asian situation is still fluid. Asian integration is market driven, and trade driven, while the integration of the EU is focused on institutions and a legal system. There are challenges that should be addressed to boost integration in the Asian continent. Especially central to this is the desire for “unity in diversity” as Asian societies, political structures, economic systems, and religious values are different from those that exist in Europe (Taghizadeh-Hesary et al. 2020).

Asia and Europe are considered as the cradle of civilizations that raised modern civilizations and lifestyles. The remarkable developments of Europe in world affairs have increased tremendously after the various discoveries during the past centuries and the period of colonialism that followed before the modern era. Subsequently, Asia has been growing fast under its expansion phase, while Europe has gradually slowed. Some of these developments are seen in several features of society, cultural, and technological aspects. After the First and Second World Wars, both Asians and Europeans struggled for several years. In modern
times, the collective potentials of both these regions are channeled more constructively with better integration and participation that lead to more tranquil and affluent regions worldwide.

The emergence of the EU has convinced many other regions of the world to consider the EU as a positive model of integration either to follow or copy their experiences. However, contrarily, there has been a remarkable development in the Asian economies. Asia’s economic growth has been phenomenal and no other region in the world has achieved such extensive economic development in a short period (Ando 2006).

A comparison of Asian and European approaches to regional integration shows that there are some similar experiences and challenges. Compared to Asia, regional economic integration has grown much deeper in Europe. The demolition caused by the First and Second World Wars persuaded Europe on the significance of integrating communities, social orders, and economies within the region. In a hard way, they realized that pooling resources with neighboring countries could produce better results than doing it separately and they can benefit from the economies of scale. The EU could make huge economic gains within the region by incorporating certain standard rules and increasing coordination between the institutions and the authorities of the member states that normally affect the economic integration in the region.

In Asia, the perspective of regional economic integration is different. The process of integration is largely controlled by the markets rather than by national authorities. The coordination and integration among governments are not so close and are more recent. Integration is focused more on economic issues and less on developing formal institutions and not much on political ambitions. The pragmatic and flexible approach of Asian economies toward regional economic integration is partly due to their past history. By pooling the sovereignty and resources with neighboring countries, the independence of Asian countries had to be compromised. It is a matter of concern as many countries have emerged lately and also came out of colonial rule and built country-wise identities. Further, compared to Europe, the differences in economic development, social structures, and political systems of Asia are much higher (Capannelli and Filippini 2009).

This chapter reviews and discusses various insights and provides an overview of Asian and European regional economic integration. The study compares Asian and European regionalism. An extensive review of literature is used for the collection of data and information pertaining to the process of Asian and European regional economic integration.

This chapter compares the differences in approaches of both regions with respect to regional integration and cooperation. The chapter
also draws lessons for Asia from the European experiences for higher endogenous growth. Although it needs to be noted that not all successful experiences of one region are practical for other regions due to social, cultural, political, geopolitical, and economic diversities.

### 4.2 Benefits of Regional Economic Integration

Regional economic integration is seen in the movement of regional resources by way of production and consumption of goods. The development of European integration is not due to the result of strong economic determinism. Also, it is not the effect of political will or the strategies of leaders. In a way, historical developments contradict the principles that are shaped by conventional and theoretical considerations of economic integration. Economic integration in a particular region should be viewed and analyzed adopting a broader approach that would address all aspects of legal, economic, and political considerations. Regional economic integration has to be viewed as a means to an end but not an end in itself. It is to be treated as a continuous process to support economic growth and development strategies, democratization, and higher consensus. Such a deeper integration refers to the broad perspective of opening to the outside world. Regional integration could be used as a tool for boosting development by increasing efficiency and improving welfare and quality of life across the region.

The literature about regional economic integration in driving economic growth is abundant. Regional economic integration refers to the interdependence between countries, issues relating to economics and trade that are more important than military and political considerations (Upadhya 1995). The world which was polarized by ideological disputes in the past has changed quickly into an economic system of blocs. In view of this trend, countries started to look for new relations with the new global group of superpowers as well as with neighboring countries.

Regional economic integration is discussed as a significant development in recent international relations and is considered an economic order globally. This development is acknowledged at international levels, and it has now achieved significance and relevance. Economic cooperation, trade, and other related problems are handled at regional levels. Improving regional cooperation in terms of economic, political, and security concerns has taken an appropriate direction in recent times. These regional integration initiatives are a rapidly growing trend similar to globalization (Haokip 2012).

Regional economic integration is concerned with the cooperation of member states depending on their geographic location in order to safeguard or promote the welfare of participants. Mattli (1999) pointed
out that regional integration in the present global economy is considered to be an economic connection between two or more independent states relating to the authority over key areas of local policy and regulations shifted to higher national levels. An association of independent states in a specific region grouping together to form into a bigger state can also be referred to as regional integration. The level and strength of regional integration are based on the willingness and commitment of individual member states in sharing their sovereignty.

According to Van Langenhove (2004), the initiatives of regional integration have to address the following eight issues: (i) increasing intraregional trade, (ii) creating an appropriate environment for the development of the private sector, (iii) supporting the economic growth and regional integration with suitable programs for infrastructure development, (iv) developing the governance of public sector institutions in an efficient and effective manner, (v) developing civil society inclusiveness and reducing the social exclusiveness (vi) safeguarding the region with a necessary contribution toward peace and security, (vii) developing suitable programs for the regional environment protection, and (viii) enhancing regional interaction with other regions around the world.

Some supporters of regional integration (Khan and Khan 2003, Sobhan 2006) argue in favor of regional economic integration indicating several benefits. Apart from diversity in trade, regional economic integration can also show results in terms of facilitation of trade at the cross-border dealing with small and medium-sized enterprises producing benefits for all members of the trade. The creation and divergence of trade is based on several factors that include market size, geographic and political unity, complementarity, and openness proximity (Krugman 1989, Nitsch 1996, Sobhan 1999).

If regional trading arrangements are developed within member states, it will generate better trade and welfare through appropriate resource allocation more effectively and viably (Wonnacott and Lutz 1989). The preferential regional arrangement of trade is considered a building block instead of a stumbling block to a higher level of the liberalized global economy (Khan and Khan 2003, ADB 2006). The trading activities between contiguous nations geographically have the advantage of lowering the transaction costs due to the market’s proximity, common infrastructure availability, and cultural factors such as common customs, consumption patterns, and language (Dubey 2005). There is a possibility of more trade among neighboring countries because of low transport costs. Moreover, instead of artificial diversion, trade creation can be strengthened (Wonnacott and Lutz 1989, Panagariya 2003). Due to this advantage, around 60% of trade worldwide is now carried out in regional areas based on preferential treatment (Dubey 2005).
Regional economic integration can step up the economies of scale in production by providing specialized services, reducing monopolies, expanding markets, reducing production cost, and improving national welfare (Pigato et al. 1997, Madawela 2003, Dubey 2005). Further, regional integration can contribute toward poverty reduction by increasing investments, generating employment, expanding versatility, and decreasing the cost of consumer products (Siriwardana and Yang 2007, Ahmed and Ghani 2010). Regional economic integration can also boost the capacity of member states in dealing with the trade systems globally as well as financing and coping with the globalization challenges. Also, regional economic integration creates a better environment for solving internal differences and increasing trust mutually to address common challenges and issues (Dubey 2005). Further, the formation of regional integration groups can increase the potential for better productivity and management in sharing the common resources like infrastructure including railways and hydroelectric power facilities (Batra 2004).

Despite several benefits of regional economic integration, cooperation is slow among various regional groups, specifically in the South Asian economies that are contiguous geographically and integrated culturally. Some research scholars (Kemal et al. 2002, Panagariya 2003, Das 2007), express their contention in the comparative benefits. They do not accept geographical proximity and cultural unity as the main basis for regional integration. Instead, they express comparative benefit as the primary factors of regional integration. Therefore, the low-level trade complementarity and limited benefits comparatively are the basic factors causing a low level of regional economic cooperation within the South Asian Association for Regional Cooperation nations. But as per other scholars in the field, trade complementarity is not adequate for deeper regional economic integration (Hirantha 2003, Batra 2004, Pitigala 2005, Sobhan 2006).

Finally, hard infrastructure including transport, roads, and communication, and soft infrastructure including rules and regulations in controlling the cross-border movement of goods, people, and services are of equal importance.

### 4.3 Comparison of European and Asian regions

There exist several dissimilarities between the Asian and European regions. However, there are some close similarities that prevail between the two regions:

- During the 1990s, Asia and Europe were hit by serious financial, economic, banking, and currency crises. Both regions share a similar ambition to regulate the measure of financial and
economic globalization in order to establish economic stability that promotes high growth and sustainability with improvement in regional welfare amenities.

• Both regions are ambitious to preserve their positive aspects of the complex and socioeconomic models. Also, both regions seek to retain the ability to effect changes in a fast-evolving environment.

Both regions are different in some of the following considerations:

• In Asia, the level of diversity is comparatively higher in regard to political, economic, social, and cultural dimensions. As an example, the economic status ranges from developed economies (such as Japan and the Republic of Korea) to others which are mostly developing economies, while the EU has developed into a more highly homogenous economic group.

• Since the Second World War, Europe has been more ambitious than Asia in terms of developing a clear political agenda to create a deeper union among European nations. Such an attempt was triggered by the extent of devastation in both the moral and material aspects resulting from the First and Second World Wars. Mainly because of this approach, Europe accepted a significant sovereignty pooling on the entire economic and political issues.

• In Asia, under the present context, there is no such political ambition for regional integration as witnessed in Europe. Therefore, all lessons drawn from the European experiences cannot be simply copied and implemented in another region. In order to execute some of the lessons, such experiences have to be aligned to the local conditions based on cultural, social, and political considerations.

The starting situation and decision-making levels of both regions are different and distinct. Both have followed different regional integration paths. The regional integration approach adopted by the EU impacted significantly on the political stability of Europe. The dynamic and continuous processes of Europe have resulted in the achievement of higher economic and political stability. However, in contrast, Asia faces more liquid and uncertain mechanisms in the integration process. The EU has allowed it to test its economic opportunities in line with open worldwide markets. Facing new issues at the multilateral level, Asia started reacting with various moves, which increases transparency. Both Europe and Asia have taken advantage of their respective special features
well. Currently, both regions are facing limitations. It is not possible to simply extend the earlier approach. There exists apprehension if appropriate regional strategies are in place (Pascha 2004).

In 1990, economic integration intensified in Asia and extended to the 21st century. As it is much later than the economic integration process in Europe, in reality, there exist greater global correlations. However, there exists strong integration and cooperation, both internally and externally, among Asian countries. In view of this aspect, Asian countries largely contribute to the area of global relations (Skulska 2005). Also, regional integration in Asia has a short history since the period of the 1997–1998 financial crisis. After the crisis, several Asian economies more closely cooperated with financial and capital markets globally. However, many European economies have been developing financial and capital markets simultaneously making progress in the process of regional integration.

Regional economic integration in Europe was initiated by a group of a limited number of economies that were mostly at the same stage of economic growth and development. Such developing economies started integrating with neighboring economies that were comparatively at a reduced level of economic growth and development. Another feature of the European integration process is that the economically stronger countries integrate with each other fairly well. This type of cooperative spirit exhibited a vital role in the stimulation of the process of integration. But economical impulses stimulate integration in Asian countries. European integration focused on social and political issues and the role of media was significantly high, whereas the Asian region focused largely on the economic front.

Further, the motivation of Asian integration is mostly based on defensive mechanisms. Lamberte (2005) provides five driving forces: (i) a defensive response toward regionalism in other regions, (ii) low progress in multilateral liberalization of trade, (iii) competition with financial institutions of other regions globally, (iv) the process of cleaning up of bilateral agreements, and (v) making economic interactions institutionalized. Strengthening relations in the Asian continent is not extraordinary, but it is a matter of returning to the normal situation (Pascha 1995).

### 4.4 Economic Integration in Europe

European economic integration boasts the following major economic achievements:
- Creation and development of the single common market so that there is free movement of capital investments, labor, goods, and
services without significant obstacles, tariffs, or constraints. The choice of a single market brought about stronger advancement of intraregional exchange of trade and monetary markets. Further, it has resulted in higher economies of scale as well as efficiency in the economic integration mechanism.

- Creation of the European Economic Monetary Union and adoption of the euro as the region’s single currency. The convergence of each of these innovations significantly improved the region’s Single Market Process structure. The equity capital markets were also beginning to grow rapidly. The eurozone saw a dramatic rise in the capitalization of the stock market and encouraged the entrance of many new business institutions into the European economy.
- Efficient and effective policy management framework. Establishment of a new institution that pools monetary policies together. Consensus practice was adopted in terms of employment policies and structural reforms.

The process of regional economic integration in Europe has been going on for over 5 decades. This period can be considered as the real development of economic integration and deepening and enlargement of the EU. European regional economic integration has been a success both in terms of economic and political considerations. Of course, there were failures and tensions in the process, however, it is possible to draw on some of the main lessons from the European economic integration experience. The distinctive aspects of political, institutional, and economic development of the EU are considered as significant achievements of the European economic integration.

Another important factor behind the economic integration in Europe is the removal of trade barriers, including tariffs, as well as the majority of the nontariff measures (NTMs) (including quotas, subsidies, etc.). However, it is important to mention that even in the EU having a high level of economic integration, some of the NTMs represent a challenge, hence authorities need to navigate the NTMs and take the necessary steps for the elimination of measures that distort trade rather than to protect consumers (Taghizadeh-Hesary 2019).

### 4.5 Economic Integration in Asia

Asian economic integration has been progressing for more than 3 decades through the establishment of greater trade, industry, and investment connections. Such connections have been controlled by market-linked regional integration without strong commitments at international levels. The economic development strategy based on the integration into global
and regional value-added supply chains, technological capabilities, and goods and services that are export aligned has effectively upheld the regional economies. During the interval in which the Asian economies experienced rapid growth, they were facing a globalized and growing economy and it was open to trade. Hence, such a situation was conducive to their growth and development (Pangetsu and Armstrong 2018).

After the global financial crisis, the slow recovery of developed countries such as the United States and Europe created a challenging situation at worldwide standards and proceeded to show lower exchange rates and economic development. Also, in addition to these effects, anti-immigration, anti-globalization, and stronger nationalistic sentiments continued to rise as witnessed in the case of the withdrawal of United Kingdom from the EU on 1 February 2020 and the anti-trade and the anti-immigration election results of the United States in 2016. Such disappointing trends had a negative impact on the perception of globalization and trade-related agreements that have led to unemployment, reduced income levels, and a higher imbalance of economic activities for Asians.

Asia's value-added supply chains improved Asian regional trade and economic integration and played an important role in the globalization of trade and economic growth in the region. Asia continues to develop and grow rapidly compared to other continents. Asia is therefore required to safeguard the global system. In order to keep open markets, it is important to preserve a strong trading system globally (Pangetsu and Armstrong 2018).

In the present globally challenging situation in terms of trade liberalization, trade agreements, and the fragile position of the World Trade Organization, it is important to consider the scope, progress, and future direction of Asian economic integration. The process of regional economic integration is required to be carried out ensuring the maximum advantages. This is possible only by pursuing appropriate policies at the regional, national, and global levels.

- Adequate cooperation on fiscal policy, trade, and investment at the regional level are necessary to improve and expand the relations between the Asian member states. Regional convergence is also required to step up and accelerate the liberalization process. Furthermore, absolute regional cooperation is needed to make considerable progress in the process of regional economic integration in terms of the financial market structures (Taghizadeh-Hesary et al. 2019). In this context, cooperation focuses on the fundamental aspects.

- Adequate cooperation is needed at the domestic level to establish a stable and standard business environment in the region. The liberalization of commercial and capital flows has
been implemented in various countries. This has resulted in
the lack of their importance to global integration in conducting
transactions at the international level.

- Proper cooperation is essential at the global level to initial steps
  that will enable the Asian region to play a constructive role in
  economic decision-making around the world (Taghizadeh-
  Hesary et al. 2020).

The major economies such as Japan, the People’s Republic of China
(PRC), the Republic of Korea, and Singapore play an important role in
global economic relations. However, in view of regional cooperation,
their influences have to be intensified—one recommended way is
through the Association of Southeast Asian Nations plus the PRC, Japan,
and the Republic of Korea grouping (ASEAN+3).

South Asia and East Asia are rich in economic diversity. The
developed economies such as Japan; Singapore; the Republic of Korea;
Hong Kong, China; and Taipei,China are at one end of the spectrum.
The least-developed economies like Bangladesh, Nepal, Cambodia,
Myanmar, and the Lao People’s Democratic Republic are at the other
end of the spectrum. Also, there are upper-middle-income countries
such as the PRC and Sri Lanka, lower-middle-income countries such
as India, Indonesia, the Philippines, and Viet Nam, and other middle-
income group countries like Malaysia and Thailand stand in between.
Further, there exist some anomalies in the case of countries such as
Brunei Darussalam and the Democratic People’s Republic of Korea.
There is a huge difference in institutions, politics, and historical legacies
that accentuate the diversity. It is, therefore, not surprising that regional
economic integration in Asia is weak even when considering the
globalization of Asia.

Regional economic integration is more evident in East Asia (PRC,
Japan, Republic of Korea), and in ASEAN, due mainly to intraregional
trade and investments. Regional economic integration in Asia is a direct
result of global economic integration, particularly in the manufacturing
sector. Asia’s share of global manufacturing exports rose from about 20%
in 1980 to 35.5% in 2005–2006. The intraregional trade flow initiated
from Japan and spread to the Republic of Korea; Taipei,China; Hong
Kong, China; and Singapore, then to Malaysia, Thailand, Indonesia, and
the Philippines, and further on to the PRC, Viet Nam, and Cambodia.
Initially, light industrial exports came and subsequently, the capital-
intensive exports of cars, steel, and ships followed. Transport and
machinery equipment followed, specifically in information and
communication technology products.
Asian economic integration is considered to be the strongest in terms of trade in machinery and transport, which accounts for over half of the global manufacturing trade (Sally 2010). The processing trade plays an important role in understanding the partial and skewed nature of Asian economic integration. The EU exhibits high levels of regional production and regional consumption. Such is not true in the case of Asian economies. The Asian region has largely fragmented markets in the fields of services, agriculture, and manufacturing, mainly because of policy barriers. In Asia, there are remarkably low regional production and low regional consumption levels.

4.6 Conclusions and Policy Recommendations

There are many disparities between regional economic integration in Asia and Europe. Regional economic integration in Europe has grown much deeper compared with Asia. The EU could make enormous economic gains in the region by exercising general standard rules enhancing cooperation between the regional institutions and government authorities that impact economic integration in the region. Asian economic integration mechanisms are not completely regulated by governments, but are mostly driven by market forces. Asian economic integration focuses mainly on economic problems and slightly on the growth of formal institutions without much political ambition. Asia continues to have a liquid mechanism for implementing the economic process of integration. In the current multilevel development environment, Asia’s liquid mechanism offers a more adaptable integration alternative that can go together at the same time, depending on global markets.

Asian regional economic integration needs to be processed under highly distinct and diverse considerations compared to European regional economic integration. It is faced with the challenge to reconcile high political, economic, and cultural diversity. Also, it is shaped in the reality of a much stronger globalized economy. As examined in this chapter, Asia can take lessons from the valuable rich European experience. However, the goal, purpose, activities, sequence, and form of Asian regional economic integration will continue to be distinctly different from other regions. Therefore, Asian regional economic integration has to be examined not from the angle of adopting the regional economic integration model from Europe, but for the different experiences that are available to learn and execute in Asia more viably. The suggestions and recommendations of this study will facilitate further insight for policy makers on the importance of regional economic
integration toward fostering stability and prosperity, and addressing the various challenges.

It is interesting to observe Asia’s growing debate on financial and macroeconomic issues, including the procedure for the prevention of crisis and stabilization of exchange rate fluctuations. Such efforts have been considered with appropriate initiatives and moved forward earnestly in the context of ASEAN. However, further to the participation of the PRC, Japan, and the Republic of Korea, the scope has been increased, but the current achievements are far behind the ideals and goals. Based on various Asian processes and discussions, including the surveillance process of ASEAN, the financial support arrangements and regulatory cooperation in the banking sector form part of the economic and monetary union experiences.

It is necessary to focus on the development model of ASEAN’s autonomous financial support mechanism, based on repurchase agreements and swap arrangements, mainly due to a large number of disparities between the members of ASEAN+3. This exercise is required to complement international institution surveillance, particularly institutions like the International Monetary Fund. There is also a danger that regional financial support could defend the exchange rate pegs and weak financial systems inadvertently. By concentrating on the trend of nominal exchange rates without the development of the process of structural reforms, policy coordination, and a strong commitment to the consolidation of the financial sector will not be appropriate. In view of the consequences, it is important to be transparent and open about the objectives, terms, and conditions in the use of such financial systems. Also, there should be proper methods to provide support in adopting policy measures, particularly to incorporate the use of regional financing and investment facilities.

Another important point for fostering regional economic integration is that, along with the trade liberalization agenda, common action plans should be developed. Such plans are essential, particularly in the financial sector and in capital movements. Also, further achievements could be possible for reducing the vulnerability in the financial sector by broadening the current cooperation on increasing the control and competition in the finance sector.

Below are the policy recommendations for fostering Asian economic integration learning from the experiences of European economic integration:

- Regional economic integration processes should ensure full benefits. This is only possible by following a suitable strategy at the national and regional levels.
• At the regional level, proper economic, trade, and investment cooperation is important for strengthening and extending relations within the Asian economies. In addition, absolute regional cooperation is needed to make progress with regard to the structures of the financial markets.

• In order to develop a successful and standard business environment in the region, cooperation is required at the domestic level. The liberalization of commercial and capital flows has been implemented in various economies. This has resulted in the lack of their importance to global integration in conducting transactions at the international level.

• In terms of promoting the importance of Asian economic integration, the developed countries such as Japan, the Republic of Korea, and the PRC have to take a leading role. Initiatives need to be exercised in that direction by ASEAN and ASEAN+3 to improve the sense of community in the Asian region. Those organizations, however, are not politically significant. It can be concluded that the success of Asian economic integration depends on the region’s ability to reduce political controversies and issues among the Asian economies.

• The well-developed infrastructure in Europe is a vital factor in advancing network connectivity. However, most of Asia’s subregions suffer from weak infrastructure facilities slowing down trade and investment with neighboring economies. Consequently, infrastructure funding is necessary for progress on economic integration. In 1958, the European Investment Bank was founded to devise policies and strategies within the European Economic Community. According to the European Investment Bank, investments in infrastructure were given high priority with increased investments in the transport sector. Recently, the Asian Development Bank and the Asian Infrastructure Investment Bank have made major strides in funding infrastructure projects aimed at developing the Asian region. Nonetheless, these are not enough and this void needs to be filled additionally by national development banks in the region.
References


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PART II
Fiscal and Monetary Integration and Safety Nets
5

Economic Integration in Central Asia Regional Economic Cooperation Member Countries: Financing Economic Corridors and the Sovereign Bonds Market

Muhammad Ayub Mehar

5.1 Introduction

One of the desirable objectives of globalization and a free trade regime is reducing the global disparities in human welfare and development through the interaction of people in a free world. This theory favors strong mutual dependency, participation, and relations among nations. Some experts have considered regional economic integration as an important way of transitioning from today’s world to a world without extreme poverty, characterized by universal health care, education, water, and sanitation. There is one premise in this reasoning: that if integration is feasible, transaction costs will be reduced and economies of scale will emerge (Pozuelo-Monfort 2014).

Although the ultimate goal of a free trade regime is global participation, it also encourages regional integration. In this paradigm, regionalization can be considered an initiation of ultimate globalization. So, it should not be seen as an alternative approach to globalization; it is a subset of globalization. It is widely believed that economic integration and mutual dependency on economic resources may diffuse political tensions and avert a cold war or warlike situation. The quantum of trade in goods and services (particularly health, education, tourism, and transportation) and cross-border mobilization of labor and capital lead to interactions among the people of participant countries.
Various models and stages of economic integration have been discussed and analyzed in economic literature. Bekeart (1995) analyzed the barriers to economic integration, while Yoshino, Morgan, and Rana (2018) and Li (2014) described economic integration in the context of contemporary globalization and the formation of a monetary union. Integration from the infrastructure development point of view has been described by Yoshino et al. (2018) and Mehar (2015).

Economic integration does not mean economic linkages among nations. In fact, economic integration is something more than economic linkages. In contrast to free trade, economic integration has been considered the second-best option for global trade where barriers to free trade cannot be removed for several political, economic, and social reasons. Various types of trade agreements construct a path for economic integration, but integration requires physical transfer of goods and services from one country to another. This implies that logistics and transport-related infrastructure are integral parts of economic integration. Table 5.1 explains the various stages of economic integration and indicates that the formation of preferential trading areas, free trade areas, customs unions, and economic and monetary unions are the earlier stages of complete economic integration. Table 5.1

### Table 5.1: Stages of Economic Integration

<table>
<thead>
<tr>
<th>Degree of Integration</th>
<th>Scope of Integration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferential Trading Area (PTA)</td>
<td>A partial abolishment of custom tariffs on the inner borders of member states</td>
</tr>
<tr>
<td>Free Trade Area (FTA)</td>
<td>A full abolishment of custom tariffs on the inner borders of member states</td>
</tr>
<tr>
<td>Customs Union</td>
<td>Unified (common external) tariffs on the exterior borders of the union</td>
</tr>
<tr>
<td>Common Market</td>
<td>Inclusion of the movement of services, capital, and labor into an FTA</td>
</tr>
<tr>
<td>Economic Union</td>
<td>A combination of a customs union and a common market</td>
</tr>
<tr>
<td>Fiscal Union</td>
<td>Introduction of a shared fiscal and budgetary policy</td>
</tr>
<tr>
<td>Monetary Union</td>
<td>Introduction of a shared currency</td>
</tr>
<tr>
<td>Complete Economic Integration</td>
<td>Unification of economic policies (tax, social welfare benefits, etc.), reductions in the rest of the trade barriers, introduction of supranational bodies, and gradual moves toward the final stage, a “political union”</td>
</tr>
</tbody>
</table>

Source: Developed by the author based on Balassa (1967).
Economic Integration in Central Asia Regional Economic Cooperation Member Countries:
Financing Economic Corridors and the Sovereign Bonds Market

is based on Balassa’s (1967) theory of economic integration. According to this theory, the barriers to trade are reduced with increased economic integration, while free movement of economic factors across national borders generates demand for further integration, not only economically but also politically. Consequently, economic communities evolve into political unions over time.

Various levels of economic integration have been experimented with in different parts of the world. The North American Free Trade Agreement (NAFTA), which belongs to the second stage (free trade), has presented a successful model of resource allocations. The European Union (EU) has adopted an advanced version of integration after passing through earlier stages. The eurozone has embraced a single currency (euro), which has eliminated the currency risk. There have been several integration attempts, including the Association of Southeast Asian Nations (ASEAN) in Southeast Asia, Mercosur in Latin America, the Economic Community for West African States, the Common Market for Eastern and Southern Africa, and the Southern African Development Community in sub-Saharan Africa, and the South Asian Association for Regional Cooperation in South Asia. Some supranational institutions have played important roles in establishing economic integrations among countries that are undergoing severe political disputes. For instance, the South Asian Association for Regional Cooperation played an important role in the implementation of the South Asian Free Trade Area. However, no significant enhancement in the mutual trade of South Asian countries has been observed because of the rapid growth in nontariff barriers in trading between India and Pakistan. The most important institution that can play an important role in the economic integration of Asia and Europe is the Economic Cooperation Organization (ECO). Currently this institution is emphasizing the construction of economic corridors to connect South Asia, Central Asia, the Middle East, and Europe. Almost the same role is being played in a different way by the Central Asia Regional Economic Cooperation (CAREC) Program. The junctions of the ECO and the CAREC Program are shown in Table 5.2.

5.2 CAREC Member Countries and Transport-related Infrastructure

The economic history of Central Asia and South Asia is largely associated with the connectivity of trade and natural and human resources among its peoples. The “Silk Route” and the “Grand Trunk Road” (known as the “GT Road” in Pakistan and India) have provided the major source of this connectivity. The direction of trade and the mobility of human resources
in the Central Asian republics were changed from South Asia to eastern Europe during the Soviet regime. Now, visible signs of the revival of historical routes can be observed in the region. After a long period of economic disassociation among the countries in this region, the CAREC Program introduced the concept of “economic corridor development” in 2010, while the ECO also introduced several projects aimed at enhancing economic relations among the countries in this region. The ratification of the Customs Convention on the International Transport of Goods under Cover of TIR Carnets (TIR Convention) by the ECO member countries, the white card scheme to make it easier for drivers to travel across the borders in ECO member countries, simplification of the visa process for traveling to ECO member countries, an ECO trade agreement to enhance the trade among the member countries, a visa sticker scheme for leading businesspeople to allow them across the border without a visa, and the formation of the “ECO Trade and Development Bank” and the “ECO Insurance Company” are the steps that have been taken by the ECO to revive the historical relations among the Central and South Asian countries.

<table>
<thead>
<tr>
<th>No.</th>
<th>Country</th>
<th>CAREC Member</th>
<th>ECO Member</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Afghanistan</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>2</td>
<td>Azerbaijan</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>3</td>
<td>PRC</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Georgia</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Iran</td>
<td></td>
<td>√</td>
</tr>
<tr>
<td>6</td>
<td>Kazakhstan</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>7</td>
<td>Kyrgyz Republic</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>8</td>
<td>Mongolia</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Pakistan</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>10</td>
<td>Tajikistan</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>11</td>
<td>Turkmenistan</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Turkey</td>
<td></td>
<td>√</td>
</tr>
<tr>
<td>13</td>
<td>Uzbekistan</td>
<td>√</td>
<td>√</td>
</tr>
</tbody>
</table>

CAREC = Central Asia Regional Economic Cooperation, ECO = Economic Cooperation Organization, PRC = People’s Republic of China.
Source: Author’s compilation.
Several agreements on economic cooperation and trade facilitation have been signed in the present regime, while various bilateral and multilateral organizations are serving to boost the economic relations among the CAREC member countries. However, no significant enhancement in their mutual trade can be observed. In fact, in the absence of good trade and transport-related infrastructure, integration among the Central Asian economies is not possible. This prerequisite step for regional integration is recognized by the member countries and several works to develop transport-related infrastructure in the member countries are in progress.

The China–Pakistan Economic Corridor (CPEC) is one of the strategies to improve regional connectivity for economic and business purposes. It is the main component of the development strategy initiated by the People’s Republic of China (PRC), the Belt and Road Initiative, formerly known as “One Belt One Road.” The basic concept of the CPEC is to join Gwadar (an Arabian seaport in Pakistan) with Kashgar (Xinjiang Uygur Autonomous Region) in the west of the PRC. Other than the Belt and Road Initiative, several corridors and trade enhancement projects are in progress in ECO member countries. These corridors and projects include the Quadrilateral Agreement on Traffic in Transit, the Islamabad–Tehran–Istanbul Train Network, the Trilateral Transit Trade Agreement, the Pakistan–Uzbekistan Transit Trade Agreement, the Pakistan–Iran–Turkmenistan Commerce Cooperation, the Afghanistan–Pakistan–India–Bangladesh–Myanmar Corridor, the Pakistan–India–Nepal Integrated Network, the Central Asia and South Asia 1000 Energy Corridor, the Indus River Trade Corridor, the North–South Transnational Corridor (Kazakhstan–Turkmenistan–Iran railway link), the Iran–Pakistan–India Pipeline, the Turkmenistan–Afghanistan–Pakistan and India Pipeline, and the Trans-Iranian Canal. These projects for efficient connectivity in transportation and energy reflect the direction of trade and mobilization of resources in the future (Mehar 2017).

The CPEC starts from the seaport city of Gwadar in Pakistan and runs to the historic western PRC city of Kashgar near the Tajikistan and Kyrgyz Republic borders. High-speed trains, adjacent major cities and economic zones, power plants, dry ports, water treatment facilities, prospective oil and gas pipelines from Iran to the PRC, mineral deposit areas, the availability of cheap labor, big markets with growing demand, and good climatic conditions are the favorable factors for success of the CPEC. It is a common opinion that this project will provide connectivity to Central Asian landlocked countries. South Asia, Central Asia, and the Middle East may be connected by this project in a greater way (Mehar 2017).
Several other plans to connect the various countries in Asia and to provide connectivity between Europe and Asia are in progress or under active consideration. One of those big projects is the Trans-Asian Railway project, which was initiated by the United Nations Economic and Social Commission for Asia and the Pacific to create an integrated freight railway network across Europe and Asia. However, it is important to note that the success of this global mega plan depends on the participation of ECO and CAREC member countries.

The deterioration in transport-related logistic services is the biggest barrier to economic integration, while it has been observed that the landlocked countries in Central Asia, Pakistan, and Afghanistan are far behind in the development of trade and transport-related infrastructure compared to other developing countries. We applied the availability of good “trade and transport-related infrastructure” as a proxy of regional integration. It is commonly observed that trade agreements and regional integrations are not successful in the absence of good transport infrastructure and logistics facilities (Mehar 2013). To establish a strong and sustainable economic integration, the participant countries have to improve their transport-related infrastructure.

It is notable that various agreements on regional integration have failed in some parts of the world because of the lack of the required trade and transport-related infrastructure. One example of this is the South Asia Free Trade Area, which has failed to make significant improvement in the mutual trade of South Asian countries. Apart from political tensions, the lack of trade and transport-related infrastructure is the main reason for the failure of regional integration in South Asia.

It is obvious that compatibility in trade and transport-related infrastructure is required for integration among the countries in the region. The availability of a good and compatible transport and trade-related infrastructure in a country will support its economic integration with the other countries in the region. In the absence of compatible infrastructure, there will be a requirement to develop trade and transport-related infrastructure, which is a prerequisite of regional integration. This implies that the quality of transport infrastructure in a country is an indicator of economic integration.

In the absence of compatible infrastructure, the participating countries will be interested in its development, upgrading, and modernization. The decision to finance the cost of infrastructure development will be determined by the incremental benefits to the participating countries after integration.
5.3 Financing of Transport and Trade-Related Infrastructure

One problematic area in developing trade and transport-related infrastructure is the lack of fiscal resources. The financing for the development of transport-related infrastructure is the most important step in considering the benefits of economic integration. It is noteworthy that the development and modernization of physical infrastructure in developing countries during the bipolar regime was largely dependent on subsidized external debts and grants from rich industrialized countries. Such facilitations were based on political ideology and alliances with the big powers. Dependency theory and the “Domino Effect” model explain the sustainability of developmental works in the middle-income and lower-middle-income countries in the bipolar regime. Hegemonic stability theory (Kindleberger 1970) explained the role of leading states in the changes of capabilities of the world economy. The belief in these theories had encouraged the developing countries to depend on big powers for their development. Higher leveraged financing is one of the offshoots of such belief (Mehar 2018).

The Asian Development Bank has estimated that developing Asia will need to invest $1.5 trillion per year in infrastructure through 2030 to maintain its economic growth momentum and tackle poverty. Total infrastructure financing as a share of gross domestic product (GDP) will need to increase from around 3.8% to 5.6% by 2020 worldwide (Yoshino, Helble, and Abidhadjaev 2018). But the drastic side of infrastructure financing in CAREC member countries is the overdependency on public-sector fiscal resources. Participation of the private sector in infrastructure financing is not common in these countries, while there is no active bonds market.

A worldwide comparison of infrastructure financing shows that debt was the most popular source of financing in 2017. The share of debt financing in infrastructure projects with private participation was 70%, divided between international and local (commercial) participants: 55% financed by international and 15% by local participants. Out of 55% of international debt financing, 30% belonged to development finance institutions, while 6% were multilateral and 24% bilateral lenders (Inderst 2018). This detail is enough to understand the patterns of infrastructure financing by private sector. It is obvious that long-term debt is the main source of infrastructure financing, while the share of short-term financing is declining globally.
Several options for financing regional connectivity-related projects are available in the contemporary world. Public–private partnerships, infrastructure sovereign bonds, equity participation, public funding, private-sector financing, institutional lending, and bilateral or multilateral borrowing are the possible options for financing transport infrastructure. However, the financing for such megaprojects to build transport and trade-related infrastructure is always associated with some macroeconomic implications. Repayment of debt and interest costs, an impact on the value of the local currency, increases in taxes to generate the funds for repayments, and effects on the value of the local currency if repayments are required in foreign currencies are the possible macroeconomic implications of debt financing for such megaprojects. The failure of fiscal policy to meet modern infrastructure requirements in various developing countries emphasizes the importance of the private sector for investment in infrastructure projects.

In this study, we analyzed the various options for financing transport-related infrastructure for economic integration among countries. It has been hypothesized that a sovereign bonds market and long-term financing by the private sector can finance the required investment in transport infrastructure for regional integration. It was also thought that financing should be generated through the public or private sectors of participant countries or other international investors. The use of sovereign bonds to finance the corridors’ infrastructure may be one of the viable options, but the success of these multilateral global projects requires the participation of all beneficiaries. The issuance of sovereign bonds to finance global or regional projects should not be based on the guarantees of a single country’s government. If the objective of the construction of economic corridors is to establish an economic integration, then the participating countries should consider the formation of a fiscal union. The issuance of sovereign bonds jointly by the participant countries of a fiscal union will minimize the political risks, which may reduce the cost of debt. Otherwise, the sizable subscription of sovereign bonds at appropriate cost cannot be successful in countries where the private bonds market is inactive and its size is negligible.

A comparison of the financial markets and monetary and fiscal policies of CAREC member countries suggests the synchronization of economic policies before launching the sovereign bonds to finance their joint infrastructure projects for their planned economic integration.
The formation of a fiscal union ensures the synchronization of tax policies.

A comparison of the macroeconomic and financial markets of ECO and CAREC member countries reveals the limitations of monetary and fiscal policies in these countries. A bird’s-eye view of the macroeconomic strength, composition of financial assets, debt burdens, and financial market development of these countries shows big variations in their financial strength and development. The bonds markets in these countries are not comparable with the industrialized countries while macroeconomic and financial risk exposures reflect the risks associated with the sovereign bonds. The most important point is that there are only four countries (the PRC, Pakistan, Kazakhstan, and Turkey) where capital markets are performing. The capital markets in other CAREC member countries are either not performing or their size is negligible. The patterns of trade and financing in CAREC and ECO member countries are shown in Tables 5.3 to 5.6. These patterns show the diversification in the financial development and financing patterns among the countries in the region.

**Table 5.3: Sovereign Risk and Market Strength: Ranking**
*(based on 62 countries)*

<table>
<thead>
<tr>
<th>Indicator/Country</th>
<th>Pakistan</th>
<th>PRC</th>
<th>Kazakhstan</th>
<th>Turkey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infrastructure Development Index</td>
<td>60</td>
<td>45</td>
<td>37</td>
<td>41</td>
</tr>
<tr>
<td>Financial Development Index</td>
<td>58</td>
<td>23</td>
<td>47</td>
<td>42</td>
</tr>
<tr>
<td>Bonds Market Development Index</td>
<td>30</td>
<td>24</td>
<td>35</td>
<td>40</td>
</tr>
<tr>
<td>Risk of Sovereign Debt Crisis</td>
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PRC = People’s Republic of China.
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GDP = gross domestic product, PRC = People’s Republic of China.

### Table 5.5: Patterns of External Debt Financing

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GDP = gross domestic product, PRC = People’s Republic of China.
Table 5.6: External Financing by International Market Mechanism

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PRC = People’s Republic of China.
5.4 Impacts of the Modes of Financing: Estimation Techniques

In the light of this background, we established a growth model in this study. It is proposed that the underlying objective of regional economic integrations is to accelerate the economic growth. Economic growth (GROWTH) in this study indicates the annual growth in GDP. The model is based on three equations, which have been estimated through ordinary least squares (OLS) estimators. In the first equation, it is hypothesized that GDP growth (GROWTH) depends on exports (EXPRT$), external debt financing (DBTTOT$), domestic credit to private sector (DCPSGDP), and short-term external debt (DBTSTTOT). Exports (EXPRT$) have been taken in billion United States dollars, short-term debt (DBTSTTOT) as percentage of total external debt, and domestic credit to private sector (DCPSGDP) as percentage of GDP. The second equation of the model explains the causal factors of exports (EXPRT$). Foreign direct investment (FDI$) in billion United States dollars, domestic credit to private sector (DCPSGDP) as percentage of GDP, share of short-term debt (DBTSTTOT) as percentage of total external debt, and transport and trade-related logistics index (LGSTTRANS) have been taken as explanatory variables in determining the exports (EXPRT$) of a country. To measure the quality and capacity of transport infrastructure we applied the “Trade and Transport-related Logistics Services Index” constructed by the World Bank (2019). This index ranges from 1 to 5, with “1” indicating the lowest quality of transport and trade-related infrastructure in a country. The third equation in the model identifies determinants of the quality of trade and transport-related infrastructure (LGSTTRANS) in a country. Public-sector long-term debt (DBTLTPB$), share of multilateral debt in total external debt (DBTMLTOT), share of short-term debt in total external debt (DBTSTTOT), and domestic credit to private sector (DCPSGDP) as percentage of GDP have been taken as determinants of the quality of trade and transport-related infrastructure (LGSTTRANS) in a country.

The simultaneity in the model is shown in Figure 5.1, which explains how regional economic integration is transformed into trade enhancement and GDP growth. Trade enhancement is measured by exports (EXPORTS), while the quality of trade and transport-related infrastructure (LGSTTRANS) has been taken as a proxy of regional integration.

Data for this analysis were extracted from the World Development Indicators data bank (World Bank 2019). The data consist of 219 countries for 10 years (from 2007 to 2016). The last 2 years (2017 and 2018) could not be included in the model because of the
unavailability of data on some indicators included in the analysis. It provides 2,190 observations.

Through these pooled data, we can analyze the impact of the regional integration policies (intervening variables) of participating governments. For this purpose, we need to introduce intervening variables in the model and establish a difference-in-differences analysis. However, it was observed that the explanatory variables included in our models represent almost the entire effect of the policy interventions. No dramatic changes over time were observed in the explained variables, which may indicate the effect of policy change over time. So, we did not introduce the policy intervening variables in the model and applied OLS estimation techniques for all the models included in the study. Country-specific effects were not observed in cross-country comparison, so we have not applied a fixed-effect model.

Figure 5.1: The Simultaneity in the Model Modes of Financing, Transport Infrastructure, and GDP Growth

GDP = gross domestic product.
Source: Author’s depiction.
The robustness in estimated parameters has been checked by using alternative options, with some falsification tests also having been conducted. For this purpose, some control variables have also been included in the regression analysis. To explain GDP growth (GROWTH), we included aggregate logistics index to measure the impact of all kinds of logistics infrastructure (LGSTALL), trade to GDP ratio (TRADGDP), export to GDP ratio (EXPRGDP), share of multilateral debts in total external debt (DBTMLTOT), foreign direct investment (FDI$), net inflow of foreign direct investment (FDIINF$), and business losses due to electric outage (ELECLOS). In determining exports, we have also tested the effects of the Logistics Index for Tracking the Shipment (LGSTRAK) and the Logistics Index for Customs Services (LGSTCUS).

To explain the quality of trade and transport-related infrastructure (LGSTTRANS), which is a proxy of regional trade integration, we included external long-term debt to private sector (DBTLTPV$), amount of bonds sanctioned to finance private-sector projects (BNDPN$A), amount of bonds sanctioned to finance public-sector guaranteed projects (BNDPP$A), amount of bonds disbursed to finance private-sector projects (BNDPN$D), amount of bonds disbursed to finance public-sector guaranteed projects (BNDPP$D), foreign direct investment (FDI$), investment in transport infrastructure under the public–private partnership program (ITRANSPPP), investment in transport infrastructure with private partnership (ITRANSP), gross domestic product (GDP), GDP growth (GROWTH), and per capita income (PCI$) as control variables.

The results of the regression analysis are presented in Tables 5.7 to 5.9. These results quantify the impacts of the explanatory variables. The OLS results indicate the significance of parameters and overall goodness of fit in the equations. However, some results are surprising and against the common intuitive.
### Table 5.7: Determinants of Growth

**Dependent Variable: GDPPGROW**

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Adjusted R²: 0.0471 0.0553 0.0562
F-statistics: 20.52 16.59 8.90

Source: Author’s estimations.

Table 5.8: Determinants of Exports

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Adjusted R²: 0.2476 0.2471 0.2462
F-statistics: 47.11 58.46 58.16

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F-statistics: 60.61 202.81 161.74

Source: Author’s estimations.
Table 5.9: Determinants of Trade and Transport Related Infrastructure

Dependent Variable: LGSTTRANS

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Source: Author’s estimations.
5.5 Conclusions and Policy Implications

The conclusion can be drawn that a country’s exports are a significant determinant of its GDP growth, while the share of short-term debt in total external debt also affects GDP growth positively. The negative impact of domestic credit to the private sector on GDP growth is against the common intuitive. However, its positive effect on exports indicates that domestic credit to the private sector may positively affect GDP indirectly. The simultaneity in the model describes the positive effect of trade and transport-related logistics infrastructure on exports while exports lead to GDP growth. Exports have a positive association with GDP growth, while domestic debt to the private sector improves the level of exports from a country.

Other than domestic credit to the private sector, the most important significant determinant of exports is the trade and transport-related logistics conditions, which are an indicator of the regional connectivity. It is notable that the indices of trade and transport-related logistics infrastructure are much lower in CAREC member countries (except for the PRC), which indicates the demand for investment in transport-related infrastructure for the success of regional integration.

Foreign direct investment (FDI) was a significant determinant of exports; however, the presence of external debt falsifies the impact of FDI on exports. It is the external financing that supports the exports from a country. The role of FDI and short-term external debt is significant but reflects some complicated relations. FDI significantly contributes to the enhancement of exports, which is a result of global economic linkages. Multinational companies and foreign investors establish their businesses and production units in countries where comparative advantages are available. The surplus domestic production enhances the exportability. However, in the presence of short-term external borrowing, the impact of FDI on exports becomes negative.

However, external debt affects GDP growth negatively. This may be because of the burden of interest payments on the national exchequer, which reduces the fiscal space. In the presence of higher debt liability and interest payments, national governments cannot provide the funds for public-sector development programs, which affects the rate of GDP growth.

The results indicate that the share of short-term debt in total external debt affects the quality of trade and transport-related logistic infrastructure positively. The effects of short-term debt are robust and significant. The effect of external long-term debt to the public sector is also positive, which indicates that utilization of public-sector external
long-term debt plays an important role in the improvement of trade and transport-related infrastructure. The effects of domestic credit to the private sector in the determination of logistics infrastructure is also positive. Surprisingly, no significant impact of multilateral external loans on trade-related infrastructure has been proved. Sovereign bonds, private-sector bonds for long-term financing, private-sector long-term debts, and FDI have not been recognized as significant determinants of trade and transport-related logistics infrastructure, which indicates that long-term external financing to the private sector does not have a significant role in the determination of trade-related infrastructure or economic corridors.

The role of sovereign bonds is also insignificant, although it seems counterintuitive. The empirical results indicate that sovereign bonds are not a feasible option for transport infrastructure to integrate the economies in a region. The higher share of short-term borrowing in external debt and long-term public-sector debt has been identified as a good option for growth and development, while the role of expansion in the domestic credit to the private sector is also important.

The significant negative impact of domestic credit to the private sector on GDP growth and its insignificant role in the determination of exports invites the rethinking of financial policies. Transport-related logistics infrastructure has proved to be an important factor in export enhancement. Its support for trade-related activities is obvious. These findings concern the core area of this study. The development of trade and transport-related infrastructure is the main component of economic integration policies. This component of economic integration becomes more important in the presence of some landlocked countries in the region. The export-led growth model is confirmed in this study by determination of growth (Table 5.7) and determination of exports (Table 5.8).

The results emphasize the causal relations between trade and transport-related infrastructure and GDP growth. It has been shown in earlier sections that there are no significant changes in the trade and transport-related infrastructure in CAREC member countries during the period included in this analysis. Transport-related infrastructure has been identified as the weakest area in the CAREC countries. The region is far behind the developed countries in the world. The weakest infrastructure explores the causes of “less integration” in the region. To achieve the benefits of integration mere trade agreements and regulatory works are not enough. Here the development of trade and transport-related infrastructure is the most important area as it can provide linkages of seven landlocked countries with the Arabian Sea. Their
mutual linkages may provide a bigger market for export enhancement and GDP growth.

These results provide important insights. The most important conclusion is the identification of short-term external borrowing as the most effective mode of financing. The results show the significant and robust effects of short-term external borrowing on growth and development. The study does not recommend long-term external borrowing or multilateral borrowing for the development of trade and transport-related infrastructure. The strong, significant, and robust impact of the share of short-term borrowing in total external debt on GDP growth, exports, and infrastructure development indicates the pressure on policy makers and economic managers for effective and efficient utilization of resources. In the presence of short-term loans, the managers have to show their success in the short term. They cannot transfer the burden of repayments and their policies to forthcoming governments. In fact, short-term borrowing is not a source of financing for long-term development; it is a part of operational activities.

This requires the attention of policy makers. A global change in the lending and investment policies of industrialized countries and lending institutions is required. Providing lending facilities to governments and public-sector organizations is a modus operandi for the development of financing by international financial institutions. In this way, the risk of failure is transferred to the governments of developing countries, which usually enhances indirect taxes for payment of interest and repayment of these loans. Unfortunately, the history of public finance in various developing countries shows the misuse of external borrowing for politically motivated and popular projects. It is obvious that this is a bias mechanism against lower-middle-class people in developing countries. The global financial architecture should focus on the provision of short-term lending facilities to improve the efficiency of developing projects.
References


6

Evolution of ASEAN Financial Integration: A Comparative Perspective

Danupon Ariyasajjakorn, Pitchaya Sirivunnabood, and Matteo Molineris

6.1 Introduction

For 20 years since the Asian financial crisis in 1997–1998, the Association of Southeast Asian Nations (ASEAN) has continuously worked on the context of financial integration and put tremendous effort into ensuring financial stability in the region. Firm development started after the Asian financial crisis with the endorsement of the Roadmap for Monetary and Financial Integration of ASEAN (RIA-FIN) by the ASEAN Finance Ministers in 2003. The RIA-FIN covers the three primary financial areas of financial services liberalization, capital account liberalization, and capital market development. In parallel, to ensure financial stability in the region, ASEAN established the Macroeconomic and Finance Surveillance Office in June 2010, which was renamed and restructured as the ASEAN Integration Monitoring Directorate (AIMD) in 2016.

Paving the way toward regional economic integration, ASEAN has endorsed two ASEAN Economic Community (AEC) blueprints, which incorporated major elements of financial integration and taxation cooperation, for different timelines, i.e., 2007–2015 and 2016–2025 (post-AEC realization in 2015). In addition to these AEC blueprints, ASEAN has endorsed the ASEAN Banking Integration Framework and the ASEAN Insurance Integration Framework 2020 as a part of financial services liberalization while the initiatives to ensure regional financial stability have been implemented through regional economic surveillance and crisis management and the ASEAN+3 (i.e., ASEAN in cooperation with the People’s Republic of China [PRC], Japan, and the Republic of Korea) Finance Cooperation.
Learning, to some extent from the experience of the European Union (EU), ASEAN has changed its approach from counting the number of implemented policy measures indicated in the blueprint to designing detailed action plans with targeted timelines. The idea of sectoral action plans was proposed for an effective implementation process in achieving its regional integration goal. Taking on this idea, the ASEAN Finance Ministers and Central Bank Governors approved the Strategic Action Plans (SAPs) for Financial Integration 2016–2025, followed by the SAP for Taxation Cooperation (ASEAN Secretariat 2016). With this approach, the initiatives settled upon in the SAPs for financial integration range beyond the ones in the RIA-FIN. The extended documents include those of the banking sector with a focus on the regional bank concept (i.e., qualified ASEAN banks or QABs), safe, secure, and innovative payment and settlement systems, financial inclusion, taxation cooperation, and financial stability. To accommodate the initiatives enhancing regional financial stability and promoting local currency debt markets, the ASEAN+3 Finance Cooperation also established working bodies with the support of the Asian Development Bank and the ASEAN+3 Macroeconomic Research Office (AMRO) as the macroeconomic and financial surveillance body.

Additionally, in terms of a monitoring process, ASEAN has endorsed the AEC Monitoring and Evaluation Framework, conducted and managed by the AIMD, to measure the implementation progress and ensure timely implementation with respective timelines. At the financial sector level, ASEAN established seven working bodies under the ASEAN Finance Ministers and Central Bank Governors for each respective financial area to implement the action plans as identified in the SAPs and to ensure sensible action plans and policies in response to the current global circumstances. The macroeconomic and financial risk monitoring process is also undertaken under the ASEAN central banks’ supervision. The regional financial safety net, also known as the Chiang Mai Initiative Multilateralization (CMIM), is operated by AMRO.

With these efforts and the ongoing initiatives, ASEAN shows its determination to achieve regional financial integration with the complement of financial inclusion and financial stability. Although the effort seems ambitious, regional initiatives have been agreed and partly implemented in all relevant coverage of banking and insurance sectors, capital account liberalization, capital market development, payment and settlement systems, taxation, financial inclusion, financial stability, financial resilience, and sustainable finance. Despite these efforts, statistics still show a low degree of financial integration at the regional level; however, different levels of integration are demonstrated across the markets and economies in the region. For example, on the
one hand, different levels of financial liberalization are evident among
the ASEAN member states. On the other hand, the capital market and
portfolio investment seem to be more integrated than banking and
money markets.

Similarly to ASEAN, the EU expended numerous resources to
achieve its goal of regional financial integration. Priority was given to
the creation of a single market and an economic and monetary union
accommodating a single currency framework. The introduction of a
single currency, i.e., the euro, has played a big part in stimulating the
deeper and more unified European financial markets. The EU’s long-
standing process of financial integration has provided tangible economic
benefits associated with an increase in investment flows, improved
efficiency led by a decrease in financial costs, particularly in the banking
sector and capital market, and a rising trend of financial professional
movement in the region. The development of an efficient system for
policy coordination has played the biggest role in the integration
process. A remarkable convergence of regulatory and supervisory
frameworks, as well as macroeconomic prudential policies, was evident
in the region to support the progress of this integration process. With
its success, the monetary policy has been completely pooled and new
institutions created, i.e., the European Monetary System, the European
Monetary Union (EMU), and the European Central Bank (ECB). The
harmonization and standardization of economic and monetary policies
have driven the EU to become the most homogeneous economic group
in the world economy. A concern, however, has been raised about the
financial stability and the spillover channel once uncertainty happens.
The EMS, therefore, strengthens the policy cooperation in the region
and reinforces financial assistance to the members.

With its ambitious initiatives for regional financial integration,
coupled with financial risks, new challenges, and disruption, e.g.,
financial technologies (fintech) and artificial intelligence, ASEAN can
learn from the EU’s experience, particularly when it comes to monitoring
and surveillance systems. Putting these systems in place not only helps
in tracking implementation progress but also ensures financial stability.
Although some commonalities are pronounced between the two regions,
e.g., complex economic and social models, the goal to pursue stability-
oriented economic and financial systems, and open regionalism, a
major variance between the regions is the fundamental difference in
organization and institutionalization. Although both ASEAN and the EU
are regional organizations founded with the original goal of promoting
peace, and hence economic integration, ASEAN is an intergovernmental
organization, while the EU is a supranational one. In other words, EU
member states have agreed to pool their sovereignty, which is exercised
by the European Commission on their behalf. In addition, the EU has a parliament as a central organization that exercises power to legislate and to veto. The major difference between the EU and ASEAN is the role of the European Commission (EC) versus that of the ASEAN Charter. While the EC functions like a central government and is entitled to enter into treaties as well as putting forward proposals for legislation, the ASEAN Charter is only an agreement that gives the Secretary-General the responsibility to report back to the member states on the progress of their compliance with their obligations. There is also a difference in the decision-making process of the two regions. ASEAN’s decision-making process is based on consensus while the EU’s process is based on voting (Koh 2017).

These differences in both political cooperation and the decision-making process lead to different abilities to pursue economic integration in the region. This also implies differences in the political ambition and timing of efforts made toward deeper financial integration. ASEAN’s financial integration process can be described as market-driven integration, where the process happens when it is beneficial to all parties, while the EU’s financial integration is based on economically and politically set arrangements subject to firm commitments and sanctioning mechanisms.

This chapter proceeds with a comparison analysis of the financial integration between the EU and ASEAN, which includes a review of EU and ASEAN initiatives for regional financial integration, empirical evidence of the financial integration trends in each economy, and the process of financial integration. The chapter also examines the effectiveness of the initiatives that ASEAN has agreed to and implemented compared to the EU’s success stories, through a set of financial indicators, as an institutional benchmark. A set of conclusions and policy recommendations are derived based on the findings of the analysis to strengthen the regional financial integration in Southeast Asia.

6.2 Comparison between the European Union and ASEAN: Policy Measures and Regional Initiatives

There is a long-standing history of financial integration in both the EU and ASEAN. Although the end goal of regionalism is similar and the common interests are evident, the processes and approaches are different. Both regions aim for an open and integrated economic and financial system complemented by stability-oriented economic and financial strategies
that enhance sustainable growth and improve economic welfare. On the other hand, economic diversity is more noticeable in Southeast Asia while the homogeneous economic grouping has appeared to be a foundation for the EU. The significant differences can be pinned down to two major areas. The first is the political willingness—in other words, the extent of the efforts made toward deepening regional integration. Europe has shown itself to be more ambitious in regard to economic integration than ASEAN in making explicit a sovereign and political goal of building social and economic ties. Second, unlike the EU, institutionalization does not appear to be a priority for ASEAN in terms of integration. The perspective of regional integration being supported by institutions imposing legally binding rules and norms on their members seems trivial in ASEAN. As already mentioned, the EC is granted the power to legislate and enter into treaties, which can accelerate the integration process and make it more effective and successful than purely relying on consensus.

As a result, some economists have referred to the process as hard economic integration in the EU based on politically set arrangements while suggesting that Asia, including ASEAN, have only pursued a concept of soft integration or strategies of open regionalism and open integration or coming together when it fits their interests (Berkofsky 2005). Economic integration is Asia thus described as market-driven integration. We should then be cautious about comparing the progress between the two regions.

This section generally compares the policy measures and regional initiatives developed and/or adopted by the EU and ASEAN in the selected financial areas. A comparison of approaches and progress between the two regions is also described here. An assessment shows a broad comparison of how the two regions design their policy frameworks and pursue the implementation of regional financial integration. The section focuses on the main sectors of the money market, banking, payment and settlement systems, capital markets, and financial stability.

### 6.2.1 Money Market

Since the announcement of the monetary union and the circulation of the euro in 2002, the European money market has become the fastest financial market segment to achieve financial integration. The Eurosystem was established as the monetary authority of the eurozone (19 EU member states that adopted the euro as their sole official currency) with the main objective of price stability, followed by financial stability and financial integration. The Eurosystem plays a significant intermediary role in providing liquidity in the regional
money market through its monetary policy operations. The ECB, on the other hand, is in charge of monetary and financial stability in the eurozone. The ECB enacts the monetary policy measures to achieve money market integration in the region. The measures include, for example, forward guidance on key interests, i.e., lending and borrowing rates, the Asset Purchase Programme, targeted long-term refinancing operations, and prolongation of the fixed rate tender procedure with full allotment in regular refinancing operations (ECB 2018). In addition, the EU established a central clearing settlement system through central counterparties for money market operation. The central counterparties help to facilitate money market activities while limiting risk exposure. To facilitate assessment of the degree of money market integration, the ECB has recently created Money Market Statistics. The data collection started in 2016 to be used for examining both the volume of cross-border transactions and interest rate convergence. With these policy measures, evidence shows an increasing number of cross-border transactions in the eurozone along with a modestly declining divergence of money market rates captured by better statistical tools.

ASEAN, on the other hand, does not have a common currency like the euro, nor unified or institutionalized policy frameworks for its money market at the regional level. Instead, ASEAN is moving toward financial integration and enhancing regulatory convergence in the region by developing a set of shared principles and regional frameworks as well as maintaining financial systems. ASEAN has established official working bodies, which are under the supervision of central bank and the ministry of finance of the ASEAN member states, to undertake these processes. Although the idea of an Asian common currency was proposed once with the inclusion of three other Asian countries, i.e., the PRC, Japan, and the Republic of Korea, the idea did not push through due to different stages of economic development in the region and unclear discussion on which country should lead this common currency initiative. Nevertheless, ASEAN has recently announced a local currency settlement framework to promote the use of local currencies to enhance trade and direct investment in the region. This framework could be the closest initiative for money market integration or, at least, minimize exchange rate risk in the region.

The operationalization of the ECB and the euro has proved strong integration in the money market in the eurozone. At the same time, the official issuances of regulatory frameworks, guidelines, and measures have ensured transparency and financial stability in the region. Although ASEAN has developed a set of shared principles, which are mostly based on international frameworks, it does not entirely guarantee the compliance of the ASEAN member states with these shared principles.
In addition, the initiative of a local-currency settlement framework is implemented on a volunteer and readiness basis, which is nothing near to being considered integrated as regards the use of a common currency.

### 6.2.2 Banking Integration

After the global financial crisis in 2008 and the subsequent sovereign debt crisis in Europe, the idea of a banking union was discussed in the EU. This idea emerged mainly due to a concern over the spillover effect from one EU member state to another given the close links between public-sector finances and the banking sector (European Parliament 2019a). The main goal of the banking union is a more transparent, unified, and safer European banking system. As a result, two pillars were introduced as a foundation that all EU countries needed to adopt in order to establish the European Banking Union. First, the Single Supervisory Mechanism is the banking supervisory system for Europe, comprising the ECB and the national supervisory authorities of participating countries. The second pillar is the Single Resolution Mechanism, which ensures the resolution of failing banks with minimal costs for taxpayers and the real economy. The ECB is a supervisory body that evaluates a bank’s performance and decides whether a bank is failing or likely to fail, while the Single Resolution Board will ensure prompt decision-making procedures once the failing occurs. The Single Resolution Fund, financed by contributions from banks, will be available to pay for resolution measures. In addition to these two pillars, a set of prudential, legal, administrative, and supervisory rules is developed in the form of the so-called “Single Rulebook” to govern and supervise the financial sector in all EU economies more efficiently (ECB 2019b). Consequently, the banking union enables harmonization and standardization of the application of EU banking rules, starting with participating countries.

For ASEAN, the ASEAN Banking Integration Framework (ABIF) was established to facilitate operationalization of the banking integration process. The so-called “2 plus X” approach was designed based on the readiness of the ASEAN member states for the integration process. In other words, ASEAN agreed to proceed with bilateral reciprocal arrangements under the ABIF to create QABs rather than having one multilateral agreement on banking integration for all. Two participating ASEAN member states can start negotiations on the bilateral arrangement.

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arrangement; once agreed and signed, in principle, a list of qualifications will be announced for interested local banks in both countries to comply with in order to set up the QABs in the other partner country. If a third ASEAN member state is interested in joining this bilateral arrangement, a request can be made to the existing parties. The objective of these bilateral reciprocal arrangements is to provide the QABs with greater market access and operational flexibility similar to that accorded to indigenous banks in the host country. In terms of banking regulatory frameworks, ASEAN has established a working committee on the ABIF to formulate initiatives that will promote the effectiveness of the supervisory framework, as well as improve regional cooperation on a prudential framework and financial stability arrangement for regional financial integration. Unlike the EU, there is no central authority to impose, implement, and monitor the progress of the policy measures. There is also no single supervisory mechanism in ASEAN.

It is clear that, when it comes to banking integration, ASEAN is still far behind the integration in the EU. To date, there are no QABs operating in ASEAN while European banks can operate and be treated like local banks anywhere in the eurozone. Furthermore, for transparency and financial stability, there are various banking supervisory and regulatory frameworks across ASEAN. All ASEAN member states are encouraged to adopt the Basel Standards but there is no single framework like the one developed by the EU.

6.2.3 Payment and Settlement Systems

The vision of a Single Euro Payments Area (SEPA) was initiated in 2002 to harmonize euro payments in the region. Although it is an ongoing initiative as the EU members can gradually participate when ready, more than 520 million citizens live in the SEPA and make 22 billion electronic payments every year (European Payments Council 2019). The SEPA road map was first adopted during the period 2004–2010, starting with credit transfer and direct debit schemes or a single set of interbank rules, practices, and standards to be observed by credit institutions and the banking industry in Europe. The timelines were set for the adoption of SEPA or SEPA migration for both EU and non-EU members in 2014 and 2016, respectively. In December 2013, the ECB announced the creation of the Euro Retail Payments Board (ERPB) to help foster the development of an integrated, innovative, and competitive market for retail payments in euros in the European Union (ECB 2019a).

In ASEAN, a working committee on payment and settlement systems was established to implement the interconnected payment systems in the region. The main objective is to achieve a safe, innovative, competitive,
efficient, and more interconnected payment system. However, there is no single framework for rules and practices. Instead, ASEAN tries to achieve the interconnection of the payment and settlement systems through the adoption of international standards (ISO20022), bilateral and/or multilateral payment system linkages while developing settlement infrastructure for cross-border transactions, i.e., trade, remittance, retail payments, and capital markets. ASEAN has recently developed the ASEAN Payment Policy Framework as guidelines for cross-border real-time retail payments across the ASEAN member states to facilitate a competitive economic environment. The ASEAN member states are encouraged to use these guidelines as a standard framework for their payment and settlement systems; however, this is voluntary.

While SEPA is the single payment settlement system in the EU operated by a single set of regulations, ASEAN as yet has no connected payment and settlement system in the region. One possibility is being developed between the PayNow system of Singapore and the PromptPay system of Thailand. In addition, the definitions of real-time settlement are still varied across the region, which leads to delays in financial transactions, less efficiency, and less interoperability. ASEAN also relies on the member states’ compliance with international standards rather than developing a regulatory framework for the region.

6.2.4 Capital Market Integration

The EU adopted a resolution on building the Capital Markets Union (CMU) in 2015 as a major initiative for the region’s capital market integration, with the aim of reducing market barriers and facilitating saving flows for cross-border investments in the region. It also set out to foster sustainable finance via direct investment in environmentally friendly projects (European Parliament 2019b). The Action Plan on Building a CMU, published in 2015, is built around the four key principles of: (i) creating more opportunities for investors, (ii) connecting financing to the real economy, (iii) fostering a stronger and more resilient financial system, and (iv) deepening financial integration and increasing competition (European Commission 2015). Three main components are included in the Action Plan on Building a CMU: making the most of a single market for consumers and investors through new European

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2 ISO20022 is an ISO standard for electronic data interchange between financial institutions. The standards cover financial information transferred between financial institutions that includes payment transactions, securities trading, and settlement information as well as credit and debit card information and other financial information.
products, supporting businesses and entrepreneurs through clearer and simple rules, and having a more efficient supervisory body of EU capital markets. To achieve these components, 13 CMU legislative initiatives and three sustainable finance legislative initiatives are proposed, covering a wide range of financial areas such as a bond framework, pension products, cross-border distribution of collective investment funds, access for small and medium-sized enterprises to finance, anti-money laundering, supervisory regimes, crowdfunding, transparency and standardization, taxonomy, etc. To monitor progress and effective implementation as well as increasing public awareness, the European Commission launched a public consultation on the CMU midterm review in 2017.

The capital market integration in ASEAN, on the other hand, is implemented through policy measures supervised and monitored by three main working bodies. First, the working committee on capital account liberalization (CAL) aims for a freer flow of capital in the region by gradually removing restrictions on current accounts, foreign direct investments, and portfolio investments. Second, the working committee on capital market development (CMD) focuses on initiatives to integrate bond markets in the region. These initiatives are developed to build capacity and lay infrastructure for the development of capital markets in ASEAN. Lastly, the ASEAN Capital Markets Forum (ACMF) targets a liquid and integrated capital market, particularly in equity markets. Several initiatives have been completed as part of capital market integration in ASEAN, i.e., the ASEAN Trading Link among three ASEAN economies (Malaysia, Singapore, and Thailand), the ASEAN Collective Investment Scheme Framework, and the ASEAN Green Bond Standards.

In addition, when it comes to regulatory and supervisory frameworks, each working body has developed a framework to ensure capital market stability. For example, CAL has created the ASEAN CAL heat map to monitor the progress of capital market integration via the relaxation of capital controls and restrictions. A policy dialogue process and safeguard mechanism are in place to monitor capital flows in the region and exchange experiences on capital market management. The CMD has implemented the ASEAN Bond Market Development Scorecard for regulatory regimes. The ACMF adopted the ASEAN Corporate Governance Scorecard to raise corporate governance standards and practices.

Beyond the ASEAN cooperation for capital market integration, ASEAN is working with the PRC, Japan, and the Republic of Korea (ASEAN+3) on the development of local currency bonds. The Asian Bond Markets Initiative (ABMI) was launched in 2003 to develop local currency bond markets and to build more accessible and well-functioning regional bond markets both for issuers and investors. The
ABMI road map was endorsed and implemented by task forces under the supervision of ASEAN+3 finance ministries and central banks.

Compared to the development in other financial markets, ASEAN’s capital markets have progressed the most, in terms of products and regulatory standardization and harmonization. However, compared to the capital market development in the EU, the integration among the member states is still low. While the CMU is operated based on the action plans covering a wide range of capital market pillars, ASEAN’s initiatives have only been adopted by some ASEAN member states whose financial infrastructure and systems are ready. The monitoring process implemented by ASEAN is mostly based on a scorecard approach, which is considered simpler than the EU’s supervisory regime that involves complex modeling and periodical public consultations.

6.2.5 Regional Financial Stability

The European System of Financial Supervision (ESFS) was established in 2010 to monitor and maintain financial stability in the EU. The ESFS is a multilayered system of micro- and macro-prudential authorities, consisting of the European System Risk Board, three European supervisory authorities (i.e., the European Banking Authority, the European Securities and Markets Authority, and the European Insurance and Occupational Pensions Authority), and national supervisors. The main function is to ensure consistent and coherent financial supervision implemented across the region in preserving financial stability. The micro-prudential supervision is conducted by the European Banking Authority, the European Securities and Markets Authority, and the European Insurance and Occupational Pensions Authority, as a joint committee while the European System Risk Board performs the macro-prudential oversight of the EU financial system. As for the financial safety net, the European Financial Stability Facility (EFSF) was established to safeguard financial stability in the EU by providing financial assistance to EU member states in economic difficulty. Contributions to the fund are made by 16 EU member states subject to the size of their economy.

ASEAN, on the other hand, does not have a central authority for financial supervision. However, the element of financial stability is clearly stated in the SAP for financial integration 2016–2025 as the policy actions are or will be undertaken by the respective working committee. The main goal is similar to the EU’s mandate, i.e., encouraging regulatory and supervisory coherence, harmonization, and standardization. ASEAN also aims to promote financial stability coordination and cooperation on supervision and crisis recovery, management, and resolution. To strengthen the macroeconomic and financial surveillance system at the
At the regional level, ASEAN established the ASEAN Integration Monitoring Office in 2011, which was restructured to the ASEAN Integration Monitoring Directorate (AIMD) in 2016. Furthermore, the Chiang Mai Initiative Multilateralization (CMIM) was established under the ASEAN+3 Finance Cooperation to create a regional safety net. The CMIM is a network of bilateral currency swap arrangements to help the ASEAN+3 member states address economic difficulty or short-term liquidity shortage. Like the EU, the contribution of the CMIM comes from the ASEAN+3 members mainly subject to the size of their economy. The CMIM is operated and monitored by the so-called ASEAN+3 Macroeconomic Research Office (AMRO), based in Singapore.

The complexity of supervisory systems in both regions is significantly different. The EFSF is a multilayered system with micro- and macro-prudential authorities while the AIMD and AMRO are not prudential authorities but rather monitoring bodies designated by the ASEAN member states. Although, in principle, the EFSF and AMRO may play similar roles for regional financial stability, AMRO seems to have a limited capacity, with a smaller number of economists and financial specialists. The AIMD, on the other hand, is a monitoring office attached to the ASEAN Secretariat to oversee the progress of all the initiatives under the ASEAN Economic Community, not just the financial integration and financial stability. Thus, the AIMD has limited coverage in financial integration and its associated policy measures and implementation.

From the stocktaking of EU and ASEAN initiatives and policy measures for financial integration in this section, a number of conclusions can be derived. First, the existing and ongoing approaches adopted by both regions confirm the previously highlighted point on different political ambitions to deepen financial cooperation between the two regions. Institutionalization can be a catalyst to stimulate the financial integration process. Thus, the EU has established relevant authorities for operation, implementation, and supervision while ASEAN relies on the regional financial integration process of the working official bodies that gather for policy and progress updates approximately twice a year. Second, the EU undertakes the implementation process with solid timelines and a range of sanctions; ASEAN, however, proceeds with a degree of flexibility based on the readiness of its member states and peer pressure. Lastly, without capacity building for the younger economies, the difference in financial development across the region will be a major obstacle for ASEAN that hampers its financial integration. This is probably one of the reasons why ASEAN has adopted a financial inclusion element, which includes financial literacy, in its SAP for financial integration in 2016–2025.
6.3 Statistic Comparison between the European Union and ASEAN: Empirical Evidence

This section applies a statistical explanation as empirical evidence to demonstrate the degree of financial integration between the EU and ASEAN as well as to evaluate the performance in forming regional financial integration in both regions. The degrees of financial integration in both regions are assessed in this section through selected financial integration indices. The analysis also serves as background documentation to derive the policy recommendations and conclusions later in the chapter.

6.3.1 Financial Integration in the European Union

This development of financial integration in the EU that took place in the money, bond, equity, and banking markets between 1995 and 2017 is presented through the statistical trends in the past 20 years in this subsection. The overall assessment of the state of integration shows insufficiently integrated or a not yet exhibited status in the EU’s policy dynamics. Empirically, the statistical evidence gathered from the Financial Integration in Europe Reports (ECB 2008–2018) suggests that the degree of integration varies across the market segments. According to the European Central Bank (ECB), the market for financial instruments is fully integrated as all participants follow a single set of rules when buying or selling those financial instruments or services, have equal access to this set of financial tools, and are treated equally while operating in the market (ECB 2007).

Money Market

Before the recent financial crises, the unsecured money market was the most central channel for transferring liquidity among the banks. Following the first circulation of the euro in 2002, the European money market was the fastest financial market segment to achieve financial integration as it reached a stage of “near-perfect” integration (ECB 2008).

The high level of integration highlighted by price-based indicators for the European money market was accompanied by a high degree of integration of the large-value payment systems (LVPS) (ECB 2008a). Figure 6.1 shows the degree of integration through the price-based subindex. Before the euro was adopted in 1998, the LVPS market was fragmented, with only domestic LVPS operating in legacy currencies. With the introduction of the euro, the principles for the provision of
payment services within the euro area changed with the existence of a single currency and the effective conduct of the single monetary policy (ECB 2007).

The SEPA road map, adopted for 2004-2010, aimed for the harmonization of credit transfer in the region, and later on, the SEPA Coordinating Committee was established in 2008 for a single direct debit system.

After 2011, the trend in the movement toward financial development and integration of the EU continued despite the financial crisis. As several financial institutions started to face liquidity constraints, the ECB’s Governing Council introduced nonstandard monetary policy measures to repair the transmission mechanism and provide liquidity support, particularly with the two 3-year long-term refinancing operations conducted in December 2011 and February 2012. This drove excess liquidity in the banking system to very high levels, with the ECB increasing its intermediation role in the financial system (European Central Bank 2012). The integration in the money market has continued steadily since 2013 due to a series of monetary policy measures implemented by the ECB.

Taking into account lessons learned from the past financial crises and their impact on money markets, the European Parliament approved the implementation of money market funds in 2006, ensuring better protection for money market fund investors as well as safeguarding the integrity of the internal market by preventing these risks.
Banking Market
During the 1990s, the European banking sector experienced a rapid process of consolidation. The deregulation of banking activities, the completion of an integrated European financial market, financial globalization, technological innovations, and the introduction of the euro are some of the key drivers that started the process of banking consolidation in Europe. In the 1990s, a period of domestic concentration focused on creating active local players led to several banks expanding across borders and sectors. By 2001, the banking sector accounted for over 23% of total merger and acquisition (M&A) transactions in Europe, and this made it one of the most active sectors in M&A activity in the world economy. However, the worldwide economic downturn experienced since 2001 brought M&A activity to its lowest level compared to that of the mid-1990s (ECB 2007).

Specific regulatory or policy frameworks for the banking sector were yet formed for banking integration in the early 2000s. A fluctuating trend of profitability among EU banks was demonstrated between 2001 and 2011, which showed a lack of policy flexibility resulting in market vulnerability to external shocks (Figure 6.2). The external shocks in the period refer to the global subprime crisis in 2008 and the EU sovereign debt crisis in 2011. This called for deeper integration of the banking system for EU members, particularly considering their interdependent nature (ECB 2009).
As a result, the European Commission endorsed the Banking Union Roadmap in 2012 to create a more stable banking sector for the single market. This set of initiatives is the foundation of the banking union, which is an essential step toward a genuine economic and monetary union (ECB 2019c). Through the banking union, EU members are provided with a benchmark for consistent application of banking rules, and a tool for a more transparent, unified, and safer market for banks, which is an essential step toward improved decision-making procedures. Two main mechanisms, the Single Supervisory Mechanism and the Single Resolution Mechanism, were launched in 2014 and 2016, respectively, to deepen the banking integration and ensure financial stability. The Single Supervisory Mechanism deals with banking supervision in the EU to provide safety in the banking system by increasing financial integration and by ensuring monitoring in the European banking system. The Single Resolution Mechanism deals with the restructuring of banks when they are failing or likely to fail in a way that will harm the broader economy or that will cause financial distress (ECB 2008).

**Bond Market**

The introduction of the euro has been one of the driving forces behind the strong development of the European corporate bond market. Government bond markets became integrated primarily in the run-up to the Economic and Monetary Union (EMU). With the removal of exchange rate risk, yields in the government bond market have converged in all countries, although the importance of local factors has not entirely disappeared. Differences in liquidity and in the availability of developed derivative markets tied to the various individual bond markets may partly account for these divergences (ECB 2009).

Divergence in the yield curves has been evident since 2007 driven mainly by liquidity concerns related to the financial market turmoil, although it has been argued that credit concerns could have played an increasing role in the divergence of yields (Figure 6.3). The sovereign yields diverged further in 2011 due to the sovereign debt crisis in 2010–2011. The overshot yields could have been caused by the overestimated associated risk, in which the effect was also extended to the corporate bond markets. Indicators suggest that country-level effects have become more critical in driving yield developments, reflecting the differences in the fiscal situation and economic outlook of euro area sovereigns. New tensions arose in 2011 in the money and sovereign bond markets amid a resurgence of risk aversion and market volatility (ECB 2012).

The ECB Governing Council adopted several measures to support the smooth transmission of monetary policy and to restore market confidence. In addition to several adjustments in the modalities of
liquidity provision, the Securities Markets Programme was formed in 2010 to reduce volatility in sovereign bond markets caused by sizable credit risk and significant fiscal imbalance.

The degree of convergence of European bond markets significantly stabilized around its 2014 levels. It could be argued that the ECB’s monetary policy has significantly shaped the dispersion of European sovereign and corporate bond yields, particularly since the announcement of outright monetary transactions in 2012 (ECB 2015).

Sovereign bond yields showed evidence of a return to cross-country convergence, while the trend of narrowing spreads of nonfinancial corporate bond yields continued on balance. The sovereign bond yield dispersion across Europe, which had increased from late 2015 until the beginning of 2017, decreased steadily for the remainder of the year, reaching once again the level seen around the announcement of the public sector purchase program in January 2015 (ECB 2018).

**Equity Market**

In the first 3 years of the EMU, favorable developments in equity markets and strong M&A activities acted as a catalyst for the development of market-based financing sources in the euro area. Quantity-based measures also indicate a rising degree of integration in equity markets. During the decade following 1997, EU residents doubled their holdings of equity issued in other euro area countries as the share of their total portfolio of shares issued in their own country and elsewhere in the euro area increased to 29% (ECB 2007).
In 2006, although progress was made in the integration of euro area equity markets, more needed to be done to further financial integration, particularly for securities infrastructure underpinning both bond and equity markets.

Despite the sharp decline in equity prices in 2008–2009, the cross-border integration of equity markets was hardly affected as the ECB’s most available indicators suggested that integration strengthened in 2010 (Figure 6.4). In 2013, the level of equity market integration improved while the price-based-indicator-related cross-country heterogeneity declined, and the negative trend in quantity-based indicators leveled off. However, most of the indicators remained somewhat distant from pre-crisis levels (ECB 2014).

In 2015, the EU announced its green paper on the CMU, aimed at facilitating the intraregional capital flows along with ensuring capital market stability. The resolution on building the CMU was released soon after with further comprehensive goals to channel savings in the region to small entrepreneurs and protect cross-border investors in the EU. These show the EU’s intention to boost capital flows through investor confidence, along with an attempt to enhance financial inclusion. The action plan on building the CMU was endorsed by the European Commission, with the four priorities to be achieved by 2019. The endorsement of this major initiative has increased investor confidence and helped to stabilize capital flows in the region as well as improving integration in this market. As part of the integration monitoring process,
a public consultation with all stakeholders was carried out in 2017 as a midterm review of the CMU Action Plan (European Commission 2019b).

Accommodated by the aforementioned policy measures and activities, trends in the euro area equity and/or securities markets generally signaled further financial integration in 2017, as indicated by the price convergence. A considerable degree of integration was achieved in European equity markets in 2018, which led to greater capital movements in the region.

**Foreign Direct Investment**

As acknowledged by the Organisation for Economic Co-operation and Development, the EU has one of the most progressive and open investment regimes. The EU has been the world’s leading source and destination for foreign direct investment (FDI) for decades. Figure 6.5 shows the EU’s FDI flows since 1990.

![Figure 6.5: Foreign Direct Investment Flows of the European Union, 1990–2017](image)

**Figure 6.5: Foreign Direct Investment Flows of the European Union, 1990–2017**

$(\text{million})$

EU = European Union, FDI = foreign direct investment.

Given the EU’s advanced foreign investment policies, EU investors have always held the biggest investment share in the region. The investment flows across the region are facilitated by EFTA agreements. The regional investors need to follow the investment rules as negotiated in EFTA. Basically, the EU investment policies aim to secure a level playing field in the region as well as facilitating an effective investment
environment through a favorable regulatory framework, transparency, good governance, social responsibility, and innovation (European Commission 2019a). A change in percentage of the EU’s intraregional FDI has also been evident from 2013 to 2017 (Figure 6.6), showing the more intraregional FDI in the EU.

![Figure 6.6: Intra-European Union Foreign Direct Investment (€ million, %)](image)

EU = European Union, FDI = foreign direct investment.

In recent years, evidence has shown a growing number of non-EU investments in the region. Although the number is still small, their economic impacts are increasingly significant due to their larger than average size and their focus on high-technology sectors. To ensure a safe and effective investment environment, the EU recently launched the EU Framework for Screening Investments. The key requirements include regulatory transparency, nondiscrimination practices, confidentiality of information exchanged, the possibility of recourse against screening decisions, and measures to identify and prevent circumvention by foreign investors.

**Some Remarks**
The significant progress in terms of financial integration in the EU is brought about and supported by the main and strong institutions established by the EU and the European Commission. Many indicators
in various financial markets, including the money market, banking market, bond market, and equity market, lead to a similar conclusion of deepening financial markets. With these strong institutions to monitor progress, and enforce and supervise rules and regulations, the financial integration process in the EU became the most successful in the global market. The results show not only integration in the eurozone but also the integration of financial markets. After the global financial crisis in 2008, the indicators displayed a sign of de-integration. However, the EU’s strong institutional backups and the accommodative policies helped stabilize the financial market and possibly the integration as shown through improving trends of the above indicators roughly since 2013.

6.3.2 Financial Integration in ASEAN

With the endorsement of the SAPs, ASEAN has been moving toward greater integration in the financial markets. ASEAN’s financial markets have tended to converge with each other, especially in the last 10 years, according to the statistical evidence. Although moving gradually, the integration of ASEAN financial markets takes a similar route when compared to those of the EU, albeit over a more extended period of time. This section shows some statistical evidence regarding the integration in the selected sectors with selected indices, including money and banking markets, bond and stock markets, FDI, and portfolio investments.

With the different level of development in ASEAN members’ financial markets, some statistical evidence suggests that the markets tend to move along with each other. Indicators adopted in this section are commonly used to measure the degree of financial integration, including correlation coefficients and coefficients of variation, for instance, with some additional indicators subject to availability (Poenisch 2014; Pungulescu 2013; Beck, Demirguc-Kunt, and Levine 2009; Berkofsky 2005; Flood and Rose 2003).

A correlation coefficient normally shows how two variables move along with each other. Since the correlation takes a value from –1 to 1, a negative value close to –1 represents a negative relationship between those variables, meaning those variables respond to each other quite closely in the opposite direction. A correlation of 0 shows no relationship between the two variables and a correlation close to 1 indicates close movement in the same direction between the two variables. Thus, in order to capture the degree of integration between markets, the correlation of the selected indices should be close to 1.

Dispersion of the indices is determined by the coefficient of variation (CV). CV is a standardized measurement of dispersion using the ratio
of the standard deviation to the mean. In contrast to the correlation coefficient, CV measures how a group of variables diverge from each other. A higher CV indicates scatteredness of the variables. In the case of financial integration, a declining CV value of the indices suggests less dispersion, meaning more integration of the respective markets.

The data from the Asia Regional Integration Center are mainly used for calculation and interpretation in order to demonstrate financial integration in ASEAN. Most common data are gathered from the five main ASEAN members—Indonesia, Malaysia, the Philippines, Singapore, and Thailand (referred to as the “ASEAN 5” from this point onward). The discussion also adopts the data from member states other than the ASEAN 5 for some indicators, if available. Moreover, investment data, including FDI and portfolio investment, are also discussed as additional indicators of financial integration within the region. The FDI and portfolio investment data are collected from the United Nations Conference on Trade and Development (UNCTAD) and ASEANstats.

This subsection discusses indicators of integration in each financial market in ASEAN: the money market, corporate lending market, bond market, stock market, portfolio investment, and foreign direct investment.

**Money Market**

Money market rates in ASEAN 5 are used to calculate correlation coefficients among the markets. The 3-month interbank offer rates or similar indices are used to represent the money market. Correlation coefficients of money market rates are shown in Table 6.1.

Correlation coefficients of the money market rate present mixed signals across the ASEAN 5. The coefficients in some years, e.g., 2005 and 2009, show a converting trend in ASEAN’s money market. However, after 2010, an inconclusive result for market integration is derived from the presented correlation coefficients. The correlation coefficient trends are presented in Figure 6.7.
Table 6.1: Correlation Coefficient of Money Market Rate in ASEAN 5 Pairwise, 2000–2012a

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<td>0.98</td>
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ASEAN = Association of Southeast Asian Nations, IND = Indonesia, MAL = Malaysia, PHI = Philippines, SIN = Singapore, THA = Thailand.

a Money market rates are 3-month interbank offer rates or equivalent money market rate.
b MEAN is arithmetic means across nation pair each year.

Source: Authors’ summary and calculations from the Asia Regional Integration Center database.
Figure 6.7 shows the fluctuating trends of the correlation coefficients in most selected economies from 2000 to 2012. There are some pairs of correlation coefficients that demonstrated deeper integration in 2012: Indonesia–Malaysia, Philippines–Singapore, Philippines–Thailand, and Thailand–Singapore. The CV of the money market rates from 2000 to 2011 is shown in Figure 6.8.
Figure 6.8 shows convergence (less variation) in the money market rates of ASEAN in two periods: 2002–2007 and after 2010. There is a constant downward trend of variation in the money market rates from 2002 until 2007. Given that money and banking markets are the fastest-growing financial markets in the region, this increasing trend of this financial depth could be inferred from the active transactions in these markets. An increase in variation during the period 2007–2009 might be an effect from external shocks caused by the global financial crisis, similarly to the EU’s experience. Even though changes in CV during this period are not as obvious as the one in 2002–2007, a slight downward trend of CV after 2009 implies convergence in the money markets in ASEAN.

Although correlation of the money market index does not show any sign of integration, the CV reveals a positive sign of less variation of the money market rates. This change in pattern of CV from Figure 6.8 is somewhat in line with the pattern in the EU’s trend. As seen in the previous section, the trend of the EU’s composite price subindicator in the money market has shown signs of improvement toward greater integration, i.e., declining for a certain period, then rising again. In the case of ASEAN, the downward CV trend during the period 2002–2007 suggests a more integrated market. Afterward, the movement of the CV follows the EU’s pattern as it increased in 2007–2009 then declined toward 2011.

Corporate Lending Market
Correlations of short-term corporate lending rates across ASEAN 5 do not suggest the same movement. The correlation coefficients are shown in Table 6.2 and Figure 6.9.

---

3 Comparisons are made between the CV of the money market indicator of ASEAN 5 and the price-based subindex in the EU’s money market. This is done just to capture the pattern regardless of the time period.
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</table>

ASEAN = Association of Southeast Asian Nations, IND = Indonesia, MAL = Malaysia, PHI = Philippines, SIN = Singapore, THA = Thailand.

Lending rates are prime rates or equivalent short-term corporate lending rates.

MEAN is arithmetic means across nation pair each year.

Source: Authors’ summary and calculations from the Asia Regional Integration Center database.
According to the coefficients, there is no clear co-movement in the lending market among ASEAN 5 countries. Similar to the correlation coefficients in the money market, the result does not lead to a solid conclusion toward more integrations in the ASEAN 5 lending market.

The CV of the lending rates in ASEAN is shown in Figure 6.10.
Figure 6.10 shows a steady trend of lending rates in the past decade as the slope is flat and not statistically significant. Thus, there is no sign of considerable convergence in ASEAN’s lending market.

Consequently, a degree of integration is not captured in the ASEAN 5 lending market. The correlations in the lending rate above do not show convincing signs of integration and the CV insignificantly indicates a slight tendency for the lending markets to collide across ASEAN 5.

**Bond Market**
Correlation coefficients of yields for 10-year bonds across five ASEAN nations from 2000 to 2012 are shown in Table 6.3. According to Table 6.3, after 2010, all coefficients indicate a positive correlation with an increasing trend. The standard deviations of the coefficient become smaller during the same period. The result implies increasingly integrated bond markets in ASEAN 5 since 2010. However, during the period 2000–2010, there were no significant signs showing financial integration in this market. Only some pairs of the indicators show a degree of bond market integration in some ASEAN 5 countries. The correlation coefficients of bond market rates show a sign of improvement in correlation, particularly between Malaysia and Singapore, and Singapore and Thailand. The rest of the coefficients during that period show mixed signals.

To assess the above correlation coefficients further, Figure 6.11 shows that, after 2009, the correlation coefficients of ASEAN 5’s bond market rates indicate an increasing degree of financial integration in this market.

Although the link is not entirely conclusive, ASEAN, under the ASEAN+3 Finance Cooperation, established the Credit Guarantee and Investment Facility in 2010 to facilitate and support the issuance of local currency (LCY) bonds in the region under the ABMI Framework. The main function of the Credit Guarantee and Investment Facility is to provide credit enhancement to allow issuers to issue local currency bonds in the ASEAN+3 region. Further to this, many initiatives are undertaken by the ABMI Taskforce under the ASEAN+3 Finance Cooperation to broaden the investor base for LCY bonds. Together, all ASEAN member states work toward removing or relaxing the restrictions on their local currency bond markets. According to Asian Bonds Online (https://asianbondsonline.adb.org), the LCY bond markets in the region, particularly in emerging East Asia, have grown rapidly in the past decade in terms of size and the diversity of issuers. The bond outstanding grew from $3.71 trillion in 2008 to $13.1 trillion at the end of December 2018. The growth in the corporate bonds was evident while new products such as Sukuk bonds (Islamic bonds) are available in the markets.

---

4 Not significant at 5% significance level; p-value = 0.015.
### Table 6.3: Correlation Coefficients of Bond Market Rate in Five ASEAN Nations Pairwise, 2000–2012a

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<td>IND–MAL</td>
<td>0.83</td>
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<td>0.51</td>
<td>0.48</td>
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<td>0.84</td>
<td>0.29</td>
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<tr>
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<td>0.85</td>
<td>0.89</td>
<td>0.70</td>
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<td>0.67</td>
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<td>0.35</td>
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<td>0.87</td>
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<td>0.68</td>
<td>0.79</td>
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<td>0.62</td>
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ASEAN = Association of Southeast Asian Nations, IND = Indonesia, MAL = Malaysia, PHI = Philippines, SIN = Singapore, THA = Thailand.

a Bond market rates are yields for domestic 10-year sovereign bonds.

b MEAN is arithmetic means across nation pair each year.

Source: Authors’ summary and calculations from the Asia Regional Integration Center database.
The above results are supported by the CV of the bond rates in the region. The coefficient of variation is shown in Figure 6.12.
Figure 6.12 shows a consistently downward trend of the CV of the bond market rates in ASEAN. A statistically significant negative trend indicates less variation in bond market rates,\(^5\) implying convergence of the bond markets in the region. Correlation coefficients and the CV of bond market rates display a changing pattern toward the same direction in ASEAN 5 markets. A positive trend of bond market integration is visible after 2010.

**Equity and/or Stock Market**

Correlation coefficients of stock market returns in ASEAN 5 with Viet Nam are shown in Table 6.4.

Compared to other financial markets, equity or stock markets could be the most progressive for regional financial integration. As previously mentioned, many initiatives have been implemented by the ACMF to promote the progressive and connected capital markets in the region. Using the correlation of stock market returns as an indicator, the result shows substantially integrated signs in ASEAN capital markets. The correlation coefficients of many selected ASEAN country pairs in Table 6.4 since 2001 show a positive sign with a positive trend over the years. Moreover, the returns on the stock market have shown a highly positive correlation since 2008, indicating movement in the same direction as stock returns among the ASEAN 5 as well as that of ASEAN 5 with Viet Nam. Although there was a drop in 2012, which may well have been caused by the shocks originating from United States markets in 2012, the stock market index indicates overall deeper capital market integration in the region. More data availability would allow us to explore more comprehensively the trend of capital market integration in ASEAN, particularly with the introduction of the stock market linkages through the ASEAN Trading Link and the Collective Investment Schemes Framework. The emerging trend stated above is clearly shown in Figure 6.13.

\(^5\) Significance at 5% significance level; p-value = 0.001.
### Table 6.4: Correlation Coefficient of Return on Stock Market in ASEAN 5 with Viet Nam, Pairwise, 2001–2012

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**ASEAN** = Association of Southeast Asian Nations, **IND** = Indonesia, **MAL** = Malaysia, **PHI** = Philippines, **SIN** = Singapore, **THA** = Thailand, **VIE** = Viet Nam.

*Stock market returns are year-on-year percentage change of daily stock price indices.

**MEAN 5** is arithmetic means across nation pair each year for five ASEAN nations.

**MEAN 6** is arithmetic means across nation pair each year for six ASEAN nations.

Source: Authors’ summary and calculations from the Asia Regional Integration Center database.
Portfolio Investment

Portfolio investment is one of the indicators used to identify a regional financial integration. Higher intraregional portfolio investment implies higher financial integration. The portfolio investment in ASEAN is shown in Figure 6.14.

From 2008 onward, an increase in portfolio investment in ASEAN is evident with the positive growth from 2008 to 2017. The growing trend of portfolio investment suggests a higher degree of financial depth in ASEAN. Nonetheless, to determine the degree of financial integration, the intra-ASEAN portfolio investment must be taken into account. It is expected that most of the intra-ASEAN portfolio investment would flow primarily within ASEAN 5 countries. The share of intra-ASEAN portfolio investment received by each ASEAN member state is shown in Table 6.5. The ASEAN average shows a lower degree of integration in the regional portfolio investment since 2014.
A real-sector indicator that is commonly used to identify financial integration is FDI. An increase in the intra-ASEAN FDI indicates movement toward more integration of current accounts. The intra-ASEAN FDI is shown in Figure 6.15.
According to Figure 6.15, the share of intra-ASEAN FDI in the past decade stayed constant, which indicates moderate improvement in financial integration. The growth of intra-ASEAN FDI has fluctuated but remained at a positive figure for most of the time within the period of focus. Furthermore, signaling from 2007, Figure 6.15 shows that the share of intra-ASEAN FDI seems to improve slightly, from 11% in 2007 toward 20% in 2017. The FDI figure could potentially lead to the conclusion that greater integration in the ASEAN financial market is achievable in the future.

Some Remarks
The ASEAN financial markets are likely to be more integrated since the adoption and implementation of the Strategic Action Plan (SAP) for ASEAN Financial Integration 2016–2025 (ASEAN Secretariat 2019). Many selected indicators in this discussion, although not all, show convincing signs of financial integration and/or a degree of financial depth. The more advanced financial markets seem to be the capital markets among ASEAN 5 members. The indicators from ASEAN capital markets show strong supportive results on financial integration within the region. The indices from the bond market also give a significant, albeit quite slight, improvement toward integration. The foreign direct investment and portfolio investment figures support the above conclusion as well. Nevertheless, there are inconclusive signs of financial integration in ASEAN money and lending market indicators.
6.4 Conclusion and Policy Recommendations

After reviewing the policy measures and assessing the relevant indices to determine the degree of financial integration in selected markets, some conclusions can be drawn along with a number of policy recommendations for ASEAN.

6.4.1 Institutionalization and Standardization

One explicit difference between the two regions when it comes to economic or financial integration is the concept of institutionalization. The EU assertively adopts this concept to expedite its integration process. The establishment of the European Central Bank, the Euro Retail Payments Board, and the European System of Financial Supervision, among others, helps ensure the enforcement of the regional regulatory and supervisory frameworks as well as the alignment of national policies to the regional policies. This approach emphasizes the importance of having an independent central body in the integration process to impose the policy measures and monitor the related progress.

It is also worth noting that the standardization and/or harmonization of supervisory and regulatory frameworks across the region drive effective financial integration. When implementing policy measures or developing policy actions, it is essential to ensure that these policies are in line with the regional frameworks for the achievement of financial integration in the region. Evidently, the EU has developed major action plans for each financial market, i.e., the Banking Union, the CMU, and SEPA, in reference to international standards. These master plans are applied to, and must be adopted by all EU member states to make sure that everyone is on the same page and to minimize complication and confusion among the member states while translating these rules to their national agenda for the agreed same goals.

Although ASEAN has established many working committees to drive the regional agenda for financial integration by developing policy actions in line with the end goals as embedded in the SAPs, there is no such central authority to monitor the implementation and enforce sanctions if deadlines are missed and the policy measures are not implemented. Many guidelines are issued to share among the member states, but there is no guarantee that these guidelines will be adopted properly due to the flexibility ASEAN gives to its member countries. Given this difference, ASEAN may want to review its approach to financial integration. Although many international standards are referred to as the benchmarks for ASEAN authorities, the single master plan is rarely
adopted in the region. As a result, the absence of institutionalization and of the adoption of single standards could hinder the process of financial integration.

It is obvious, at least for the time being, that it is difficult for ASEAN to follow the EU’s practices and establish a similar central institution. However, strengthening the capacity of the ASEAN Secretariat may be an option to think about to accelerate the financial integration process in the region. Although no penalties or sanctions would be imposed on any member states if they could not achieve what has been agreed, a stronger monitoring process for financial integration could be conducted and strictly implemented by the ASEAN Secretariat. The most important matter is to provide programs to improve the capacity of the ASEAN member states. In addition, the continuality of working committees is critical for the integration process to be successful.

In terms of improving standardization and harmonization, regional frameworks should be developed along with narrowing development gaps among the ASEAN member states. Capacity-building programs in the priority areas and international frameworks and guidelines should be encouraged further in a continuous manner. This will help the newer members to catch up with the ASEAN 5 and build up their ability to develop regulatory frameworks in line with international standards.

6.4.2 Regional Financial Integration Framework and Implementation

As previously mentioned, regional frameworks and a single set of rules and standards are necessary to achieve financial integration. Both the EU and ASEAN have master plans for integration in their region. While the EU has developed a comprehensive set of regulations and rules for each market, e.g., the Eurosystem, Banking Union, the CMU, and SEPA, ASEAN endorses two strategic action plans for their financial integration, i.e., the SAP for Financial Integration 2016–2025 and the SAP for Taxation Cooperation 2016–2025.

The implementation of these action plans is even more important for achieving regional financial integration. Having reviewed the chorological implementation process of each region, evidence shows that the EU has laid down far more precise policy measures and rules that the member states need to comply with, subject to its strict timelines for implementation. Its serious implementation is visible through the sanctions and penalties they put in place. ASEAN, on the other hand, has developed a broad set of end goals and associated timelines. The policy actions included in the SAPs
are deliberately broad to give the member states flexibility to adopt and comply with. To achieve the end goals in a timely manner, a firm implementation process must be inaugurated to induce transparency, manage expectation, and thus boost investor confidence. This strict implementation can be strengthened by stronger commitment from the ASEAN member states to the same goal of financial integration in the near future.

### 6.4.3 Monitoring and Evaluation Process

In relation to the implementation process for financial integration, both regions use their own process as a monitoring and evaluation mechanism. The EU conducts regular midterm reviews and a public consultation when new initiatives or regulatory frameworks come out. The ECB also produces regular reports on financial integration with comprehensive data and indices. ASEAN established the ASEAN Integration Monitoring Directorate as a monitoring body to keep track of the progress of economic integration in the region according to its master plans and blueprints. Under the finance track, the working body called the Senior Level Committee on Financial Integration also implements the monitoring process by adopting the key performance indicators for each financial market to capture the degree of financial integration.

The concern, however, is not about the monitoring body and the process, but rather the comprehensive data set and its availability to be used for the assessment. It is recommended to develop a comprehensive database for monitoring and evaluation purposes. The available database will enhance transparency, reduce speculation, and improve investor confidence. ASEAN should also encourage transparent sharing of public information through periodic reports. This information sharing and raising public awareness are part of the effective process of financial integration. Regular public–private consultations should also be conducted not only to upgrade the process of reaching out to the public, but also to get feedback and inputs from stakeholders to develop and improve the existing regulatory frameworks and policy measures.

### 6.4.4 Financial Surveillance System for Financial Stability

The assessment of the financial indices in Section 6.3 shows that integration in both regions could be affected by external shocks, e.g., a global financial crisis. The creation of robust macroeconomic and
financial surveillance systems is crucial for a stable financial integration process. Given the possible spillovers channeled from an integrated economy, robust surveillance systems will help limit the uncertainty related to such shocks that may occur during the process. In addition, the complement of a regional financial safety net helps facilitate financial stability through the process by guaranteeing liquidity during crises for the member countries.

These safeguard mechanisms are available in both the EU and ASEAN, with the only difference being the operationalization. The most important thing is to make sure that the surveillance system and the risk-pooling funds are operated efficiently and promptly. One recommendation for ASEAN is to strengthen the capacity of an operating body by equipping it with relevant knowledge and international cooperation with international organizations, e.g., the International Monetary Fund, the World Bank, and the Asian Development Bank.

6.4.5 Regional Cooperation

To achieve financial integration, political will is mandatory because it reflects the willingness and efforts that all nations in the region put in to reach the targeted destination. The EU has obviously been giving maximum effort to implementing regional financial integration through institutionalization, regional cooperation, and standardization.

Due to diverse levels of economic and financial development across the region, ASEAN emphasizes the importance of capacity-building programs to help the newer member countries catch up with current developments and the global and regional environment. This is to ensure that no one is left behind in this integration process. However, the willingness to adopt and implement the regional frameworks is still questionable. It is recommended for ASEAN to consider strengthening regional cooperation to advance its financial integration process, particularly in capacity-building and training programs, to enhance financial literacy, and narrow the development gaps across the ASEAN member states. Enhanced capacity that is equipped with improved knowledge and best practices will help the ASEAN member states to adopt international standards and catch up with technological advancements, which are key factors in successful regional financial integration.

Although ASEAN’s integration formula of ASEAN minus X or 2 plus X is intended to provide the newer ASEAN member countries with flexibility and allow more time to adopt the regional framework and catch up with others, it could also delay the integration process,
particularly when these countries are not able to deliver the required outcomes according to the indicated timelines. ASEAN’s working committees in respective financial subsectors should play more assertive roles in expediting the implementation of the measures identified in the SAPs. The monitoring process of the integration progress must be implemented effectively to ensure the desirable outcomes in a timely manner as scheduled in the blueprint and the SAPs.
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7

Creation and Evolution of European Economic and Monetary Union: Lessons for Asian Economic Integration

Muthurangam Subramanian, Farhad Taghizadeh-Hesary, and Chul Ju Kim

7.1 Introduction

The world economy has been subjected to broad changes and a large number of countries are facing enormous challenges in effectively dealing with the changes caused by liberalization and globalization. In order to meet such challenges, it would be beneficial to unite and cooperate mutually and develop economic integration among neighboring countries by making use of the various comparative advantages and the existing complementarities (Khan and Khan 2003). Based on this concept, many trade agreements and blocs relating to regional integration have been developed.

The prestigious project of European economic integration has been steadily progressing over a period of 50 years. During this period enormous efforts have been made toward economic cooperation and deeper integration of the union. The European Union (EU) has been successful in terms of both political and economic considerations, although there have been several failures and challenges, such as the European financial crisis of 2007 to 2008, the great recession of 2008 through 2012, and Brexit (which refers to the United Kingdom [UK] leaving the EU) on 31 January 2020. The European Economic and Monetary Union (EEMU) was, perhaps, only a smaller part of the greater vision of European integration. The evolution and development of the EEMU was a long process with many stages of significant historical
experiences. The concept of a single currency is considered to be the most significant breakthrough step ever attempted in financial history.

The development of the EEMU is considered to be the result of the EU’s steady and progressive economic integration process. It is an expansion of the EU’s single market with common product regulations and free movement of goods, capital, labor, and services. The common single currency, the euro, was introduced into the euro zone, which comprised 19 EU member states at that time. All the 28 EU member states except for the UK and Denmark were to adopt the common currency after a minimum of 2 years of participation and fulfillment of convergence criteria.

Also, a single monetary policy was set up by the European Central Bank (ECB). However, there was no specific institution solely responsible for the economic policies within the EU. The responsibility was therefore divided between the EU member states and the institutions involved in economic and fiscal issues. The single currency provides several advantages, such as lowering financial transaction costs, easier travel among the member states, and strengthening Europe’s position at the international level.

There are several lessons that can be drawn from the experience of European integration in terms of both economic and institutional development of the EU. The EU’s experience provides some of these lessons, such as the driving forces behind the integration process, the institutions that were developed to manage the integration, and the impact of integration on trade patterns and income levels across the countries of the EU. The overall European experience can provide useful lessons for Asian economic integration.

However, the two continents are different in terms of economic and political considerations. From the economic point of view, integration resulted in a substantial impact on European trade and revenues mainly through increased competition and trade creation. It is possible that the heterogeneity of countries in Asia might offer an even greater potential for trade creation, and also for using integration as a force to develop productivity growth and sustainable development in the region. In terms of the political level, the European experience suggests that achieving economic gains requires continuing and far-reaching policy measures. Such measures, in turn, require a deeper political commitment to integration and the establishment of institutions to promote cooperation and also protect from the inter-member state frictions that are inevitable.

Asian economic integration is both essential and compelling. However, the lack of political commitment at different levels indicates that trade integration need not follow economic integration. With its greater diversity among members, Asian integration could generate
greater trade creation, investment flows, and competitive pressures than European integration, but possibly at the expense of greater divergence among members. In order to reap the economic benefits of integration, it is necessary to resolve various frictions and barriers to trade at intraregional levels. In Europe, such measures resulted in the continuing expansion of the EU, but in Asia, such dynamic activities have led to competition among countries in regard to gaining hub status.

The aim of this chapter is to review the creation and evolution process of the EEMU and discuss various insights into, and perspectives of, the key lessons for Asian economic integration. The chapter focuses on comparative features of Asian and European economic integration. The review of literature method is adopted extensively for the collection of data and information pertaining to the creation and evolution of the EEMU and Asian economic integration. Also, the chapter draws lessons from the EEMU for Asian economic integration by addressing the common challenges and roadblocks.

7.2 Historical Overview of the European Economic Monetary Union

Monetary union is the sixth level of economic integration. One level after it is political integration, which is the highest level of integration (Taghizadeh-Hesary et al. 2020). The EEMU has been a great experience for Europe. It is, therefore, of significant interest to discuss the EEMU’s evolution, history, and importance, as well as its future (Van Veen 2002).

In 1969, the heads of state governments formulated a new objective of European integration, which was perhaps the start of the EEMU. In 1972, the EU tried to bring new momentum to monetary integration by developing a mechanism for the floating of currencies against the United States (US) dollar within a close margin of variation. In 1978, the European Monetary System was created with a view to establishing a system for monetary stability with a fixed but adjustable exchange rate mechanism as the basis. The exchange rate mechanism consisted of all the member states’ currencies except for the UK. The rate of exchange of these currencies was based on the centrally fixed exchange rates against the European Currency Unit. Efforts were made to reduce variability in the exchange rates and system flexibility. Also, the European Monetary System made a political resolve for economic integration and, to some extent, sustainable currency stability was achieved.

In 1988, a committee was set up with a view to studying the EEMU, and in 1989, a proposal was submitted for the introduction and strengthening of the EEMU in three phases. Further, the committee’s
The EU treaty proposed introducing the EEMU in three stages: Stage I (1990 to 1993): free capital movement between the members; Stage II (1994 to 1998): convergence of economic policy of the EU member states and improving cooperation among the national central banks; and Stage III (from 1999 onward): gradual introduction of the euro as the single currency of the member states as well as the implementation of a common monetary policy with the support and protection of the ECB. The responsibility for developing the framework and implementation process of the single monetary policy was assigned to the European System of Central Banks. The EU member countries’ national central banks and the ECB are the constituent banking institutions of the European System of Central Banks.

7.3 Structure and Success of the European Economic Monetary Union

The EEMU was started on 1 January 1999 with 11 countries: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain (ECB 2008). In order to gain membership of the EEMU, economic convergence was considered an essential criterion. As there is a loss of exchange rate adjustments in a monetary union, it is important for the EEMU participating economies to have uniformity in regard to productivity, structure, and gross domestic product (GDP) growth rates. Hence, convergence is an important criterion to be fulfilled by countries before joining as members of the EEMU. In general, it is important to have convergence for the purpose of the optimum currency area. An optimum currency area only includes countries with higher gains than losses from participating in a monetary union. Gains are described above. Losses are attributed to the fact that a country cannot operate an independent monetary policy for national economic stability. The organization and implementation of the monetary policy is entrusted to a common centralized bank (Krugman, Obstfeld, and Melitz 2012).

According to the summary of the monetary policy, the gains and losses would depend on the weight and degree of economic integration
among the countries that are participating in the EEMU. Integration is generally defined as a high level of factor mobility among countries. Gains increase with increasing integration as the main advantage, the lack of exchange rate risk with a predictable basis for decisions is more important if the trade volume generated is high (Krugman, Obstfeld, and Melitz 2012). Losses will be reduced with increasing integration. With high factor mobility in a currency area, internal and external shocks will have a lower effect on the economies. The need for (now impossible) regional monetary policy is reduced, therefore. In order to evaluate the currency area, the degree of economic integration is taken into consideration. The optimum currency area criteria have to be evaluated while considering the problems of the EEMU.

Hence, the level of economic integration is not only an essential prequalification requirement (as in the optimal currency area discussions) but it can also measure the success of the integration within the EEMU (Mongelli and Vega 2006). The level of economic integration can be measured based on the trade volume of intra-trade in the EEMU, which is expected to increase over a period. There are two types of proposals that are generally expressed relating to economic integration. The process can either be carried out by convergence and integration before joining the monetary union, which will not cause any problem, or alternatively the convergence and integration can be increased in the monetary union as a consequence of positive effects on integration (Mongelli and Vega 2006). But the latter option is risky as it suggests countries join the union that have not yet reached a sufficient level of integration. Besides these indicators of success that are closely related to a monetary union, there are other indicators that can generally be expected in any well-established nation or area: a successful economic policy with political and financial stability.

Also, the EEMU stipulated rules on exchange rate stability, long-term interest rates, budget deficits, public debt, and inflation (ECB 2014). All EEMU members agreed to cooperate and expressed their willingness to adopt the euro as a single common currency for the region. However, the UK and Denmark from the beginning did not agree to participate in the last stage of the EEMU and hence did not adopt the euro. Accordingly, these two members were exempt from participating in the EEMU.

The euro was therefore considered to have significant economic relevance. The purpose of the creation of the euro as a single currency was to build an integrated European market similar to that in the US (Salvatore 2008). In 2015, after facing the sovereign debt crisis, the EU leaders decided to improve their governance with a view to strengthening the EEMU. With this objective, a report was published by the presidents of the ECB, the European Commission, the Euro Group, the European
Council, and the European Parliament. Their report explained the
reform plan of aiming to achieve a genuine fiscal, economic, and political
EU for completion by 2025 in three stages.

The EU single internal market was the main support for additional
integration of the EEMU with a single currency and a common European
central bank. The EEMU comprises several sovereign member states
that have accepted the euro as the single currency and single monetary
policy without having a consensus on mutual fiscal policy acceptance
(Stanković 2013).

According to Zirojević and Jelisavac (2002), the adoption of the euro
had two basic postulates: that the member states of the EEMU have to be
compatible with the euro, and a suitable mechanism for protecting the
purchasing power of the euro should be developed by the EEMU. While
many economists and authors supported the euro as a single currency, a
few others were apprehensive about the concept. Some experts argued
that the fiscal and economic conditions of some countries could cause
the downfall of the EEMU.

However, the performance of the euro was satisfactory until the
global financial crisis in 2008. Most countries worldwide suffered due
to the crisis. Those eurozone member states with weaker economies
suffered in repaying their debts. This aspect damaged confidence in
the euro as a single currency. In 2010, Greece suffered a major financial
crisis, which further worsened the situation. In anticipation of other
weak member states of the eurozone facing a similar crisis and aiming
at financial stability, a facility was created for providing loans to those
member countries in the eurozone that were affected by the financial
crisis in the region.

If we take a broader perspective, the EEMU has been a useful
proposition for the entire European region and indeed for the whole
world (Stanković 2013). It would be advantageous to be a member,
particularly for those companies that have an association with European
countries. Such companies will not be affected by the exchange rate
movement and commission rates. It can, therefore, be concluded that
EEMU membership could be advantageous for companies in Pan-
Europe (Neu 2000). However, the advantages and disadvantages of
becoming an EEMU member can have repercussions based on economic
and noneconomic factors. The stability of the euro can exhibit some
psychological advantages, such as enhanced self-respect and improved
national identity.

Being a member of the EEMU has significant advantages, which
can be classified as macroeconomic and microeconomic benefits.
The increase in efficiency, the reduction in transaction costs, and
the elimination of variation in exchange rates are some of the major
advantages in terms of microeconomic aspects. There is no requirement
to exchange currencies and the lower transaction costs can be seen in
customer savings. The elimination of fluctuations in exchange rates
contributes to the financial objectives of true and fair reports of financial
statements. As transaction costs are eliminated within the eurozone,
members can travel freely at extremely low cost regardless of the travel
purpose, including for study or work. Also, since the region is dominated
by a single-currency area, people traveling across countries do not
face the problem of currency conversion and therefore currency rate
fluctuations and consequent losses can be avoided.

Several benefits have been gained by business enterprises in terms of
the elimination of currency exchange among the members of the EEMU.
Since the launch of the euro as a single currency, and with the fixation
of exchange rate parity, the participants in the market do not have to
face risks due to exchange rate variation within the EEMU. Fostering
the growth of the member countries’ GDP with higher trading volumes
is considered to be the main advantage of the EEMU. GDP growth is an
indicator of a successful monetary union (Mongelli and Vega 2006).

In general, the total annual market value of all the goods and services
that are produced within a particular country is known as the national
GDP. It is considered a vital barometer in assessing the strength of a
country. Also, real GDP, after making adjustments for changes in prices,
is considered to be the key economic growth-measuring indicator. The
real GDP growth in the EEMU and the eurozone from 2014 to 2018 along
with the estimates for the period until 2024 are shown in Figure 7.1. It
is worth noting that in 2018, the real GDP in the EEMU increased by
around 2.2% compared to 2017.

There are several further advantages of having a single currency:
prices can be compared more easily, information costs are reduced, and
there is increased market competition (ECB 2008).

The EEMU’s most significant achievement is the euro as a single
currency, which ensures the financial stability of business enterprises and
the national economy, and controls international currency speculation.
The euro is not only a European currency but an international currency
as well. The euro as a single currency of Europe made a strong impact
on international currencies such as the dollar, the yen, the pound, and
other national currencies as their value gets reduced at the international
level. As the US dollar was used as an international currency, the US
could make higher gains. The euro as a single currency of the eurozone
replaced the domination of the US dollar in international trade as well.

The concept of a single currency helped Frankfurt and Amsterdam
to compete against New York, which was considered to be the world’s
financial center (Dunn 1999). The most important feature of the euro is
its role as an international investment currency, as a financial reserve, and as a trading currency in countries other than EEMU member countries too. Such countries have linked their national currencies to the euro and conducted financial transactions relating to international commerce and trading in euros.

However, despite the euro’s status as an international currency, it has failed to reach the level of the US dollar in regard to international invoicing and global reserves (Cooper and Tomić 2007). If all 27 countries had joined the eurozone it could have performed well, with higher priority over the US in various aspects such as the population and global GDP. Due to the financial market integration and the subsequent developments, the euro continued to grow. The euro’s global role is an important factor in determining its use by foreign investors (MuchaLeszko and Kakol 2009).

In general, the appreciation and global impact of the national currency are considered to be the strength of a nation. Thus, the strength and stability of the EEMU depend on the value and stability of the euro as the single currency. Currency stability provides stability in larger investments and commission rates and provides safety for business enterprises in the region. The euro’s stability stimulates trade between...
the eurozone countries and the rest of the world. The euro as the common currency of the EEMU made the member states coordinate and react to the global economic crisis; it also ensured better stability that was not possible to achieve at times of crisis (European Commission 2012).

An independent central bank supports the EEMU, and the central bank is mainly focused on reducing the inflation rate and also improving the monetary integration of the region. Due to financial instability in the inflows, the independent ECB’s role is considered necessary. The impact of the euro as a single currency results in a stronger effect on the capital flows and the profitability of the EEMU member states (Stanek 2001). The removal of the fluctuations in the currency exchange rates had largely affected the domestic market, lowering investment risks as well as stimulating foreign direct investment. Eventually, such actions would make the EEMU a bigger and stronger economic and monetary union. However, some of the economically smaller-sized countries are bound to accept the vulnerability in the exchange rates. The import and export trade activities of these smaller countries are sometimes higher than those of larger countries. Some of the changes that take place in the exports and imports of smaller countries can result in bigger exchange rate fluctuations. In the case of a smaller country, joining the EEMU magnifies the economic quantum effectively. The elimination of exchange rate risk would result in the reduction and elimination of the relative price instability among the EEMU member states.

There exists a higher level of transparency in trade among the EEMU members. This price transparency leads to price homogenization in the EU, which results in an overall reduction of the price level. The reduction in price variation stimulates better trade within the EEMU. Further, the market integration of commodities and services should promote economic efficiency within the eurozone. The transparency in prices leads to stiffer competition. Taking a broader view results in higher efficiency in a single market, which will affect the low prices for users, and a higher level of competition among global European companies.

After the launch of the euro as a single currency, the European single market developed into a more efficient channel, facilitating competition in various business activities among sellers from other countries. As the prices of commodities, products, and services are expressed in terms of the euro, there is a possibility of currency appreciation and this can contribute toward a boom in the EU. Therefore, the launch of the euro as a single currency can increase job creation and improve economic growth and development (Zirojević and Jelisavac 2002). Some of the study results show a positive correlation between the launch of the euro as a single currency and trade and commercial integration, as
having different national currencies used to cause constraints to trade. The empirical study indicates that the launch of the euro resulted in a 50% increase in trade among the EEMU member states (Tavlas 2004). The EEMU facilitates capital allocation efficiently and supports the member states toward the functioning of a European single market. This results in a more competitive European economy. The eurozone has become the biggest trade power in the world. The elimination of market segmentation and a reduction in price discrimination have been achieved because of the single currency instead of many national currencies.

Competitive devaluation shows that a country devalues its currency to export more commodities. Devaluation causes inflation, higher growth, and increased demand for exports. As the EEMU aimed to keep the inflation rate at lower levels, the launch of the euro as a single currency makes economic sense. Also, the euro can eliminate speculation among the member states of the EEMU. High commission rates hindered trade. The economies of the EEMU member states could develop faster due to the elimination of speculation. Since the introduction of a single currency, one member state of the EEMU alone cannot devalue its national currency in relation to other member states’ currency in order to achieve a price advantage in the export business.

The questions relating to the rules and regulations of the functioning of the eurozone include the EEMU’s future prospects, the countries that were affected by the financial crisis, the level of financial discipline, and the eurozone’s growth possibilities. The euro as a single currency, along with the European single market, can be considered as the basis for growth. However, some experts have commented that if appropriate measures are not taken there is a possibility that the failure of the euro could lead to the failure of Europe. But if we can handle the situation at the time of a financial crisis, Europe will emerge stronger and more robust economically (Issing 2011).

De Grauwe (2010) commented that the eurozone authorities and the financial markets should take responsibility for the financial crisis situation. If every member of the EEMU acts according to its own will, it will lead to the disintegration of the EEMU. The EEMU’s inefficient management could harm the competitiveness of all the EEMU member states. It is a challenge to stipulate rules and regulations aimed at making the EEMU sustainable for a long period of time (Kösters 2010).

The public finance situation reveals an increase in public debt in almost all the EEMU member states. The financial position reflects the management of the current budgets by the governments. The unit labor cost has increased, and it is divergent across the member countries. The inflation rates are also experiencing the same trend. The balance-of-
payments situation reflects surplus and deficit and differences prevail among the member states of the EEMU. Hence, it is hard to eliminate the differences and such measures require financial discipline for a long period (Issing 2011).

### 7.4 Recent Developments in the European Economic Monetary Union

Starting from 1999, over the last 2 decades the performance of the euro has confirmed its stability, its role as the second most vital global currency, and the ECB's ability to keep inflation under control. The euro as a single currency avails itself of the full support of the eurozone population, and this is considered to be good for the EU. During its first decade as a functioning body (1999–2008), high growth along with macroeconomic and financial stability were witnessed in the European economy. This trend changed in the second decade (2009–2018). During this period, the European economy was hit by the financial crisis. The ECB's monetary status was considered largely sufficient.

In 2018, during the financial crisis in Europe, a survey was conducted to collect opinions on the EEMU with the euro as a single currency in Italy and the results are shown in Figure 7.2. As the chart shows, 65% of the respondents were for the EEMU and 26% were not in full support of the EEMU.

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**Figure 7.2: Survey on the EEMU and the Euro**

<table>
<thead>
<tr>
<th>Responses on the EEMU</th>
<th>Share of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>For</strong></td>
<td>65</td>
</tr>
<tr>
<td><strong>Against</strong></td>
<td>26</td>
</tr>
</tbody>
</table>

EEMU = European Economic Monetary Union.

Note: Survey responses on the EEMU with the single currency in Italy, 2018.

During the crisis situation, the eurozone countries resisted the deflationary pressure and managed well in this respect. But some countries underwent either a sovereign debt or a banking crisis. Greece had the worst experience of an extremely painful and long crisis, and it was on the verge of quitting the eurozone in July 2015. However, thanks to the rescue package provided by the European Stability Mechanism, such a withdrawal was avoided. The International Monetary Fund (IMF 2002) provided conditional bailouts for those countries that were affected and lost access to the market. Also, some of the other countries received financial support in the eurozone along with ECB support. However, the quantum of rescue packages and the mode of delivery led to economic, political, and legal controversy until today.

Many institutional reforms in the eurozone, as well as in the EEMU, were instigated due to the economic and financial crisis situation. The reform process in the eurozone is expected to continue for a longer period. In 2015, the agenda for the reforms was presented in the five presidents’ report. But a consensus with regard to several proposals is lacking. Examples include the degree of political and fiscal integration, financial instruments, and the euro area budget. In view of the high degree of public debt in many eurozone countries and the fiscal crisis in most countries, it is important to strengthen fiscal discipline. The EEMU member countries outside the eurozone are expected to consider adopting the euro in the future. It would increase homogeneity politically and economically in the EEMU, thereby avoiding institutional issues relating to integration (Dabrowski 2019).

### 7.5 Conclusions and Policy Implications

European integration has been successful mainly because of the continuing process involving several steps to achieve deeper integration by taking a broader perspective and ignoring the minor issues in the progress of economic integration. The EEMU experience shows how these stresses can be handled and points to the importance of deeper integration in achieving the full potential of a regional agreement. The success of the EEMU can be attributed to maintaining price stability as well as positive growth for a considerably longer period. However, the financial and political stability in the region has not been realized. Apart from maintaining price stability and positive growth rates successfully, the criteria for the success of the EEMU have not been fully met (Milow 2014).

The euro crisis witnessed both financial and political instability, causing severe disturbances in the region. In the case of the EEMU, the concept of a single market was an excellent initiative with structural reforms over a longer term in all sectors of the European economy.
Also, the positive impact provided by world trade liberalization gave excellent support for the success of the EEMU. Another factor of the EEMU’s success was the introduction of a single currency. All these success factors were aimed at real convergence and regional economic integration. More accomplishments could have been possible by reducing financial instability. In order to achieve financial stability, it is important to broaden the existing European integration with stricter regulations and by increasing competition in the financial sector.

While both the success and the failure of the EEMU could provide valuable lessons for Asian economic integration, it is important to focus on real convergence for realizing macroeconomic and financial stability in the Asian region. The complementarities among the Asian economies show that there are benefits to be gained from Asian economic integration. However, Asian economic integration is progressing under a high level of diversified considerations, as compared to European economic integration. Asian integration is faced with the challenge of reconciling itself to high economic, political, and cultural diversity, and in reality, it is taking the shape of a much stronger economy with global perspectives. The review highlights and the recommendations of this chapter relating to the EEMU, and European and Asian economic integration are expected to facilitate further insight for leaders and administrators on the importance of regional economic integration toward fostering stability and prosperity, and addressing various challenges.

A comparison between European and Asian approaches to regional integration reveals different processes, various challenges, and some similar experiences. The process of regional integration in Europe has advanced much further than in Asian integration. European integration is characterized by structural policies, institutions, and the EEMU, whereas financial cooperation, trade, and production networks are more relevant to Asian integration. Both entities face obstacles and challenges in terms of progress and growth prospects (Capannelli and Filippini 2009).

Both Europe and Asia have taken advantage of their respective advantages well. Both face limitations now. The former approach cannot be simply extended, and there are doubts over whether convincing regional strategies have already been found (Pascha 2004). The achievement of deeper European integration was possible mainly because of united Europe’s strong vision. Also, there was political balance in Europe and the development of the institutions of the EU. However, there are no such features present in Asia. The Asian economies’ complementary situation creates gains from trade liberalization, but Asia may not follow the European route of deep integration or obtain the consequent economic benefits (Venables, Winters, and Yueh 2008).
In contrast to Europe, Asia lacks some of the successful features that have formed European regional integration. There is an absence of a specific vision, and a strong willingness to develop central organizations does not exist. There exists a disparate set of economic powers and a lack of ability to reach compromising agreements. Asian integration refers mostly to defensive motives reacting to regional tendencies. There is slow progress on multilateral trade agreements and the recognition of rapid regional trade development. The moves toward integration are thus motivated by economic gains without a corresponding political will and institutional vision. The balance of power further suggests that one or two countries will dominate any arrangement, moving Asia more toward a hub-and-spoke system than an integrated region.

Today, in Asia, there are several discussions about taking full advantage of globalization and at the same time avoiding the recurrence of any financial crisis. However, the progress of Asian economic integration has been slow and steady. While there is a leading trend in economic integration with the strengthening of trade and foreign direct investment, there is a lagging trend in terms of financial integration (ARIC 2018). Deepening of the regional integration, trade openness, and improving institutional quality are seen as a solution to increase economic and financial integration (Taghizadeh-Hesary et al. 2019). Regional integration is planned in the areas of trade, macroeconomic surveillance, balance-of-payments support, and strengthening of financial sectors. In Asia, there are several debates concerning macroeconomic and finance-related issues. Such debates should include approaches to crisis prevention and currency exchange rate stabilization.

However, due to increasing levels of liberalization of capital movements, the monetary policy arrangements are not effective since they are not adequately backed by structural reforms and macroeconomic policy coordination. Based on the ASEAN Secretariat’s assessments, an appropriate macroeconomic surveillance procedure with the support of the finance ministers’ dialogues could be considered as an important policy instrument. Further, based on the analytical findings, peer group pressure has been an important tool in the EEMU. European integration has been effective, as it was backed by independent and strong institutions of high repute. Also, the recommendations and conclusions of the EEMU member countries were made public, and that reinforced the peer group pressure.

In order to achieve long-lasting macroeconomic and financial sector stability in a regional group of countries as diverse as ASEAN, it is essential to focus on real convergence. In the EEMU, the single market concept was an ambitious initiative with far-reaching structural reforms in almost all sectors of the economy. Further, along with the positive
impetus provided by the world trade liberalization, this gave important support for the final success of the EEMU along with the introduction of the euro as a single currency. Europe continued to pursue real and nominal convergence at the same time. More achievements are also possible toward reducing financial vulnerability by broadening the existing cooperation on strengthening the prudential regulations and increasing competition in the financial sector.

Asian regional integration is progressing under more complex and diversified considerations than European integration. Further, Asian regional integration is facing challenges in reconciling a higher degree of economic, cultural, and political diversification, and regionalism is formed amidst the reality of a much stronger global economy. Some of the economic issues discussed at various Asian forums are almost identical to the European challenges. Therefore, Asia has the opportunity to use the valuable lessons learned from the European experience, similarly to the creation of institutions such as the EEMU. However, the objectives, sequence, dynamics, and form of Asian regional integration will continue to diverge. Although lessons can be taken from European experiences like the EEMU, Asian regional integration must not be evaluated from the viewpoint of following the model of European integration. It has to be viewed in terms of its effective performance in the reality of the Asian region, as well as the entire world.
References


8

The Evolution of the European Stability Mechanism: Lessons for Asian Integration

Frank Rövekamp

8.1 Introduction

The European Stability Mechanism (ESM) was formally founded at the height of the European sovereign debt crisis in 2012 to provide and improve eurozone financial stability. The ESM is the institution that grants financial assistance to member countries of the currency area facing a fiscal or financial crisis with the potential to affect the stability of the eurozone as a whole. The ESM and its predecessor, the European Financial Stability Facility (EFSF), have accordingly granted loans to Greece, Ireland, Portugal, Spain, and Cyprus. Opinions differ widely, however, with some seeing the ESM as an adequate vehicle for solidarity and risk sharing, while others regard it as a dysfunctional organization, encouraging moral hazard among its members. Notwithstanding, movements to upgrade the ESM are underway, with discussions focusing on enhancing its lending capabilities, equipping it with economic surveillance competencies, and softening conditions to access funds. There are even calls to transform the ESM into a European Monetary Fund, thereby granting it powers to provide financing not only in times of systemic crisis, but also for more ordinary economic development purposes.

While the ESM helped to contain the European sovereign debt crisis and thus fulfilled its purpose in the short term, judgment on its long-term effects on economic integration in Europe is pending. The ESM story nevertheless offers valuable lessons for Asian integration by providing hints for the following questions: Is a financial stability mechanism needed at all for the promotion of regional integration? If yes, what should be its scope? Finally, what kind of organizational design
and which decision-making processes should be devised, or at least be avoided, to assure effective functioning of the mechanism?

Accordingly, this chapter will analyze and evaluate the function of the ESM as a regional financial safety mechanism, and will formulate some lessons to be drawn for regional integration in Asia. For this purpose, the founding process of the ESM will be reviewed, as well as its functioning in concert with other European institutions and the International Monetary Fund (IMF). Recent developments and reform proposals will then be discussed. Finally, policy proposals to strengthen the regional financial safety net in Asia will be formulated based on the European experience.

8.2 The European Debt Crisis and the Foundation of the European Stability Mechanism

The European Union and the eurozone were not constructed under the premise of risk sharing through the creation of a common emergency fund. In fact, the opposite was the case. To safeguard financial stability, the Stability and Growth Pact of 1997 obliged each country to adhere to fiscal stability rules as codified in the Maastricht criteria (European Commission 2019). According to these rules, a member state should achieve a gross domestic product (GDP)-to-debt ratio of not more than 60%, while the national budget deficit is targeted at 3% or below. To stress this point, Article 125 of the Treaty on Functioning of the European Union (EU) (TFEU, which together with the Treaty of the European Union forms the constitutional basis of the EU), the so-called no bailout clause, states that neither the union nor member states shall be liable for or assume the commitments of other member states (EUR-Lex 2019). The European Union was not meant to provide a fiscal insurance mechanism. Each member state was to be responsible for its own financial health.

Things dramatically changed in the wake of the global financial crisis of 2008–2009, when state debt soared to finance fiscal programs to avoid even deeper recession, or to recapitalize banks on the verge of failure. The increased debt levels led to a crisis first in Greece in early 2010. Yields of Greek government bonds increased steeply as soon as it became known that Greece had significantly underreported its budget deficits for several years running. It quickly became apparent that Greece would lose access to the financial markets and face insolvency without financial support from the other eurozone member states. Although the Greek economy only amounts to about 2% of the EU’s GDP, strong
contagion effects were feared in the case of Greek insolvency, as many banks were holding Greek government bonds at the time and were still considered vulnerable immediately following the global financial crisis.

The eurozone member countries decided to provide financial support initially through the so-called Greek Loan Facility, which pooled bilateral credits given to Greece by individual countries. Especially at the insistence of Germany, the IMF also joined the ranks of the creditors. The entire program reached a total volume of €80 billion (Moschella 2016).

As a debt crisis was also looming in countries like Ireland, Portugal, and Spain, the eurozone members sought a better institutional basis for financial crisis management and founded the EFSF in June 2010. The EFSF was equipped with a lending capacity of €400 billion, but had a limited time span of 3 years; the “no bailout” clause did not allow for a permanent mechanism without changes in the TFEU (Tomkin 2013).

The EFSF had to grant financial assistance to Ireland in November 2010, and to Portugal in May 2011. In order to overcome the 3-year tenure of the institution, the euro area moved on to establish the ESM as a permanent mechanism, which was not an easy task in the no bailout legal environment. For this purpose, an amendment to the TFEU was initiated, allowing for such a mechanism if the stability of the euro area as a whole is endangered, and the granting of financial assistance is based on strict conditions. The ESM was established in February 2012 and has the following features (ESM 2019a):

- The mechanism is based on an intergovernmental agreement and is therefore not an institution within the legal framework of the EU. There are thus no supervisory or other legal relationships with EU institutions like the European Parliament, the European Council, or the European Commission.
- The ESM assumes the entire operations of the EFSF, which did not engage in new programs after 2013, but continues to be a legally separate entity.
- The ESM is designed as a pure financing vehicle: the formulation and negotiation of economic reform programs for crisis countries and surveillance are beyond its scope. According to the Treaty on the ESM, these tasks are assigned to the European Commission (EC), the European Central Bank (ECB), and, “wherever possible”, the IMF (European Council 2012, Article 13). Notwithstanding, the ESM has built up internal capacities for debt sustainability analysis, the so-called early warning system, thus fostering its own resources for surveillance (Guttenberg 2017). The European financial
stability arrangement does not rest on one institution, therefore, but on the complex cooperation of a number of institutions.

- The ESM has a lending capacity of €500 billion. Besides loans to sovereign states, financial assistance can also include support to banks, interventions in the primary and secondary bond markets, and precautionary credit lines.
- The highest decision-making body of the ESM is the Board of Governors, consisting of the finance ministers of the 19 member states. In most cases, new financial assistance programs have to be approved by the Board unanimously. Qualified majority voting with a threshold of 85% is possible in emergency situations, but even then, the three largest member states—Germany, France, and Italy—have a veto (Guttenberg 2019).

The establishment of the EFSF and ESM was challenged before several courts of member states and before the European Court of Justice on the grounds of violating the no bailout clause or circumventing EU law. The latter argument was based on the fact that by setting up the ESM on the basis of an inter-governmental treaty, an institution was formed which could heavily influence the workings of the European economic and monetary union, but which was not overseen by the European Parliament or any other EU institution. The cases were rejected by the courts, but in the process, the German Federal Constitutional Court strengthened the right of the German Parliament to preapprove any major commitment the government may make in connection with financial assistance programs by the stability mechanism (Tomkin 2013). Notwithstanding the verdicts, a widespread feeling remained that the euro area had twisted and bent its rules to the maximum possible degree. The cumbersome share of work between the ESM on the one hand, and the EC, the ECB, and the IMF on the other hand was presumably also designed to alleviate concerns with regard to the no bailout clause and the positioning of the ESM outside the EU legal structure.

### 8.3 Activities and Evaluation of the European Stability Mechanism

Soon after the outbreak of the Greek crisis, other countries followed suit, seeking financial support from the EFSF and later from the ESM. During this phase of “firefighting,” not much time could be spared for the optimization of the organizational arrangements and processes. The issues with the latter only fully emerged after the crisis calmed down.
8.3.1 The European Stability Mechanism in Action

The ESM and its preceding organization, the EFSF, engaged in a range of crisis programs (ESM 2019b). In November 2010, a financial assistance package was approved for Ireland. Already in 2007 a property market bubble had burst there, and the government had given blanket guarantees to the domestic banks involved. With no further access to financial markets at reasonable conditions, the government turned to the EFSF. Support totaling €67.5 billion was provided by the EFSF, eurozone member states, the EU, and the IMF. Repayment of the EFSF loan is scheduled for the period 2029–2042.

A financial assistance package for Portugal was approved by the EFSF in May 2011. A total of €78 billion was disbursed jointly by the EFSF, the EU, and the IMF. Repayment of the EFSF loan is scheduled for the period 2025–2040.

In July 2012, the ESM approved loans to recapitalize Spanish banks, which were on the verge of failure due to the bursting of a property bubble. In this case, €41.3 billion was provided solely by the ESM, as the IMF has no facility for direct bank recapitalization. The repayment of the ESM loan is scheduled for the period 2022–2027.

Cyprus was hit by a full-blown banking crisis in 2011, and financial assistance was finally approved by the ESM (€9 billion) and the IMF (€1 billion) in April 2013. Repayment of the loans is due between 2025 and 2031.

Whereas Ireland, Portugal, Spain, and Cyprus were able to regain access to the financial markets after these programs, Greece proved to be more intractable. Soon after the first program in 2010, it emerged that the optimistic projections and assumptions for fiscal and economic recovery were widely off the mark. Instead, the situation worsened. A second program amounting to €141.8 billion, with the EFSF as the main lender and with IMF participation, was negotiated in 2012. This was accompanied by a “voluntary” write-off for private bond holders in the amount of €100 billion (Moschella 2016). Still, this proved to be insufficient, and Greece was thrown into turmoil again in 2015 after national elections and a change of government in January 2015. In June 2015, the country defaulted on repayment of an IMF loan. Nevertheless, the euro area stepped in again, and a third financial assistance program led by the ESM was agreed in August 2015. The total loans to Greece by the EFSF/ESM and the IMF reached €280 billion. However, debt relief measures were devised as well: interest rates were reduced, and the amortization of the EFSF/ESM loans was extended to 2070 (ESM 2019b).
The Greek story revealed the difficulties stemming from the complex institutional setup of the European regional financial stability arrangement, with different viewpoints and different interests of the institutions requiring reconciliation.

Differences quickly emerged, especially with regard to the IMF (IMF 2018). The IMF was part of the European financial stability arrangement for several reasons, particularly as a result of the insistence of Germany. First of all, European institutions had no experience in formulating and supervising economic reform programs to overcome fiscal crises. Most importantly, however, the IMF was supposed to enforce strict conditionality, which the European institutions were likely more reluctant to do. Finally, the participation of the IMF was also deemed important to avoid potential competition between global and regional financial stability mechanisms.

As early as 2011, the IMF doubted the sustainability of Greece’s debt (IEO 2017). It therefore requested a write-off involving all private and public creditors. This was strictly rejected by the European institutions, however, for various reasons. The member countries of the ESM feared the wrath of the electorate, as governments had promised that in spite of the rescue packages no financial loss was to be expected, leaving the no bailout clause more or less intact. The ECB, in particular, feared deeper direct consequences (Moschella 2016). Within the framework of its quantitative easing, the ECB had acquired a significant stock of Greek government bonds and feared that its monetary policy would lose credibility should a devaluation of its holdings take place. Therefore, a write-off for private investors only was accepted, which was labeled “voluntary” but only achieved by exerting significant political pressure on the private banking industry. The rift between the IMF and European institutions became ever more pronounced. Greece, on the other hand, appeared to see this as an opportunity to lessen the influence of the IMF’s role in the program’s surveillance, or possibly even to promote its exit. In April 2019, the Greek government announced its intention to repay the IMF loans early despite the objections of other Eurozone members (Reuters 2019a).

The ESM program for Greece was formally concluded in August 2018, and the country successfully tested the financial markets again in January 2019 with a €2.5 billion bond issue (Bloomberg 2019). With a sovereign debt-to-GDP ratio of over 180% (Trading Economics 2019b), its financial health remains precarious. This ratio is projected to be reduced by only 25% by 2060 (EMS 2019b), considering the measures agreed upon by the European institutions and the IMF. In the meantime, Greece has already announced that it will deviate from some of these
measures by increasing the minimum wage for the first time since the debt crisis erupted (Reuters 2019b).

8.3.2 Between Solidarity, Risk Sharing, Moral Hazard, and Institutional Over-complexity: Pros and Cons of the European Stability Mechanism

Proponents of the ESM and the financial stability arrangement around it consider the financial assistance programs necessary and successful, and a good example for how solidarity and risk sharing between the member countries of the monetary union can overcome even a very severe crisis. According to this viewpoint, the euro area has been successfully stabilized by the rescue packages. The bond yields for all crisis countries except Greece have quickly come down to normal market levels. Ireland concluded its program in December 2013 and has become one of the most vibrant economies in Europe ever since. Portugal exited the program in June 2014 without needing further assistance. The budget deficit was reduced, and growth resumed again. Spain, on ending the program in December 2013, started to repay the loans earlier than required, and signaled a strong recovery. Cyprus finally exited the program in March 2016, after successfully reforming its financial industry (ESM 2019b). Only the case of Greece has proven to be more difficult; without the EFSF and ESM, however, the country may have had to face insolvency and leave the eurozone. A breakup of the monetary union could have been the consequence.

Right from the beginning of the rescue operations for Greece, however, the emerging financial stability arrangement was criticized on the grounds of classic moral hazard arguments. Moral hazard argues that countries that assume they will be rescued by external funds in times of even self-inflicted fiscal crisis will have much less incentive to enforce fiscal discipline and keep national debt under control (World Finance 2012). The strict conditionality of the programs may be meant to minimize moral hazard behavior, but critics point out that the credibility of such “strict” conditionality was impaired from the very start with the de facto abolishment of the no bailout clause, which is considered to be the ultimate defense against moral hazard. If the no bailout principle is not enforceable from the start, goes the argument, how can program conditions be expected to change anything?

The prolonged Greek crisis has indeed offered various indications of moral hazard behavior. Agreed on economic reform measures were frequently delayed or not met. Examples include the slow pace of the privatization of state assets, or the reform of the pension system, which
have not progressed sufficiently. Following the national elections in 2015, the new government even announced that it would cease to cooperate with the “troika” as the EC, the ECB, and the IMF were collectively referred to at that time. The crisis peaked again in the same year, with Greece on the verge of leaving the eurozone. After prolonged and emotionally charged discussions, compromises were made and the EC, the ECB, and the IMF were able to continue their work, albeit not under the name troika anymore, but collectively called “The Institutions” (Darvas 2017) from that time onward. The Greek crisis of 2015 has significantly contributed to growing disillusionment and discontent with the EU and the euro.

The latest example of presumably unabashed moral hazard concerns Italy (CNBC 2019). After the populist Northern League and the Five Star Movement formed a coalition in May 2018, the government revoked its commitment to restore fiscal health and reduce the high debt level. Instead, it introduced welfare programs such as the basis universal program for the poor, thereby guaranteeing a minimum income for all citizens, and promised tax cuts. The level of bad debts in the banking sector remains largely unresolved, which poses another threat to Italy’s financial stability. The budget deficit and government debts are expected to soar again in the coming years, but the government, even after its formation without the populist Northern League in September 2019, appears to be unimpressed. Italy well may have concluded that the eurozone will avoid the insolvency of one of its members at all costs, no matter how tough the no bailout rhetoric may be. With gross state debts of more than €2.3 trillion (Trading Economics 2019a), however, an Italian debt crisis would overwhelm the rescue capacity of the ESM.

Beyond these specific cases, critics of the ESM point out that the eurozone as a whole is still far from sustainable stability and strong economic performance. The growth outlook for the euro area remains weak, and other issues like the high unemployment rate in countries such as Spain offer little incentive to move vigorously toward restoring fiscal health. Unexpected political problems, like those in France with the Yellow Vest protests that erupted in October 2018, easily lead to loosening budgetary commitments. France has already compromised on keeping its budget deficit below 3% in the coming years (CNBC 2018).

While it is debatable whether the European financial stability arrangement contributes to strengthen the eurozone or rather to moral hazard and fiscal profligacy, the institutional complexity in terms of number of players and dividing responsibilities can only be considered dysfunctional. This will not be simply mended by giving the ESM a role in the design and monitoring of financial assistance programs, as these
duties will be shared with the EC, leading to further possibilities for friction.

Disagreements between the European institutions and the IMF have already been pointed out above. The involvement of the ECB, however, has raised problems of a different nature (Moscella 2016).

The main mandate of the ECB is to safeguard price stability in the eurozone—i.e., to prevent deflation and excessive inflation. With its quantitative easing program, the ECB has made a foray into indirect state financing. The purchasing of government bonds of the countries in the eurozone has brought down the yields and thus contributed to recovery in the crisis countries. In the process, the ECB has also lowered the quality standards of the securities it is willing to accept as collateral for credits to commercial banks (Nyborg 2017). This has especially helped Greek banks. The ECB can therefore hardly be considered a neutral partner in the formulation and monitoring of the ESM financial assistance programs, and it has indeed signaled some discomfort with this role. The ECB is certainly eager to avoid the insolvency of a crisis country, as it would probably then be expected to be the last resort lender, even if this would further blur the line between monetary and fiscal policy and thus compromise the credibility of the central bank. This potentially impairs the ECB’s role of surveillance of crisis countries.

To sum up, proponents of the ESM see the European financial stability arrangement as a manifestation of solidarity and risk sharing within the euro area. Furthermore, the ESM has shown itself to be indispensable in saving the monetary union in times of crisis.

Critics, on the other hand, point out the following:

- The moral hazard problem, which goes hand-in-hand with any financial safety net, is a greater threat in the eurozone as a result of effectively breaking the no bailout clause, which in turn impairs the credibility of even strict conditionality.
- The whole institutional financial stability arrangement between the ESM, the EC, the ECB, and the IMF is complex and fraught with conflicts of interest.

8.4 From European Stability Mechanism to European Monetary Fund?

Notwithstanding the aforementioned issues, an even larger role for the ESM is being considered in the context of discussions regarding strengthening the European Monetary Union (Guttenberg 2017).

Some proposals center on the conditions for access to the ESM-funds, which so far can only be tapped in cases where the stability of
the euro area as a whole is at stake and all member states unanimously approve a program. A “rainy day” fund, which could be used in times of asymmetric shock or downturns, as proposed by the managing director of the ESM, Klaus Regling (ESM 2018), or a “rapid response facility” should lower the bar for access and facilitate speedier decision-making in disbursing funds.

Other proposals focus on the scope of the ESM, which is currently limited to raising, administering, and disbursing program funds, whereas the formulation of economic reform measures, negotiations with crisis countries, and surveillance are carried out by the EC, the ECB, and the IMF. Concentrating these activities under the ESM roof would involve a significant build-up of expertise and staff resources. Nonetheless, it is seen as a solution to the manifold problems associated with the institutional complexities of the current setup.

Finally, there are proposals to change the legal structure of the ESM and bring it into the framework of European Law. This should resolve any remaining doubts about the legitimacy of the mechanism.

The reform discussions gained traction after the newly elected French president Macron made a range of proposals to strengthen the European Union. The ideas included a separate budget for the euro area and much closer fiscal coordination among the member countries, potentially even under the responsibility of a euro area finance minister (Macron 2017). Certainly, these ideas influenced the European Commission’s proposal in 2017 to transform the ESM into a European Monetary Fund under EU law with enhanced competencies (European Parliament 2019).

Despite well-intentioned proposals, real reform has not progressed. This is largely due to the fact that the question of ESM reform is embedded in the larger issue of reform of the monetary union. How much fiscal coordination, especially regarding tax and social security, is needed? How strictly or flexibly should the fiscal rules be applied? How much risk and burden sharing are acceptable in cases of asymmetric downturns in the area? To what extent should the ECB restrict measures that can be interpreted as trespassing into the realm of state financing? As long as these questions remain highly controversial among the member countries of the monetary union, significant ESM reforms, which would require a unanimous decision to change the ESM treaty, remain elusive. Additionally, transforming the ESM treaty into EU law would require a further unanimous decision in the European Council and the approval of the European Parliament. Finally, depending on the extent of the transfer of surveillance rights from the EC to the ESM, it is possible that even changes in the TFEU may be required, which would necessitate parliamentary ratification procedures within the
EU member countries, including those which are not members of the monetary union (Guttenberg 2017). At present, these legal hurdles appear to be insurmountable.

The fact remains, therefore, that the entire European institutional arrangement for regional financial stability is hard to improve or reform, as any significant changes require unanimous decisions by all member countries of the monetary union and might then still be challenged in the courts with a good chance of success. The advancement of the ESM into a European Monetary Fund not only by name but also in substance is thus elusive for the foreseeable future. Against this backdrop, it is hardly surprising that ESM reforms agreed upon at the Euro Summit in December 2018 will not significantly alter the current limitations and procedures (European Council 2019). The only substantial change envisioned is a role for the ESM in the eurozone banking union. The ESM is supposed to resume a backstop function for the Single Resolution Fund, which has been established to cover potential bank insolvencies in the future (ESM 2019c). The ESM is furthermore scheduled to have a role in formulating program conditionality together with the EC. Even these limited reforms, however, are currently (as of January 2020) stalled. Italy raised objections, the government requesting further changes in the design of the European Banking Union before agreeing to the ESM reform (New Europe 2019). The necessary change to the ESM treaty will furthermore require the approval of national parliaments in some member states. In the case of Germany, discussion is underway as to whether this approval may even need a two-thirds majority on constitutional grounds (Schorkopf 2018). It is therefore likely that the German Federal Constitutional Court will also be involved before Germany can give its final consent to the treaty amendment (Tofall 2019).

**8.5 Providing Regional Financial Stability in Asia**

Regional financial stability has also been an issue since the Asian crisis of 1997–1998. Contrary to the situation in Europe, however, the discussion only developed after the crisis, not at its onset. On the one hand, this has allowed more careful deliberations with regard to organizational design and processes; however, without strong pressure, progress has been incremental and the outcome remains largely untested. The European financial stability arrangement, where the crisis experience revealed its pros and cons, can therefore provide hints for effective institutional advancement in Asia.

During the Asian crisis, Japan proposed the foundation of an Asian Monetary Fund as a regional counterpart to the IMF. Resistance from
the United States (US) and disunity among the Asian countries quickly led to abandonment of the idea, presumably because a duplication of tasks and competition with the IMF were feared (Park 2017). Instead, the Association of Southeast Asian Nations (ASEAN) member countries and the People’s Republic of China, Japan, and the Republic of Korea (ASEAN +3) settled on the less ambitious idea of setting up a network of currency swap agreements among each other. This way, the Chiang Mai Initiative (CMI) took shape in May 2000. The CMI has increased its scope over time. In the beginning, the swaps were only supposed to cover short-term liquidity problems and thus had short-term maturities. These were extended step by step. Also, the agreed-on swap amounts were increased, and the network of bilateral swaps transferred into a multilateral scheme in 2010, the Chiang Mai Initiative Multilateralization (CMIM). Furthermore, a regional surveillance unit, the ASEAN+3 Macroeconomic Research Office (AMRO), accorded the legal status of an international organization in 2016, was set up in Singapore with responsibility for monitoring the economic performance of the member countries at regular intervals and implementing regional financial arrangements (AMRO 2019).

The CMI has not been active until now, even though two of its members, the Republic of Korea and Singapore, were in need of US dollars in the wake of the global financial crisis at the end of 2008. Instead of turning to their own regional financial safety net, they turned to the US to conclude bilateral swap agreements (Park 2017).

This has illuminated the weaknesses of the CMIM, which have become more apparent when contrasted with the European experience:

- Contrary to the ESM, the CMIM provides pledged funding and not paid-in funding. In the case of a force majeure, however, member countries can withdraw from their pledges and not contribute even if asked to do so, although the European sovereign debt crisis showed that funding needs to be available without delay in order to calm markets. There is no time for second thoughts during crisis fighting.

- The total financing volume of the fund amounts to $240 billion. Furthermore, a single country can only draw a fraction of this amount, ranging from $38.40 billion for Japan to $0.30 billion for Brunei Darussalam or the Lao People’s Democratic Republic. This appears to be wholly inadequate in times of a severe emergency like the Asian crisis of 1997–1998 or the global financial crisis of 2008–2009. The Republic of Korea’s and Singapore’s bilateral swap with the US each had a volume of $30 billion. Funds in the order of over €400 billion were
necessary to contain the debt crisis in Greece, Portugal, Ireland, and Cyprus, all of which belong to the smaller economies of the eurozone. Much bigger amounts would be necessary if a financial crisis hit countries like Italy, France, and Germany.

- Of the funds potentially available from the CMIM, 70% are linked to the condition that the requesting country undergoes an IMF program. This further reduces the independent firepower of the mechanism, and may also negatively influence its speed of decision-making. This issue corresponds with the European experience, where the rather unstructured cooperation with the IMF has led to frictions and delays in the process.

- The ability of AMRO to function as a credible macroeconomic surveillance unit that formulates, negotiates, and monitors economic reform programs is questionable due to inadequate capacity and standing. The lessons from the European sovereign debt crisis, however, underline the need for independent design and monitoring of economic reforms to improve the situation in crisis countries.

Some see the CMI, therefore, as a forum for enhancing trust building and mutual understanding between the participating countries, but generally inadequate and perhaps even useless in times of a real-world crisis (Pascha 2014).

Plenty of proposals have been made to improve the mechanism (e.g., Azis 2012, Park 2017). Among them is the establishment of a paid-in fund, with contributions from the currency reserves of the participating countries. The sum of these reserves is a multiple of the total financing capacity of the CMIM. Such a fund could be administered within the institutional and decision-making framework of the CMIM, or by a complete separate entity. It could furthermore raise additional capital through the issue of bonds, thus enhancing its crisis fighting capabilities (Park 2017).

Such bold ideas remain proposals. There is no indication that a serious discussion on such ideas has even started among the relevant decision makers. The reason for this appears to be that a regional financial safety mechanism is embedded in the larger question of regional economic integration. If there is no implicit or explicit understanding of how far economic integration should go, then there is no basis for the design of a credible financial safety mechanism (Grimes 2011). Considering the manifold political differences between the participating members of the ASEAN+3 area, it is not surprising that a consensus on the extent of economic integration is still elusive.
8.6 Conclusion and Policy Recommendations

Economic integration can be defined as a process whereby measures are designed with the aim of abolishing discrimination between economic units of different national states (Balassa 1961). It usually progresses in a stepwise fashion by reducing tariffs and other barriers against the free flow of goods and services and promoting the free movement of capital and labor. Further integration can be achieved with managed exchange rates and the coordination of fiscal policies, especially in the areas of tax and securities, which can then lead to a unification of monetary, fiscal, social, and countercyclical policies.

The welfare effects of economic integration are considered positive, but consideration needs to be given to the impact on income distribution and the possibility of asymmetric shocks (Stiglitz 2010), as there will always be winners and losers in the process. Moreover, if the development is seen largely to favor certain regions or groups, the integration process may come under severe political pressure. The deeper the integration, the more coordination is needed between the participating countries. Similarly, as economic integration progresses, the need for economic insurance or a financial stability mechanism increases. It appears, however, that more research is required on the relationship between the degree of economic integration and the type and level of financial stability mechanism.

Seen from this perspective, two problems can be identified with regard to the way regional financial stability has been handled in Europe:

• One is the widely discussed fact that, with respect to the monetary union, the euro area has got economic integration in the wrong order. With little or no fiscal cooperation so far, total monetary integration is bound to lead to imbalances and financial instability also in the future.

• With the no bailout clause, the EU flatly denied the need for any economic insurance or a regional financial stability mechanism in any form, despite its intention of ever-closer economic integration. When this position could no longer be maintained as a consequence of the financial crisis, the hastily constructed solution was bound to suffer serious shortcomings such as lack of credibility, legal vulnerability, and institutional awkwardness. Mending this will remain an arduous task for the foreseeable future.
Asia may draw the following lessons from the European experience:

- Steps should be taken to enhance the credibility of the regional financial stability mechanism, so that is seen to be of real practical use in times of need. For this purpose, a centralized fund made up of paid-in contributions by participating members could deliver a signal of stronger commitment than the current system of pledged funding. Initially, it may be sufficient to raise an amount that would cover a crisis in one of the smaller countries of the region, as probably no amount of paid-in capital would be sufficient to cover a crisis in one of the bigger countries or the entire region.

- The institutional structure and decision-making procedures should be kept transparent and simple. Only one institution—for example, an enhanced AMRO—should be in charge. The decision-making procedures should allow at least qualified majority voting, as experience shows that unanimous decisions or veto powers may easily bring the whole system to a halt.

- The relationship with the IMF needs to be recalibrated in such a way that it does not hinder quick and independent action within the region—as the current linkage between CMIM funding and IMF oversight may do—and that competition between the IMF and the regional mechanism does not arise. The literature offers various proposals to this end (Rhee, Lea, and Shahin 2013). A straightforward solution may be an agreement with the IMF to provide financial assistance to the regional financial safety mechanism in times of crisis, rather than directly to the individual countries.
References


9

Reflections on the Development of Regional Financing Arrangements: Experiences from Europe

Gong Cheng

9.1 Introduction

In the past decade, Europe has suffered two successive and interlinked crises, the global financial crisis and the euro area debt crisis. The crises encouraged policy makers to implement a package of reforms, aimed at enhancing the resilience of the European Union (EU), in particular that of the currency union, the euro area. The European Central Bank (ECB) adopted unconventional monetary policy measures to stimulate credit growth and economic recovery. EU member states revamped union-wide economic governance and policy coordination. The EU also centralized the supervision and resolution of systemically important banks with the creation of the Banking Union. Finally, severe liquidity pressures that a number of EU members faced during the crisis drove the strengthening of crisis resolution mechanisms and the creation of the European Stability Mechanism (ESM). The literature has largely focused on the

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1 The views in this chapter are the author's and are neither those of the Bank for International Settlements nor those of the European Stability Mechanism. I thank Rimtautas Bartkus, Nicola Giammarioli, Michele Hamel, Ilhyock Shim, and Rolf Strauch for their insightful comments. I thank colleagues of the ASEAN+3 Macroeconomic Research Office, especially Ika Mustika Sari and Wang Hongbo, for their useful comments on the development of the Chiang Mai Initiative Multilateralization. I also thank the participants in the ADB workshop “Strengthening Regional Surveillance and Financial Safety Net Mechanisms in Asia,” especially Junkyu Lee and Peter Rosenkranz, for the constructive discussions. Finally, I thank Lea Caillouet for her excellent research assistance.
effect of the ECB’s monetary policy on crisis resolution, EU economic policy coordination, and progress toward the Banking Union. Therefore, this chapter aims to shed light on the development of European financial backstops, so-called “regional financing arrangements” (RFAs), with a particular focus on the ESM.

Another reason to focus on the European financial firewalls is that since the global financial crisis there have also been several attempts to create or strengthen RFAs in other parts of the world. For instance, the Latin American Reserve Fund (Fondo Latinoamericano de Reservas or FLAR) increased its subscribed capital by 40% in 2012 and the Arab Monetary Fund doubled its authorized capital in 2013 (Cheng et al. 2018). Six members of the Eurasian Economic Community created an anti-crisis fund with $8.5 billion in firepower in 2009, which evolved into the Eurasian Fund for Stabilization and Development in 2015 (Cheng, Miernik, and Turani 2019). In line with the European experience, the Association of Southeast Asian Nations plus the People’s Republic of China, Japan, and the Republic of Korea (ASEAN+3) pooled resources for crisis resolution and agreed on the Chiang Mai Initiative (CMI) as a response to the Asian financial crisis in 1997–1998. During the recent global financial turmoil, the CMI evolved from a set of bilateral arrangements into a single and multilateral contract, i.e., the Chiang Mai Initiative Multilateralization (CMIM). Its overall financing capacity increased to $240 billion in 2014 from $120 billion previously agreed (Cheng et al. 2018). A surveillance unit—the ASEAN+3 Macroeconomic Research Office (AMRO)—was also created in 2011 to support CMIM operationalization and decision-making.

This chapter has a dual objective. First, it provides an overview of the evolution of the different layers of the financial firewalls in Europe, and the change in mentality that spurred the setting up of a euro area-specific RFA, the ESM. Second, it aims to draw some potential lessons from the European experience for East Asia. An RFA is normally set up to address regional specific issues, e.g., economic shocks to which a region is particularly prone. The literature on RFAs (such as Rhee, Sumulong, and Vallée 2013) often casts doubt on the comparability between the Asian and European RFAs, especially between the ESM and the CMIM, given their very different mandates. This chapter will argue that the different mandates were fixed to deal with specific regional crises, but that they both aim to provide a regional line of defense to prevent future crises or to provide emergency liquidity to their member governments when a crisis occurs.

This chapter will first present the key features of the development of European RFAs since the global financial crisis (section 9.2). It will then discuss four sets of issues that were primordial in designing the
European RFAs (section 9.3). This section aims to shed light on: (i) what mandate an RFA assumes and what types of shocks it is created to deal with; (ii) the extent to which an RFA’s tool kit should be tailored to regional needs; (iii) the choice of an RFA’s funding strategy; and (iv) the impact of the governance structure on an RFA’s decision-making process.

9.2 Overview of the Development of European Regional Financing Arrangements

9.2.1 Crisis-Fighting Objectives Evolved from a Balance-of-Payments Focus to a Broader Financial Stability Perspective

Before the onset of the global financial crisis, the EU had only one crisis resolution mechanism, the EU balance-of-payments facility (EU BOP), designed to deal with medium-term financing constraints in member states. This facility, created in 1972 for the members of the European Economic Community (EEC), became a single facility in 1988 after the establishment of the Single Market by Council Regulation No. 1969/88. Italy, Greece, France, and Ireland used this instrument in the past before the recent financial turmoil. The EU BOP facility functions like International Monetary Fund (IMF) loans and provides short- to medium-term foreign currency liquidity to a member state facing trade imbalances or disruptive capital flows as a result of exchange rate misalignment.

With the creation of the euro, euro area countries ceased to use their national currencies, thereby eliminating nominal exchange rate volatilities among them. Since then, only EU members that have not yet adopted the euro have been eligible for the EU BOP facility. The overall size of the EU BOP facility was fixed at €12 billion in 2002, compared to 16 billion in European Currency Units before the euro was created.

Eligible EU member states did not use the EU BOP facility until the Lehman Brothers collapse. Hungary was the first to apply for joint balance-of-payments assistance from the IMF and the EU BOP facility in October 2008, totaling €14.2 billion, of which €8.7 billion came from the IMF and €5.5 billion from the EU BOP facility. Latvia and Romania followed, requesting financial assistance in December 2008 and spring 2009, respectively. Facing increasing demand for balance-of-payments assistance, the facility’s initial size proved insufficient. As a quick response to the global financial crisis, the EU twice increased the facility. Council Regulation No. 431/2009 raised the limit to €25 billion
in December 2008 from €12 billion in 2002 and to the final amount of €50 billion in May 2009. From 2008 to 2015, the EU BOP facility made available €18 billion for Hungary, Latvia, and Romania, of which it disbursed €13.4 billion. Romania, in particular, requested three programs in total, i.e., a loan facility and two precautionary credit lines that were not drawn upon in the end. Figure 9.1 shows the financial split from all contributing parties for these three countries. Hungary exited its EU BOP facility program on 3 November 2010 and the post-program monitoring also ended in January 2015. The Latvian balance-of-payments program ended on 19 January 2012 and the post-program monitoring in the country terminated in January 2015. The first Romanian program ended in 2011 with two successive precautionary arrangements until 2015; its post-program monitoring ended in 2018.

![Figure 9.1: Recent EU Balance-of-Payments Facility Programs](image)

EU BOP = European Union balance-of-payments facility, IMF = International Monetary Fund.

Note: All figures indicate the financial commitment, which may differ from actual disbursements. Other financing sources for Latvia include Nordic countries (Sweden, Denmark, Finland, and Estonia), the European Bank for Reconstruction and Development (EBRD), Czechia, and Poland. Other financing sources for Romania include the European Investment Bank and the EBRD.


While the EU members that have not adopted the euro were protected by the EU BOP facility against balance-of-payment shocks, euro area member states seemed unprotected on the eve of the European banking and sovereign debt crisis. A common belief was that adopting the euro removed intraregional exchange rate volatilities and the strong fundamentals of the monetary union could ensure its members
had sustained access to financial markets. In addition, the Maastricht Treaty and the Stability and Growth Pact introduced clear fiscal rules aimed at ensuring fiscal discipline in the EU, especially for its members using the single monetary policy. Deviations from the preset rules would imply necessary policy corrections to restore market confidence. The recent financial tremors in Europe challenged this common view; they revealed the vulnerabilities of currency union members in the absence of a common fiscal backstop. Not only had financial markets undervalued sovereign risk in anticipation of some form of regional solidarity should crises occur, but the spillovers between currency union members proved to be much stronger than in other regions.

More importantly, the problems some euro area countries faced did not take the form of traditional balance-of-payments shocks, but stemmed instead from deep homegrown roots, for instance interlinkages between public finance and domestic banks’ resilience or accumulation of fiscal imbalances over years. In some countries, domestic banks were the first hit during the crisis. To prevent a complete collapse in banking systems, European governments rescued their banks with urgent support amounting to €1.6 trillion between 2008 and 2011, the equivalent of 13% of the EU’s annual gross domestic product (GDP). The need for some sovereign governments to bail out domestic banks drove public finance into large deficits. As an example, markets cast doubt on the refinancing capacity of the Irish government when it recapitalized domestic banks. Its banking crisis then evolved into a government liquidity problem. On the other hand, as recession deepened across the euro area, it became clear that some euro area governments, such as Greece, had borrowed heavily to finance budgets for some years. The accumulation of public debt weakened market confidence and increased sovereign default probability in these countries. Tainted government creditworthiness in turn undermined domestic banks’ balance sheets given their large holding of impaired sovereign assets. In short, a sovereign-bank diabolic loop (Brunnermeier et al. 2016) was at work in the euro area crisis.

Therefore, in 2010, policy makers needed to design specific backstops to resolve the euro area financial turmoil. The objective shifted from a pure balance-of-payments focus to a financial stability perspective.

### 9.2.2 Shifting from Bilateral to Multilateral Financial Assistance

The first financial assistance support for a euro area country was bilateral. On 2 May 2010, the Eurogroup agreed to provide the so-called “Greek Loan Facility (GLF),” i.e., an €80 billion bilateral loan commitment for Greece from May 2010 to June 2013, complemented by a €30 billion loan from the IMF, under the Stand-By Arrangement (SBA).
Pooling bilateral loans was the quickest way to mobilize resources to help Greece. Fitch, Moody’s, and Standard & Poor’s had downgraded the country’s credit rating to junk bond status on 27 April 2010. In response, risk premiums on long-term Greek government bonds surged and the country was cut off from financial markets. At that time in 2010, euro area politicians might have thought that bilateral assistance was sufficient to help Greece, an economy that formed only 2% of euro area GDP. However, this bilateral arrangement quickly demonstrated some weaknesses. Without institutional reinforcement, bilateral arrangements were subject to economic circumstances in creditor countries. The initial €80 billion GLF commitment shrank by €2.7 billion because the Slovakian Parliament rejected the inter-creditor agreement on the Greek bailout. Ireland and Portugal stepped down from the facility when they requested financial assistance themselves, making it difficult to coordinate simultaneous financial assistance programs through bilateral arrangements.

While disbursing the first tranches of the financial aid to Greece from the GLF, European leaders started to seek regional solutions for multilateral financial assistance. In this context, the European Financial Stabilisation Mechanism (EFSM) was established in May 2010 and a month later, on 7 June 2010, the European Financial Stability Facility (EFSF) was created.

Established by Council Regulation (EU) No. 407/2010, the EFSM extends the EU BOP facility to the full EU membership in order to cover euro area countries in case of financial turmoil. It can provide financial assistance “to all 28 EU Member States where (i) a Member State is experiencing, or is seriously threatened with, a severe financial disturbance; (ii) the financial disturbance or threat of financial disturbance is due to events beyond the control of the Member State concerned” (Council Regulation (EU) No. 407/2010). Unlike the GLF, the EFSM is a multilateral framework, financed by the European Commission’s borrowing from financial markets. Market financing takes the form of security issues backed by the EU budget. The EFSM’s maximum lending capacity is slightly higher than the EU BOP facility, reaching €60 billion. EFSM financial assistance can be a loan or a precautionary credit line.

Since its creation, this mechanism has provided financing to Ireland and Portugal for a total committed amount of €22.5 billion (fully disbursed) and €26 billion (of which €24.3 billion were disbursed), respectively. Both countries exited their programs successfully and entered post-program surveillance. The EFSM was created to temporarily ease financial instability in Europe, and some governments,
including the United Kingdom, opposed the use of the EFSM to fuel big future bailouts for EU member states. Non-euro area countries have been particularly concerned by the dual need to bolster both the EU BOP facility and the EFSM. Following the end of the Irish and Portuguese programs, the EFSM has since provided only short-term financing of €7.16 billion to Greece, in July 2015, for the country to transfer to an ESM from an EFSF program. The Council Regulation establishing the EFSM was amended in August 2015 (Council Regulation (EU) 2015/1360) to emphasize the exceptional nature of EFSM financing, especially after the euro area permanent crisis resolution mechanism, the ESM, was created. In addition, non-euro area countries required appropriate guarantees and collateral to ensure that they would be “fully compensated in the event of non payment under the EFSM facility.”

The EFSF, another multilateral crisis resolution mechanism, was created in 2010 alongside the EFSM and it is euro area specific covering 17 countries: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Malta, Portugal, Slovenia, Slovakia, and Spain. Latvia and Lithuania adopted the euro after the EFSF ceased to grant new loans in July 2013; therefore, neither country is a member state and guarantor of the EFSF. Compared with the EFSM, the EFSF has a different financial structure, giving it much bigger firepower. The EFSF receives guarantees from its member states based on a contribution key, with which it issues securities and raises funds to finance countries in need. Backed by €779 billion in guarantee commitments, the EFSF has a lending capacity of €440 billion after the heads of state and government agreed to increase the EFSF’s scope in July 2011. Since its inception, the EFSF has assisted Ireland (€17.7 billion commitment) and Portugal (€26 billion commitment), alongside the EFSM and the IMF. It also cofinanced with the IMF the second macroeconomic adjustment program for Greece from February 2012 to 2015 with a total financial envelope of €144 billion, making the EFSF the Greek government’s biggest creditor.

9.2.3 Converting Temporary Crisis Resolution Funds into a Permanent Firewall

The EFSF was only expected to exist temporarily. The EFSF Framework Agreement stipulates that the EFSF be liquidated “on the earliest date after 30 June 2013 on which there is no longer Financial Assistance outstanding to a euro-area Member State and all Funding Instruments issued by EFSF and any reimbursement amounts due to Guarantors have been repaid in full” (Article 11 of the EFSF Framework Agreement).
However, the escalating debt crisis demonstrated that temporary measures might not be enough to restore market confidence and sustain market access for countries hit by crises. The heads of state or government quickly reached consensus on 28 and 29 October 2010 within the European Council on a permanent crisis mechanism to safeguard euro area financial stability. While the EFSF was providing financing to the Irish, Portuguese, and the second Greek economic adjustment programs, euro area members started technical and political preparations to establish the ESM. Finance ministers of the then 17 euro area countries signed an original intergovernmental treaty to establish the ESM on 11 July 2011. An amendment was introduced shortly after on 2 February 2012 to improve the effectiveness of the mechanism. The ESM Treaty entered into force on 27 September 2012 and the ESM was inaugurated on 8 October 2012, following ratification of the Treaty by all 17 euro area member states. Latvia and Lithuania successively joined the ESM in 2014 and 2015 after becoming euro area members.

The EFSF ceased to engage in new financing programs from 1 July 2013, and the ESM then became the sole permanent crisis resolution mechanism in the euro area. The EFSF will continue managing its outstanding debt until fully repaid.

The permanent ESM institutionalization presents several advantages. First, the ESM’s capital structure is much stronger than the EFSF’s guarantee schemes, as ESM members paid in €80.55 billion of its capital and established clear mechanisms to mobilize the remaining €624.25 billion of callable capital in the ESM Treaty. In addition, the ESM enjoys preferred creditor status, only junior to the IMF, whereas EFSF loans rank pari passu with other creditors. Credit rating agencies recognize these features by assigning higher ratings to the ESM (currently rated AAA by Fitch). In addition, the funds that the EFSF raises from the market are seen as national debt, because its member states provide direct guarantee commitments. The ESM, in contrast, is considered a self-standing international institution whose liabilities—ESM securities—are detached from member states, and thus do not increase their national debt.2

Between 2013 and 2018, the ESM provided assistance to Spain (€100 billion financial commitment), Cyprus (€10 billion commitment), and Greece (the third Greek program, up to €86 billion commitment).

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With Greece exiting its ESM program in August 2018, all three countries terminated their programs and entered post-program monitoring. Figure 9.2 illustrates the involvement of the EFSF and ESM in all euro area programs in cooperation with other peer institutions.

The development of European RFAs since 2010, in particular the transition from temporary resolution mechanisms to the permanent euro area financial backstop, also required overcoming various legal hurdles. Before the crisis, the EU treaties did not allow temporary transfers among member states for crisis resolution. To set up the ESM, EU member states decided to make crisis resolution an explicit option for euro area members under a set of defined conditions. Using a simplified procedure for treaty change foreseen in Article 48(6) of the Treaty on the European Union, the European Council introduced in 2010 a third paragraph into Article 136 of the Treaty on the Functioning of the European Union: “The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any

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**Figure 9.2: Euro Area Programs and Relative Financial Contributions**

<table>
<thead>
<tr>
<th>Country</th>
<th>EFSM</th>
<th>EFSF</th>
<th>ESM</th>
<th>IMF</th>
<th>Other</th>
</tr>
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<tbody>
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<tr>
<td>Greece II</td>
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<tr>
<td>Greece III</td>
<td>19.8</td>
<td>86</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

EFSM = European Financial Stabilisation Mechanism, EFSF = European Financial Stability Facility, ESM = European Stability Mechanism, IMF = International Monetary Fund.

Note: All figures indicate the initial financial commitment, which may differ from actual disbursements. Other financing for Ireland comes from bilateral loans from Sweden, Denmark, and the United Kingdom, as well as funds from the Irish Treasury and National Pension Reserve Fund. Other financing for Greece I comes from the pooled bilateral loans from European countries, the so-called “Greek Loan Facility.” The undisbursed amounts under Greece I were transferred to Greece II.

Source: Author’s calculation.
required financial assistance under the mechanism will be made subject to strict conditionality.”

In addition, a few national courts, such as those of Germany, Ireland, and Estonia, judged the compatibility of the financial assistance under an ESM program and the procedure for capital calls with the EU Treaties. The legal questions focused on whether member states have the right to establish a permanent crisis resolution mechanism, whether the ESM subverts the EU’s coordination role for economic policies, and whether the ESM financial assistance violates the “no-bailout principle” enshrined in Article 125 of the Treaty on the Functioning of the European Union. At the end, the European Court of Justice (ECJ) confirmed the compatibility of setting up a permanent crisis resolution mechanism and providing financial assistance to member states with EU Treaties in the Pringle judgment (case C-370/12), which was exceptionally rendered in a plenary session. The preliminary ruling was rendered in a record time of 4 months. As a result, financial assistance among euro area member states is legalized and subject to two cumulative conditions. First, the country receiving assistance must remain responsible for its commitments to its creditors; and second, financial assistance is subject to strict conditionality, to propel the beneficiary member state into implementing a sound budgetary policy.

To conclude, the EU has established or strengthened three layers of protection against future economic shocks since 2009. The ESM is the permanent crisis resolution mechanism for euro area financial stability, replacing the temporary crisis resolution fund—the EFSF. EU members outside the euro area can benefit from the EU BOP facility for balance-of-payments shocks. The EFSM covers the entire EU membership to prevent or treat a severe financial disturbance in exceptional circumstances.

9.3 Some Reflections from the Development of European Regional Financing Arrangements

The overview of European RFAs’ development sheds light on a number of questions that are crucial for an RFA to be functional and to respond to specific regional needs for crisis prevention and management. Building on the ESM’s experience, this section highlights four core and interlinked issues: an RFA’s mandate and the types of shocks it aims to tackle, its tool kit design, its funding strategy, and how its governance structure influences decision-making.
9.3.1 A Specific Mandate to Deal with Specific Shocks

An RFA is often created in a specific context to fulfill a clearly defined regional mandate. Its mandate, i.e., what an RFA is created for and what kinds of shocks it is intended to deal with, will condition the operational features of the institution. Article 3 of the ESM Treaty states that “the purpose of the ESM shall be to mobilise funding and provide stability support under strict conditionality, appropriate to the financial assistance instrument chosen, to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its member states.” The ESM’s mandate in safeguarding euro area financial stability is closely related to the types of crises this financial backstop is supposed to combat. In contrast to other regions, which are mostly vulnerable to foreign-currency capital reversals or exchange rate misalignments, the euro area has primarily faced intraregional imbalances and a sovereign-bank feedback loop in recent crises. The transmission channels between public finance and banking sector resilience are particularly strong in a currency union. In comparison, the CMIM’s core objective is to address balance-of-payment difficulties, and to alleviate member states’ short-term United States (US) dollar liquidity shortages.

Historical crisis data compiled by Reinhart and Rogoff (2011) also suggest that the euro area and the ASEAN+3 region faced different shocks in the past, thereby motivating the distinct mandates of their regional financial firewalls. Figure 9.3 shows that while the euro area was mainly facing a banking crisis in 2008–2010, the 1997–1998 Asian financial crisis was principally a twin currency-banking crisis with implications for stock markets. In comparison, FLAR member countries experienced shocks of a different nature during the Latin American crisis of the 1980s. Currency depreciations, inflation surges, and external debt problems were the most salient. Therefore, in designing financial firewalls, the euro area mostly targeted financial stability, especially banking sector resilience. The ASEAN+3 region needs to tackle potential twin crises with currency mismatches. In addition, FLAR memberships ought to add one more dimension to include foreign debt management.

An RFA might also need to adapt its mandate to the changing regional and international environment to deal with new challenges and risks. The role of the ESM in euro area programs has evolved over time following the shareholders’ reviews. At the beginning, the EFSF—the ESM’s predecessor—functioned as a cash machine, only responsible for raising money and disbursing loans. The ESM has taken on additional
tasks and has been more closely involved in the design and monitoring of the programs. For instance, the ESM led the debt sustainability analysis in the ESM Greek program. What was first a troika has become a quartet.

Currently, EU countries are working toward strengthening the currency area with many new reforms, including assigning a bigger role to the ESM in safeguarding euro area financial stability. EU member states have already agreed for the ESM to provide a credit line to the newly established Single Resolution Fund in the Banking Union when its funds to save systemically important banks fall short. This would require a change of the ESM’s mandate defined in the current treaty, as the credit line from the ESM to the Single Resolution Fund would constitute interinstitutional lending, while the current treaty only allows the ESM to lend to a member state. Enhancing the role of the ESM in crisis management is another topic of reform. Given that the current ESM Treaty is not explicit on its preventive function, the reforms are likely to develop it by allowing the ESM to join the European Commission for economic surveillance over the 19 euro area members based on the

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**Figure 9.3: Average Occurrence of a Given Crisis in Memberships of Regional Financing Arrangements**

- **Euro Area 2008–2010**
- **ASEAN+3 1997–1998**
- **FLAR 1980–1989**

Legend:
- ■ Currency
- □ Inflation
- ▪ Stock market
- □ Domestic debt
- ■ External debt
- □ Banking

**Note:** Crisis classification and data come from Reinhart and Rogoff (2011). Reinhart and Rogoff’s database includes only 11 euro area countries and nine ASEAN+3 countries while FLAR’s full membership, i.e., eight countries, is covered. The average occurrence of a crisis is calculated as the total number of shocks divided by the number of countries in the sample for a given regional financing arrangement.

Source: Author’s depiction based on Reinhart and Rogoff (2011).
ESM’s complementary technical expertise. In addition, some proposals also support the idea of the ESM providing liquidity to smooth business cycles, whereas the current treaty confines ESM interventions to tail and systemic shocks.

Other RFAs may face similar situations in the future when their mandates need to keep pace with the changing business needs in their regions.

9.3.2 A Regional Financing Arrangement’s Tool Kit Should Be Tailored to Regional Needs

An RFA’s mandate largely conditions the tool kit it will have to fulfill it. Ideally, if an RFA’s mandate aims to address regional vulnerabilities, its tool kit, lending policies, and financing terms should best accommodate those regional needs. This would also enhance RFAs’ complementarity vis-à-vis the global crisis fighter, the IMF.

Figure 9.4 gives an overview of the ESM tool kit compared with that of the IMF under the General Resources Account to highlight regional specificities in Europe. The ESM’s loan facility, the so-called “Macroeconomic Adjustment Program,” constitutes its workhorse instrument and is similar to the IMF’s SBA and its Extended Fund Facility. The objective of these loans is to provide emergency resources to fill a budgetary financing gap in the requesting member state in the short run in exchange for policy corrections. In the long run, the loan facility would enable its user countries to regain market financing and keep their public debt sustainable. In addition, the ESM also has two precautionary instruments, the Precautionary Conditioned Credit Line and the Enhanced Conditions Credit Line, which mirror the IMF’s Flexible Credit Line and Precautionary and Liquidity Line. Precautionary financial assistance is aimed at supporting sound policies and preventing crises by allowing ESM members to secure a credit line before they face major financing difficulties in capital markets. This type of instrument is particularly important if an RFA wants to send positive market signals to enhance investors’ confidence or to prevent potential crisis spillovers to stand-by countries. The current reforms of the ESM tool kit are aimed in particular at enhancing the predictability and attractiveness of its precautionary instruments.

The reforms are subject to political decisions at the highest level in the EU. However, the European Commission and the ESM published a joint position on their collaboration, which touches on potential new ESM mandates.
Given that the ESM’s mandate has a strong focus on financial stability, it has been equipped with specific financial sector and market-oriented tools. For instance, it can provide a loan to a member’s government specifically for banking sector recapitalization. This is by nature a sectoral lending instrument that the IMF does not have. With this instrument, the ESM provided a €100 billion financial envelope to Spain for banking reform, out of which €41.3 billion were actually disbursed between December 2012 and February 2013. This assistance enabled Spain to recapitalize while limiting negative spillovers to public finances. There are also policy conditions attached to these loans but they mainly focus on the requesting country’s financial sector, e.g., strengthening financial supervision and corporate governance, establishing domestic laws relating to restructuring and resolution mechanisms, etc. In addition to this indirect bank recapitalization tool, the ESM can use an ultimate weapon—Direct Recapitalization of Institutions—in exceptional circumstances. It would enable the ESM to participate directly in the capital of a bank whose viability needs to be restored. This tool is aimed at severing the feedback loop between the balance sheet of the sovereign government and that of banks.

The ESM also has two side instruments as highlighted in purple in Figure 9.4: primary and secondary market support facilities. Instead of providing a standard loan, the ESM may purchase debt securities issued by a beneficiary member country in the primary or secondary market. The advantage of this market operation over direct loans is that it allows the beneficiary member to maintain or restore its relationship with the investment community and therefore reduce the risk of failed auctions in crisis times. These two complementary tools also reflect the particular attention that the ESM pays to its members’ market access.

The ESM’s lending policies and the financial terms of its assistance also mirror regional specificities. Table 9.1 demonstrates that ESM facilities have in general lower financial costs and much longer maturities than the IMF’s General Resources Account instruments. The ESM governing bodies specifically selected the longer maturities to accompany the beneficiary members while they implemented longer-term structural reforms. These financing features, which are also documented in Corsetti, Erce, and Uy (2017), demonstrate a strong regional solidarity. Low-cost and long-term EFSF/ESM loans to Greece save the country about €12 billion per year, or 6.7% of its GDP, compared to market financing (ESM 2019). Moreover, all ESM instruments provide assistance in euro, the common currency. This underlines that the instability the ESM is created to deal with results from intraregional financial and fiscal problems, rather than from foreign-currency liquidity shortages.
Based on the European experience, the CMIM can consider three issues pertaining to tool kit design. First, the CMIM currently possesses two instruments: a stability facility and a precautionary facility. Both instruments are aimed at providing dollar liquidity to a member state hit by a balance-of-payments crisis. Given the large-scale cross-border bank flows and growing importance of fintech financing, the ASEAN+3 region may need to tackle financial stability issues directly in the future. Moreover, the CMIM financing is based only on US dollars. This reflects the dominance of the US dollar in regional trade and financial transactions. Given increasing regional financial integration (ADB 2018)
Table 9.1: Financing Terms of IMF SBA and EFF vs. ESM Loan Facility

<table>
<thead>
<tr>
<th>Loan Size</th>
<th>Base Rate</th>
<th>Margins/Surcharge</th>
<th>Repayment Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>IMF</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Normal access:</td>
<td></td>
<td>Basic margin: 100 bp</td>
<td>SBA: 5 years maximum</td>
</tr>
<tr>
<td>up to 145% (annually) and 435% (cumulatively in a program) of a country’s quota</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Exceptional access:</td>
<td></td>
<td>SDR rate (1.1% as of 31 December 2018)</td>
<td>EFF: 10 years maximum</td>
</tr>
<tr>
<td>no explicit upper limit, conditional on the IMF’s forward commitment capacity</td>
<td>Surcharge: 200 bp on credit outstanding &gt; 187.5% of quota Additional 100 bp if repayment period exceeds 36 months (SBA) or 51 months (EFF)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The IMF SBA for Greece in 2010 reached 3212% of the country’s quota</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ESM</td>
<td></td>
<td>Loans: 10 bp</td>
<td>Flexible approach:</td>
</tr>
<tr>
<td>Flexible approach:</td>
<td></td>
<td>Indirect bank recapitalization: 30 bp</td>
<td>no preset rules</td>
</tr>
<tr>
<td>no preset upper limit</td>
<td></td>
<td>Possible penalty interest on overdue amounts</td>
<td>Effective average maturities range between 12.5 and 42.65 years</td>
</tr>
<tr>
<td>Cost of funding (0.61% as of 31 December 2018)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>bp = basis point, EFF = Extended Fund Facility, ESM = European Stability Mechanism, IMF = International Monetary Fund, SBA = Stand-By Arrangement, SDR = special drawing rights. Source: Author’s calculation based on IMF and ESM pricing policies and Cheng, Miernik, and Turani (2019).</td>
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</tbody>
</table>

and the broader use of two regional currencies, the renminbi and the yen, CMIM decision makers could also consider denominating part of CMIM resources in one of the regional currencies to reflect strengthened regional economic linkages among ASEAN+3 countries. In this regard, AMRO published a joint research study in 2019 that explores the plausibility of local currency contribution to the CMIM (Sussangkarn et al. 2019). Finally, as some CMIM resources can only be mobilized jointly with an IMF program, one specific issue is the compatibility of the CMIM repayment period, which needs to reflect the IMF’s preferred creditor status and financial assurance policy for cofinanced programs. The ASEAN+3 Finance Ministers and Central Bank Governors decided in 2018 to extend the length of the CMIM supporting periods under the IMF-linked portion (AFMGM 2018). Cheng et al. (2018) shed light on the potential complementarity in IMF and RFA instruments in
terms of repayment periods. Cheng, Miernik, and Turani (2019) argue in particular that the ESM could complement the IMF's workhorse instruments with its long-term instruments whereas the CMIM stability facility, especially the delinked portion, could provide a quick first line of defense against a liquidity shock of a limited scope.

### 9.3.3 Regional Financing Arrangements’ Mandate Also Conditions Their Funding Strategy

Another crucial issue that RFA shareholders need to decide upon is how to fund the RFAs’ assistance programs. Cheng and Lennkh (2018) studied the typology of RFAs’ financial structures, as shown in Figure 9.5.

![Figure 9.5: Diverse Funding Strategies among Regional Financing Arrangements](image)


Source: Author’s depiction based on Cheng and Lennkh (2018).
The European RFAs finance their programs exclusively by issuing supranational bonds and bills. EU BOP and EFSM funding activities are backed by the EU budget. The EFSF and ESM’s fundraising capacity is ensured by the very strong political and financial support of their respective shareholders. The EFSF’s debt issuance benefits from an irrevocable and unconditional guarantee from 13 euro area member states. Total guarantees amount to 165% of the EFSF’s outstanding securities, ensuring over-collateralization of the EFSF’s debt issuance. As of November 2018, the AAA-rated member states (Moody’s rating scale) contribute to 35.5% of total guarantees, covering nearly 57% of the EFSF’s issues. The ESM possesses even stronger capital buffers thanks to the capital structure provided by its 19 members. The mechanism has €80.55 billion of paid-in capital and €624.25 billion of callable capital. The paid-in capital, together with the retained earnings in a specific reserve fund, cannot be lent to members but must be invested in high-quality securities. The mechanisms that allow calling for additional capital serve as a strong buffer to protect ESM bondholders (Article 9 of the ESM Treaty).

For funding activities, the ESM uses capital market and money market instruments. Capital market tools include benchmark bonds with maturities of 1 to 45 years. The ESM may hold its own bonds for a limited amount, to raise additional funding by selling them on the secondary market or by using them as collateral in the secured money market. The ESM may also issue promissory and/or registered notes. The ESM issues bills through regular auctions and may engage in unsecured money market transactions. Transactions may be conducted overnight, on a rolling basis, or for tenors of up to 1 year. The ESM may also issue commercial paper and money market promissory notes, as well as engaging in repo transactions. It has established liquidity lines with ESM members’ debt management offices and a network of credit lines with private banks. Overall, ESM securities are very safe and liquid and the Basel Committee on Banking Supervision has designated ESM securities as Level 1 High-Quality Liquid Assets, which are therefore included in the list of entities receiving a 0% risk weighting under Basel II.

In contrast to the European RFAs, the CMIM and the Brazil, Russian Federation, India, People’s Republic of China, and South Africa (BRICS) Contingent Reserve Arrangement can only use their member states’ contributions for assistance programs. The contributions for

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4 Note that Cyprus, Greece, Ireland, and Portugal ceased acting as EFSF guarantors because they borrowed from the facility. They are expected to return as guarantors once their ratings improve and are beneficial to the EFSF’s overall ratings.
these two arrangements are based on the financial commitments among the participating countries’ central banks, and are not paid in with the RFA. While the Eurasian Fund for Stabilization and Development also bases its lending only on member states’ contributions, $3.059 billion is paid in out of a total subscribed capital of $8.153 billion. This particular feature of the swap line-based RFAs casts doubt on the predictability and swiftness of their liquidity provision in times of crisis, thereby motivating regular test runs to ensure that the funds can be pooled from different central banks and channeled to the central bank of the country requesting assistance.

To enhance predictability in the future, CMIM members could consider making part of the total $240 billion stand-by and immediately available, for instance the “delinked portions,” i.e., 30% of CMIM resources that can be mobilized without an IMF program. This is equivalent to $72 billion. The paid-in contributions could send a stronger signal to the market on the readiness of the CMIM to deal with future shocks. In noncrisis periods, the paid-in resources can be invested in highly secured and liquid assets, which could also constitute an additional income stream for the ASEAN+3 financial backstop.

If the CMIM was to consider tapping financial markets in the future, member states would need to think about a few design questions, for instance the capital structure, the relative weight between paid-in and callable resources, and the interaction with rating agencies. Cheng and Lennkh (2018) put forward a dynamic relationship between the creditworthiness of member states, their relative contribution to the RFA, and the split between paid-in and callable capital. On the one hand, the higher the paid-in capital—which represents a direct transfer from the member states to an RFA—the larger the borrowing capacity of an RFA, and thus the higher its financial assistance capacity. On the other hand, the larger the callable capital, especially when it is associated with the highest-rated member states, the higher member states’ support is perceived by the markets, and the higher the creditworthiness the RFA possesses to raise funds on its own. Figure 9.6 compares the rating history based on RFA shareholder support between the ESM, FLAR, and the CMIM. Given the share of the Plus Three countries (the People’s Republic of China, Japan, and the Republic of Korea), the CMIM could potentially benefit from a relatively strong support rating. The example of FLAR also shows that a good management and an excellent repayment record—no FLAR member states have ever defaulted on FLAR’s credit—could raise an RFA’s credit rating, even several notches above that of the supporting membership.
9.3.4 Governance Structure and Decision-Making

Finally, the governance structure and decision-making procedure will directly affect an RFA’s operations. The governance structure not only reflects the balance of power among the member states, but it will also condition the swiftness of liquidity provision and conditionality design, wherever that is relevant. Figure 9.7 maps out the governance structure and voting procedure in different RFAs regarding the decision to grant an assistance program. The IMF was introduced as a reference point. The ESM seems to have the most demanding decision-making structure as granting financial assistance requires the unanimity of 19 euro area
finance ministers. In some members, finance ministers must also submit the prepared financial assistance program to members of their national parliaments for approval.

The ESM’s highest decision-making organ is its board of governors (BOG), which consists of finance ministers of the euro area member states. The European Commissioner for Economic and Monetary Affairs and the ECB president may participate as observers. The BOG meetings are chaired by a chairperson, who has been the president of the Eurogroup since the inception of the ESM. The BOG makes decisions regarding financial assistance, capital increases, ESM membership, and the managing director’s appointment. The most important decisions, including whether to provide stability support to an ESM member state, the choice of instruments, conditions, and terms of such support, require mutual agreement among governors. In a number of other areas highlighted in Article 5 of the ESM Treaty, the BOG makes decisions by a qualified majority, defined as 80% of the votes cast with voting rights equal to the number of shares allocated to each country. In addition,
each governor in the ESM BOG appoints one director and one alternate director that form the board of directors (BOD). The BOD works based on the competences delegated by the BOG and ensures that the ESM is run in accordance with the ESM Treaty and the by-laws.

The managing director, who is nominated by the BOG, chairs BOD meetings and conducts the day-to-day business of the ESM with assistance from the ESM management board. The managing director also serves as the ESM’s chief of staff and legal representative. The current ESM managing director is Klaus Regling, nominated in 2012 for an initial 5-year term and reappointed for a second term from 8 October 2017.

As regards the decision-making procedure for the ESM to grant financial assistance, the ESM Evaluation Report (Tumpel-Gugerell 2017) sheds light on the extensive involvement of ESM/EFSF governing bodies in elaborating decision criteria and in setting up program governance frameworks. In part, this was because crisis resolution in the currency union was a new experience for euro area members; they needed to establish rules and guidelines as the crisis unfolded. After policy makers decided that the ESM should serve as a backstop for the Banking Union’s Single Resolution Fund, one key technical discussion was to put in place appropriate procedures to allow for swift and efficient decision-making to fit the timeline of bank resolution, while respecting national constitutional requirements. Disbursements under the common backstop are proposed to be approved by a unanimous decision of the ESM Board of Directors guided by a number of criteria.

Compared with the ESM, the CMIM governance structure has slightly softer voting rules for granting a program (i.e., a qualified majority), and decision makers are at deputy ministerial level. This does not necessarily mean that decisions on financial assistance would be made more easily given greater heterogeneity across the ASEAN+3 membership. FLAR provides a completely different experience as their members have equal voting power and they decide with a 75% qualified majority. The FLAR executive president can approve the use of liquidity and contingency credit lines; only the balance-of-payments support would require the approval of the board of directors, which is composed of central bank governors. This governance structure helps FLAR to react to regional shocks promptly. In fact, as the institution has often provided “bridge financing” to its members while waiting for a fully-fledged IMF program with a bigger financing envelope and conditionality (Cheng, Giraldo, and Hamel 2018), providing liquidity promptly is a FLAR design feature.

The CMIM faces one complication, which is the separation between its crisis resolution resources and the entity supporting the implementation of the CMIM, i.e., AMRO. As an international
organization, AMRO has provided support for the development and continuous enhancement of the CMIM by contributing to the CMIM’s operational guidelines, conducting surveillance, enhancing the Economic Review and Policy Dialogue Matrix, and organizing CMIM test runs. AMRO has also provided intellectual and administrative support to strengthen further the CMIM by establishing the CMIM’s conditionality framework and facilitating collaboration between the CMIM and its peer institutions (see past collaborative activities between in the joint statements issued by AMRO and its peer institutions in 2016–2020).

9.4 Conclusion and Recap of Policy Recommendations

Six years have passed since the EFSF—the ESM’s predecessor—was created and its first financial assistance program was agreed. Since Greece exited the ESM program in August 2018, all euro area country programs—in Ireland, Portugal, Spain, Cyprus, and Greece—have successfully terminated and all program countries have started post-program monitoring. The ESM will accompany them for a long period until the full repayment of ESM funds given their very long maturities. The past 6 years also witnessed the institutional development of the euro area crisis resolution mechanism. From the crisis resolution ATM for the euro area, the ESM’s role has evolved quickly.

The ESM’s institutional development sheds light on a number of relevant policy issues for the CMIM to consider for its own evolution. Most importantly, the CMIM could reexamine its mandate against region-specific shocks, which may have changed in nature since the Asian financial crisis 20 years ago. For instance, demographic changes and climate change may have raised new challenges for public finance management and rapid expansion of fintech flows may have created new sources of capital flow volatilities. These changes in turn may encourage the CMIM to think about new instruments, which could necessitate new funding strategies. For instance, member state governments in the region may need longer-term financing to tackle structural issues. In this case, the CMIM may think of developing a credit line similar to the IMF Extended Fund Facility or the ESM loan with a macroeconomic adjustment program. From this perspective, CMIM pooled resources based on swap commitment among the participating central banks may not be the most appropriate. Some part of the committed resources may need to be paid in to ensure this longer-term support for structural reforms. To deal with liquidity shocks of a limited scope, the CMIM
could think about the feasibility of further developing a regional liquidity instrument, as proposed by the Group of 20 Eminent Persons Group. One way forward is to enhance the access policy and predictability of the CMIM delinked portions. Cheng, Miernik, and Turani (2019) show that the delinked 30% of CMIM resources could already provide a financing envelope similar to the IMF’s Short-term Liquidity Swap proposal for eight out of 14 jurisdictions covered by the CMIM. CMIM member states could also consider strengthening the link between CMIM resources and additional bilateral swap lines that exist in the region.
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10

Reflections on Fiscal Coordination and Integration in Europe

Gong Cheng and Kari Korhonen*

10.1 Introduction

A monetary arrangement that adopts a common currency or fixes exchange rates, exposes its member countries to spillovers from divergent economic performance. It also requires coordination of policy strategies to ensure competitiveness and real economic convergence (Mundell 1961). This largely reduces the effective policy tools to fiscal and structural policy areas. The most striking example is Greece, which lost its competitiveness toward its main trading partners and supported its national economy with large public stimulus after the adoption of the euro. This led to macroeconomic imbalances in Greece, while the core euro area countries were making productivity gains. Then, the correction of the Greek crisis was prolonged because successive governments tackled the situation without a coherent plan or social support. The Greek crisis subsequently exposed other members of the Economic and Monetary Union (EMU) that had weak fundamentals to a market shock. The euro area crisis shows that a monetary union requires an advanced safety net to stabilize market expectations, which will allow time to take determined action and correct the imbalances.

In his *The Theory of Economic Integration*, Balassa defines economic integration as a gradual and stepwise process to reduce and eliminate

* This chapter was written when Gong Cheng was a senior economist at the European Stability Mechanism. We thank European Stability Mechanism colleagues for the constructive discussions and insightful comments. The views in this chapter are the authors’ and are neither those of the Bank for International Settlements nor those of the European Stability Mechanism.
barriers between the countries involved (Balassa 1961). With the willingness to create synergies and to remove barriers, the countries involved in economic integration may achieve the following forms of cooperation step-by-step: a preferential trading area, a free trade area, a customs union, a common market, an economic and monetary union, and ultimately a union with some degree of political and social integration.

European integration has epitomized this stepwise process. From the creation of the Council of Europe to the adoption of the euro by some member states as their single currency, the European Union (EU) has become a well-functioning union with broad prerogatives. However, a decade ago, the onset of the global financial crisis and the euro area debt crisis revealed some institutional shortcomings of the EMU. It also provided a timely opportunity to conduct necessary reforms to make policy coordination among members work better and to make the EU as a whole more resilient to future shocks. Euro area policy makers have since stepped up efforts to strengthen the architecture of a coordinated economic and fiscal policy.

In their 2015 joint report (European Commission 2015), the presidents of the European Commission, the European Central Bank (ECB), the European Council, the Eurogroup, and the European

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**Figure 10.1: Road Map to Deepen the European Economic and Monetary Union**

Source: Authors’ depiction based on the Five Presidents’ Report (European Commission 2015).
Parliament presented their vision for the design and implementation of these reforms. This road map (Figure 10.1) proposes measures to foster economic convergence and competitiveness in the EU, to improve financial resilience and integration with the creation of the banking and capital market unions, to move toward a fiscal union with an integrated framework for sound and coordinated financial policies, and to enhance the EU’s democratic accountability and legitimacy. The purpose of this enhanced integration is to provide regional common goods via policy coordination, sharing and pooling of resources, and where necessary to grant certain national decision-making powers to upper echelons.

In this chapter, we will present a description of the reforms and policy discussions related to fiscal integration that took place in Europe in the past decade before the onset of the coronavirus disease 2019 (COVID-19) global pandemic. We will especially focus on the key challenges and strategies, both now and in the future. We argue that when compared to economic and financial integration, fiscal integration would require a much stronger degree of political support. In addition, similar to the process of economic integration, fiscal integration is not meant to be achieved overnight but should also take a stepwise approach, building on the political capital available. Figure 10.2 illustrates the possible steps to propel fiscal integration in Europe. Some of these steps have already been implemented, whereas others are under political discussion, or need a longer time for an optimal design.

![Figure 10.2: Stepwise Fiscal Integration](source: Authors’ depiction.)

In a monetary union such as the euro area, a minimum degree of fiscal policy coordination is necessary to smooth the business cycles and to facilitate convergence. Since the creation of the EMU, this policy coordination has been ensured by the Stability and Growth Pact
The SGP has been reformed several times, and the most recent enhancement was made during the euro area debt crisis. To go one step further toward regional solidarity, fiscal integration would require temporary “transfers” or insurance mechanisms to deal with cyclical and systemic crises. Ultimately, a common budget would be needed to further strengthen fiscal integration in a monetary union. Finally, a degree of debt mutualization would complete the policy framework. However, to achieve this, voters’ support and political capital would be indispensable. In this chapter, we will describe the different steps of financial integration in Europe, including those steps that it will need to think about in the future. We will also present some reflections for East Asia based on the European experience.

The rest of the chapter is structured as follows. Section 10.2 describes the initial post-crisis measures that were taken to strengthen fiscal coordination in the euro area. Section 10.3 outlines the key proposals for euro area fiscal capacity. Section 10.4 addresses the question of debt mutualization, which is perhaps the most controversial aspect of European fiscal integration. In section 10.5, we present some lessons from the European experience for future East Asian and Southeast Asian efforts.

### 10.2 Fiscal Coordination: Minimum Requirement for a Well-Functioning Monetary Union

An extensive literature has found that the lack of an effective fiscal policy coordination accentuated shock transmission and spillovers during the previous crises Europe has undergone (Lane 2012, Landmann 2018). This section will review the numerous critical attempts that the EU made to enhance economic policy coordination before and during the euro area debt crisis.

#### 10.2.1 Fiscal Coordination within the Stability and Growth Pact

The SGP was designed as the fiscal backbone of the euro area. However, the SGP worked on the basis of the budgetary deficit, which was seen as the key figure to assess a country’s budgetary and economic policy. Although any country’s deficit is obviously very important, there were other elements that were neglected by the SGP, such as sectorial developments. For example, Spain had been in surplus for many years and its growing real estate bubble went “undetected” by the SGP criteria. We now know that there are other elements, such as competitiveness
and contingent liabilities of the government, that need to be taken into account to see the true picture of the public finances.

The decisions that were taken during the crisis reinforced the governance framework in the EU, especially in the detection of fiscal and macroeconomic imbalances, and in the capacity to prevent the European crisis. The Treaty on Stability, Coordination and Governance, the Six-Pack, and the Two-Pack improved the surveillance procedures and incentives for compliance. The Macroeconomic Imbalance Procedure also extended the fiscal surveillance framework to other macro policy areas. In addition, the reforms introduced a policy cycle to engage national fiscal policies at an early stage to minimize intra-union spillovers. As we will explain later, national governments now need to submit their budget plans first to the European Commission. They are then required to make any necessary adjustments based on the country-specific recommendations issued by the European Commission. However, the first experiences within this governance framework were mixed. The follow-up to the country-specific recommendations is frequently far from complete, particularly in the area of structural reforms. In numerous cases, the implementation of structural reforms required multiple years of constant efforts. Compared with the costs of implementation, measurable benefits only came with considerable delays. Efforts still need to continue in this area.

The amendments to the SGP framework aimed to (i) strengthen and deepen budgetary surveillance by making it more continuous and integrated, also via an intensified sanctions mechanism; and (ii) ensure the correction of any excessive deficits and the integration of the EU policy recommendations in the euro area member states’ budgetary processes through additional country surveillance procedures (European Commission 2014).

Consequently, budgetary rules were modified to focus more strongly on the debt trajectory. The crisis years imposed a need to consider exceptional circumstances and led to a more flexible deficit rule. Under the European Semester, member states now submit their budgetary plans to the European Commission before the national parliaments adopt the annual budgets. Some decisions can now only be overturned when a majority of member states opposes the recommendations of the European Commission in the Council. In certain circumstances, for instance when a country exits a financial assistance program with a macroeconomic adjustment, it can be put under enhanced surveillance that allows the European Commission to closely scrutinize any economic and budgetary developments. It also strengthened the enforceability of the framework through the European Court of Justice. In addition, there was a deliberate attempt to increase national ownership.
The Fiscal Compact required countries to implement European fiscal rules into national law and install councils of fiscal experts as monitoring and policy advisory bodies.

10.2.2 New Institutional Changes since the Global Financial Crisis

In addition to the SGP reform, the recent euro area crisis has also propelled improvements in economic policy coordination among the EU member states, especially on the fiscal front. Here, we highlight two sets of reforms: the establishment of the European Semester, and the creation of fiscal boards at the European and national levels.

**European Semester**

The European Semester is a cycle of economic and fiscal policy coordination within the EU. It is part of the EU’s economic governance framework. Its focus is on the 6-month period from the beginning of each year, hence its name—the “semester.” During the European Semester, the member states align their budgetary and economic policies with the objectives and rules agreed at the EU level.

By setting up the European Semester, fiscal policy making in EU member states is expected to incorporate an additional union-wide layer and to contain cross-country spillovers. With this new procedure, the European Commission helps to set priorities for the member states’ economic and financial policies, and, to a less binding degree, for their structural and employment policies. The European Council of the ministers make country-specific recommendations following the Commission’s proposals.

While progress has been made, the European Court of Auditors (2019) has recently assessed that the Commission has limited assurance that national budgetary frameworks are properly implemented and applied. Experience on the implementation of the country-specific recommendations over the years has been disparate, and countries often need a considerable amount of time to implement the reforms, and subsequently to meet their medium-term fiscal policy targets. Moreover, the transparency of the Commission’s decision-making criteria relevant for the macroeconomic imbalance assessments and the communication of these assessments could benefit from further improvement (European Court of Auditors 2018).

Although the European Semester has improved aggregate attainment of medium-term fiscal objectives, only part of the increase in government revenues contributed to build up of fiscal buffers. In particular, high debt countries have struggled to save increases
Efstathou and Wolff (2018) find that countries with excessive imbalances have struggled to implement the reforms. The implementation rates have been highest on recommendations concerning private sector policies and lowest in relation to public administration (e.g., sustainability of public finances, unemployment, tax base, and debt bias). Furthermore, the overall discipline is not supported by a relatively weak implementation rate by the two largest countries, Germany and France.

**Creation of the European Fiscal Board and National Fiscal Councils**

During the crisis, the EU leaders decided to create a fiscal advisory body at the EU level, the so-called European Fiscal Board (EFB), and they encouraged the member states to set up national fiscal councils as well. The overall purpose of fiscal councils is to strengthen fiscal disciplines in member countries and to prevent contagion from national fiscal policies in times of crisis. Their main task is to provide an independent assessment of budgetary forecasts and policy objectives, and to monitor fiscal stance and the compliance with the relevant fiscal rules. In addition, they play a role in the activation of correction mechanisms. In some cases, they also prepare or endorse macroeconomic forecasts for the purposes of fiscal policy making.

The EFB was established to contribute in an advisory capacity to the exercise of the Commission’s functions in the EU’s multilateral surveillance. Its work is particularly important for the euro area, which is still developing the effective common practices that will be required in a tighter union.

Within the SGP rules, the EFB informs about the appropriate fiscal stance for the euro area as a whole. It may advise the Commission on the consistent national fiscal stances. It also keeps track of how the EU’s fiscal framework is implemented, particularly regarding the horizontal consistency of the decisions, the serious noncompliance cases, and the implementation of budgetary surveillance. In addition, the EFB may make suggestions for the further evolution of the EU fiscal framework. Finally, it is tasked to cooperate with the newly established national fiscal councils to exchange best practices and facilitate common understanding on matters related to the EU’s fiscal framework. Ultimately, this cooperation should enhance national ownership of the EU’s fiscal rules. Considering that the national implementation of the fiscal councils varies considerably in terms of objectives, resources, and de facto powers, the EFB can play a useful role in promoting common
standards in surveillance and supporting the performance of the national bodies in influencing the public opinion through transparency of their assessments. Nevertheless, the European Court of Auditors’s (2019) review found that firmer standards for the design and operative capacity of fiscal councils are necessary to ensure their effectiveness and consistency between countries.

The EFB is composed of a chair and four members who are appointed for a period of 3 years, renewable once. It publishes an annual report of its activities, including summaries of its advice and evaluations rendered to the European Commission. Given that the EFB is advisory, its reputation and effectiveness of its advice will depend on the stature of the member experts. The quality of the advice depends on access to information at the European and national level.

While the EFB’s reports have been found of good quality, the follow-up of its recommendations by the European Commission has not been adequately formalized, which reflects its weak statutory position according to the Court of Auditors (European Court of Auditors 2019).

10.3 Thrust for Common Fiscal Capacity

Fiscal integration is a political question. Until now, the EU has settled on a relatively small EU budget—about 1% of EU27 gross national income at 2018 prices—and has focused on convergence, agricultural policy, and supporting growth initiatives (Council of the European Union 2019). The EU’s budget supports the whole of the EU. Many argue that a larger fiscal capacity is necessary for the euro area. However, expanding the fully discretionary budget further is currently politically challenging. More targeted facilities seem to obtain better traction, which could take the form of a special fund or budget scheme. There have been proposals to increase conditionality related to EU budget allocations. More rules-based arrangements also have appeal.

Fiscal capacity is understood as the ability of governments to raise their own (taxable) resources and fund public goods or redistribute such resources in line with some solidarity objective. This may take various forms of revenue, governance, and execution.

Generally, federations have been understood to establish fiscal capacity for four purposes: (i) pursuit of macroeconomic stability; (ii) avoidance of member states underproviding public goods (e.g., control of pollution or clandestine migration, import of counterfeit products, or provision of health care against transmissible deceases) for which significant externalities are present in a regional context; (iii) explicit equalization of resources between member states; and (iv) longer-run convergence of member economies.
A number of models have been proposed for the euro area in recent years as members have made efforts to scope for direction. Decision makers have reflected on the idea, despite various concerns regarding political feasibility and effective implementation. The key questions tend to address their governance arrangements and the nature of the support allocated. However, the no bailout rule of the Treaty on the Functioning of the European Union limits the scope for arrangements that would create joint liabilities.

One strand of the debate concentrates on temporary support, which would pose limited fiscal risks. Temporary support can be understood as access to self-insurance or short-to-medium-term loans. In this context permanent transfers (i.e., invariably one-sided flows) are understood as grants or partial subsidies. The latter would be required to address equalization and convergence objectives. Some proposals on potential suspension of budget contributions have also been made but these would lead to temporarily diminished resources while appropriations would most likely have to be made.

Another aspect is the operating target sought, where it is crucial to agree on whether or not the objective would be to compensate for all major losses (costs or missed revenue) or limit damages through an insurance. The basic advantage of an insurance scheme is that it would not react to all shocks and would only indemnify part of the damage caused by an eligible shock, which preserves financial capacity. At the same time, it reassures sovereign bond investors and other market players because it provides a floor for shock impacts. Insurance models can also rely on a rules-based approach, which would limit bias to discretion. Well-designed rules-based models may be particularly appropriate where the participants’ influence on decision-making is not equally distributed.

A form of insurance to deal with tail-event risks was set up during the euro area crisis—the European Stability Mechanism (ESM) and its predecessor, the European Financial Stability Facility (EFSF), were created as financial firewalls for the euro area countries. The euro area countries have pooled resources to build a common firewall of €700 billion, which is available for financial support by means of various instrument and under appropriate conditionality. So far, €380 billion of the lending capacity remains untapped, leaving sufficient room to address any possible future crisis shocks. There is an emerging literature on this type of insurance against tail risks (e.g., Cheng 2020, Chapter 9 of this book). Therefore, we focus on another type of insurance in this section: macroeconomic stabilization to deal with cyclical shocks.

The most striking missing piece in the EMU architecture is a fiscal capacity that would support the members’ ability to withstand
idiosyncratic shocks triggered by business cycles. Currently, stabilization burden falls on national fiscal policies, which means that countries should accumulate fiscal buffers during good times to be able to conduct sufficiently active countercyclical policies.

The introduction of cross-border transfers to stabilize business cycles in EMU countries is the frontrunner among the reform proposals. This concept is based on the McDougall Report (1977), which highlighted the need for a stabilization function in a monetary union. This need arises when members experience the effects of monetary policy differently or asymmetric events shock the economy.

These arrangements would operate as buffers between mild cycles and crisis times, which would entail a threatened market access and eventually lead to a serious sovereign liquidity crisis. These arrangements are often presented as response tools to more or less well-defined shocks. Some academics even refer to major shocks, while the objective is still limited to dealing with cycles characterized as normal times.

A member state would experience stabilization capacity through two basic processes. First, during downturns, members would receive transfers from the center, which would increase fiscal space under constraining fiscal rules to avoid procyclical budget cuts. The additional fiscal space would avoid excessively harsh adjustments consequent of liquidity crises. Second, during upturns, members should make transfers to the stabilization capacity as constraining fiscal rules force creation of buffers.

This should lead to more synchronized business cycles across the members. Some examples can be found in Allard et al. (2013), Delbecque (2013), Enderlein, Guttenberg, and Spiess (2013), Furceri and Zdzienicka (2013), Carnot et al. (2015), Carnot, Kizior, and Mourre (2017), Arnold et al. (2018), Beetsma et al. (2018), Benassy Quere et al. (2018), and Lenarčič and Korhonen (2018). Three specific kinds of stabilization funds (i.e., rainy-day funds, unemployment insurance, and investment support) merit further attention in light of the evolution of the ongoing debate.

10.3.1 Rainy-Day Fund

Some members of the EU have established practices to build buffers within their national public finance procedures. The efforts to muscle the resilience of the EMU could concentrate on helping member states to accumulate buffers in a common rainy-day fund. Buffers are necessary because market access may become expensive during a slump, when revenues also become scarce. A common fund would allow the amount of self-insurance to be rationalized.
Rainy-day funds are based on the idea of building self-insurance during good times, which is used in a downturn. As cycles change, the balances evolve. In the United States (US), these funds form the backbone of the states’ balanced budget rules. In parallel, the US federal government has established rainy funds that bolster, for example, the state unemployment systems in deeper recessions.

Some of the first proposals for a stabilization fund include the cyclical stabilization insurance fund (by Tommaso Padoa Schioppa Group, see Enderlein et al. 2012) and cyclical shock insurance fund (Enderlein, Guttenberg, and Spiess 2013). Allard et al. (2013) sketched out a rainy-day fund for the euro area based on continued collection of contributions and temporary transfers in case of a shock.

A commitment to take advance precautions before significant common resources be made available would support the political acceptability of a rainy-day fund solution. A common fund can also increase transparency of the conduct of sound fiscal policies. Lenarčič and Korhonen (2018) spelled out how the US system could be effectively translated into the euro area framework in a way that empowers the member states to manage their fiscal policies in a more countercyclical manner while profiting from the asymmetric nature of the national business cycles to pool available resources without mutualization. The European rainy-day fund would take the form of a common fund made of national compartments and a mechanism of limited borrowing between the compartments in case of need. Target compartment sizes would reflect the volatility of national economies and access to the funds would be granted based on a trigger. The institutional characteristics and transparency safeguards are important for the arrangement’s effectiveness (e.g., to manage moral hazard). Legally, the mechanism could be installed through an intergovernmental agreement with the national components anchored in domestic budget procedures and laws.

### 10.3.2 Unemployment Insurance

Although the EU has reduced requirements for work-based migration, the euro area’s labor mobility rate does not resemble mobility in the US. Unemployment benefits represent a large increase in public expenditure of member states that suffer from economic shocks. Therefore, some form of support to bolster unemployment protection would be politically appealing. However, it would be crucial to differentiate structural and cyclical components of the unemployment problem.

Several types of euro area unemployment insurance arrangements have been proposed: common unemployment insurance (Allard et al. 2013), a common basic benefit scheme (France Trésor 2014), the
complementary European unemployment insurance scheme (New Pact for Europe 2014), and reinsurance of national unemployment benefit schemes (Beblavy, Gros, and Maselli 2015). Nevertheless, Dhéret et al. (2013) noted that this scheme would require a stronger role for labor policies in the European Semester. In most cases, this would require harmonization of basic assistance to be considered, or relying on an agreed notional benefit as a basis for indemnity from which member states may divert in disbursements to citizens, execution of active labor market policies, or even harmonization of labor taxation.

In a genuine insurance model, national contributions would be revised based on the history of usage (experience rating). In view of moral hazard problems, such schemes have to set initial entry criteria. In addition, the payouts would be subject to a deductible, which should help the appropriate scaling of assistance and alleviate moral hazard issues.

Given the lack of harmonization among national schemes, a rainy-day fund adapted to react to cyclical unemployment variation would be the most promising way forward (Carnot, Kízior, and Mourre 2017; Lenarčič and Korhonen 2018) because the payouts can be made as budget support with intrusive strings attached. An alternative would be to agree on a notional compensation by eligible registered unemployed scaled to national earnings or cost of living. These designs could avoid strong interventions in national social policies.

10.3.3 Investment Support

The crisis period has demonstrated that investment expenditure is the first area where governments have to implement cuts when revenues decline and financing costs increase. The EFB has advised that the option of implementing an investment protection scheme is superior to the alternative fiscal stabilization instruments in the short run (European Fiscal Board 2017).

During the recent crisis, the European Commission devised an investment catalyst initiative, called the European Fund for Strategic Investment, in cooperation with the European Investment Bank and supported by EU budget guarantees. However, this fund is of a temporary nature.

For the future framework, there are several proposals under discussion. We will next sketch the two most prominent proposals.

The European Investment Stabilization Function is one of the prominent proposals. In this proposal, the European Commission suggests providing liquidity support to member states affected by an economic downturn to maintain public investment, using subsidized
loans that are financed by a fund built up through national contributions. The member state would be obliged to maintain the average level of public investments of the past 5 years. Eligibility would be subject to meeting an unemployment criterion (European Commission 2018).

Given political constraints for the creation of a euro area-specific budget, the member states started to discuss a budgetary instrument for convergence and competitiveness within the EU budget that would be connected to combined reform and investment commitments agreed through the European Semester process. The discussion has received a strong propulsion recently in the context of the common response of the EU to the COVID-19 pandemic, which, however, goes beyond the scope of this chapter. The availability of the investment support funds would also follow the European Semester's decision-making schedule and the achievement of milestones in agreed reforms (e.g., increasing retirement age, setting up active labor market policy, or implementing a more efficient public administration). The amount would be subject to reduced cofinancing by the beneficiary member and part of it could be used to react flexibly to a member's immediate challenges to meet euro area policy priorities. This linked the utilization of the budget to the SGP and the European Semester. The key decision affecting the effectiveness of the instrument will be its degree of redistribution among the members and the size of the instrument, which would be defined in the multiannual financing framework. Because the budget allocation would be limited, the European Commission foresees a possibility of voluntary contributions to augment the support capacity in the future.

10.4 Debt Mutualization: A Necessary Chore Requiring Strong Political Support

Capacity to raise public debt represents yet another fiscal capacity that may be used to promote long-term growth by allowing investment in infrastructure, innovation or human capital, and timely debt issuance would allow accumulation of resources for countercyclical stimulus. In addition, liquid public debt will provide safe assets to the private sector, serving, for example, as a collateral, and it will increase the transparency of financial sector pricing (Kose et al. 2020).

After the introduction of the single currency, many euro area countries profited from rapidly converging financing conditions. Their foreign-financed debt balances increased rapidly. In some countries, this was driven by private sector, while in others, government policies piled on national debt. The onset of the euro area debt crisis revealed that a doom loop between banks’ and the sovereign’s balance sheets was
at work, as many scholars have previously emphasized (Brunnermeier et al. 2016a). On the one hand, when a bank holds a large share of the securities issued by the sovereign state in which it is located, it is exposed to any macroeconomic shocks weakening the sovereign’s creditworthiness because of potential bank asset losses. On the other hand, when a country has a large banking sector, potential fiscal needs for bank recapitalization will be an extremely heavy burden and this will deteriorate public finance because of large bailout needs.

Given the architecture enshrined in the EU Treaty, the euro area missed an opportunity to develop sufficiently abundant safe assets as alternatives to the best-rated government paper. In this context, intense policy and academic discussions have emerged about how to break the doom loop and to make sovereign securities safer in the monetary union. These proposals range from adjusting sovereign risk weight in banks’ balance sheets, offering European safe assets, to debt mutualization. Many economists have already argued that regulation of sovereign exposures (e.g., adjustment of sovereign risk weight) will not be able to lower concentration risk and this will lead to the banks’ exposure to domestic government securities (Alogoskoufis and Langfield 2018). Table 10.1 summarizes a few of the proposals on this broad topic.

In this section, we will briefly discuss the key factors to consider in this public debate on safe asset and potential debt mutualization in the future when there will be public and political support.

10.4.1 Euro Debt: Crucial Factors to Consider

To illustrate the factors that would be crucial for the successful implementation of euro area safe asset or debt mutualization, we base our discussion on the European Parliament’s study of eurobills and a debt redemption fund (Tumpel-Gugerell 2014).

Following a commitment made on 12 March 2013 to the European Parliament as part of the overall agreement on the two-pack legislation, the European Commission established an expert group, chaired by Gertrude Tumpel-Gugerell, to work on proposals of debt redemption fund and eurobills. Published on 31 March 2014, the final report of the expert group provides qualitative assessments of the mechanisms, merits, and risks of the joint public debt issuance in the euro area.

The eurobill proposal aims to set up a common debt management office in the euro area to issue short-term bills. The protagonists of this proposal expect these common short-term debt instruments to increase confidence effects, enable progress in financial market integration, and enhance support for monetary policy transmission over time and sustain their benefits. The Tumpel-Gugerell report builds upon a very strong
Table 10.1: Proposals on Debt Mutualization or Safe Assets since the Euro Area Debt Crisis

<table>
<thead>
<tr>
<th>Proposals</th>
<th>Authors and Date</th>
<th>Key Messages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Blue bond – red bond</td>
<td>Delpla and von Weizsacker (2011)</td>
<td>• Debt below 60% could be issued jointly and severally.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Debt markets would be split in very senior blue debt and very junior red debt.</td>
</tr>
<tr>
<td>Stability bonds</td>
<td>European Commission Green Paper (2011)</td>
<td>• Partial or total joint and several issuance of debt.</td>
</tr>
<tr>
<td>Sovereign cocos/GDP-indexed bonds</td>
<td>Brooke et al. (2013)</td>
<td>• Sovereign cocos are bonds that would automatically extend in repayment maturity when a country receives official sector emergency liquidity assistance.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• GDP-linked bonds are debt instruments that directly link principal and interest payments to the level of a country’s nominal GDP.</td>
</tr>
<tr>
<td>Debt/equity swap</td>
<td>Allen, Eichengreen, and Evans (2014)</td>
<td>• Swap of public debt held by ECB for program countries’ properties/developmental projects.</td>
</tr>
<tr>
<td>PADRE plan</td>
<td>Pâris and Wyploz (2014)</td>
<td>• An agency purchases a given amount of eurozone public debt at face value according to a predetermined key (e.g., capital share in the ECB) and transforms it in perpetual bonds with no interest rates (assets).</td>
</tr>
<tr>
<td>Eurobill and debt redemption fund</td>
<td>An expert group led by Tumpel-Gugerell (Tumpel-Gugerell 2014), commissioned by the European Parliament</td>
<td>• Euro area countries jointly issue short-term bills based on a predetermined key.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Long-term debt can be bought by the debt redemption fund based on a strict and well-defined rule.</td>
</tr>
<tr>
<td>European Safe Bonds (ESBies) and European Junior Bonds (EJBies)</td>
<td>Brunnermeier et al. (2011), Brunnermeier et al. (2016b)</td>
<td>• A portfolio of euro area sovereign bonds, issued by each participating member, according to a predetermined rule.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• ESBies are the senior tranche while EJBies are the junior tranche.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• A union-wide safe asset without joint liability.</td>
</tr>
</tbody>
</table>

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Table 10.1 continued

<table>
<thead>
<tr>
<th>Proposals</th>
<th>Authors and Date</th>
<th>Key Messages</th>
</tr>
</thead>
</table>
| E-bonds                    | Leandro and Zettelmeyer (2018)          | • A senior public intermediary (e.g., the ESM) would issue a single bond backed by a diversified portfolio of euro area sovereign debt bought at face value.  
• Seniority based on the ESM’s preferential creditor status. |
| Covid debt mutualization   | Beck (2020)                             | • Debt mutualization with joint and several liability to raise funds for fighting the global pandemic. |
|                            | Bénassy-Quéré et al. (2020)             |                                                                              |
|                            | Giavazzi and Tabellini (2020)           |                                                                              |

ECB = European Central Bank, ESM = European Stability Mechanism, GDP = gross domestic product.

Note: the chapter was written in 2019 and thus does not cover new debt mutualization ideas developed during the coronavirus disease (COVID-19) pandemic. However, we would like to provide our reader with some references to these recent ideas.

Source: Authors’ depiction based on the papers cited.

fiscal framework and will set prior conditions for euro area member countries to access the joint short-term bill issuance scheme.

In contrast, the proposal to set up a debt redemption fund (DRF) aims to allow member states to off-load a predefined portion of its public debt. According to the Tumpel-Gugerell proposal, the DRF “would issue bonds above a maturity of 2 years so that national debt can be switched into medium- to long-term euro area debt.” After the phase-in, the fund would redeem bonds over 20–25 years during which member states jointly repay their European debt receiving revenues from member states. The fund would close when all bonds have been redeemed. The DRF would thus deal with long-term debt issuance in the euro area.

It seems to us that there are three sets of key factors for this plan to work in the future, which are also relevant for other proposals of a similar nature. The reader should, however, bear in mind that in the current political context in the EU, the discussions on debt mutualization and safe assets remain an academic topic. Not only do many technical issues remain unsolved but there is also little political consensus in this regard. Certain countries insist on the need to reduce legacy risks (e.g., banks’ high nonperforming loans and excessive debt levels) before embarking on further discussions about additional risk sharing (e.g., through debt mutualization).

Member States’ Responsibility

A key discussion here is to what extent the euro area member states who would eventually participate in issuing joint debt or safe assets would need to assume financial responsibility.
Two guarantee schemes were conceived by the expert group when designing the DRF and eurobills: joint and several guarantee or pro rata guarantee. That is, if a participating member state fails to redeem its debt or to pay back eurobills holders, then either all of the participating member states would need to step in and guarantee nonpayment or their responsibility would be limited to some predetermined shares.

A joint and several scheme requires that the joint issuance would be fully guaranteed by each member state, while the credit rating of the DRF or eurobills fund would be similar to that of the best-rated participating member(s). This scheme requires the participation of the largest and most solvent countries in the euro area for the guarantee to be meaningful. In the baseline case of the DRF, the maximum size of the DRF after the roll-in phase would amount to €2.85 trillion. It is impossible for smaller countries to carry the payment burden in case a large member state did not participate or failed to pay. It would also affect the rating of all participating countries for large amounts of mutualized debt. The implementation of a joint and several liability scheme requires EU Treaty changes, which can only build upon a solid political support.

A pro rata scheme limits each participating member state’s responsibility to a predetermined contribution key. In the DRF, a country’s capital contribution should reflect its share in transferred debt while in the eurobills fund the contribution key needs to be defined in the founding legal text, according to the existing ESM capital key or not. This guarantee scheme would undermine the overall credit quality of any joint issuance mechanism because some of the country “guarantors” of the pro rata liability have relatively high debt and weaker credit ratings. Therefore, credit enhancement measures are needed with the pro rata scheme. As credit enhancement measures, the expert group proposes pledging collateral of 20% of the value of the transferred debt or earmarking tax revenues for the servicing of redemption payments in the case of the DRF, or use the ESM as a backstop in the case of eurobills.

The same set of pros and cons applies to other proposals of safe assets. For instance, the ESBies advanced by Brunnermeier et al. (2011) clearly state that they would not require the joint and several responsibility. On the contrary, the stability bond proposal of the European Commission would require partial or full joint and several responsibility.

**Membership**

Another recurrent topic is how to motivate countries to participate in the safe asset project. As far as the DRF and eurobills are concerned, there are two main considerations relative to the membership of the proposed joint issuance mechanisms: (i) how to motivate high-credit-quality countries, and (ii) whether to include ESM program countries. With regard to high-credit-quality countries, they would need to guarantee debt incurred by
other countries in a joint and several guarantee structure. In a pro rata structure, they might find their sovereign financing costs increasing considerably as the credit quality of the joint issuance mechanism is pulled down by the inclusion of low-credit-quality countries. National parliaments of high-credit-quality countries could face a serious challenge to approve their participation in view of increased financial costs. The second concern regards program countries (this is especially an issue for eurobills). Including program countries is crucial to increase financial resilience in the euro area and create positive incentives working toward exiting an ESM program. However, the participation of these countries, which are highly indebted and low rated, at least for a period of time, undermines the overall credit quality of the joint issuance schemes and thus raises funding costs for other member states. European safe assets or debt mutualization also require the designers to think whether to limit the membership to euro area countries or to extend the participation to the EU members that have not adopted the euro. This would be a critical question with respect to the proposals involving the ESM as the mechanism issuing euro area safe assets.

Size of Debt Mutualization
Finally, the size of debt mutualization is critical and requires a fine art of balancing between credibility and effectiveness. On the one hand, if the size is too big, then it would require a large capital structure or a large guarantee scheme. An important amount of mutualized debt would also increase the burden of high-credit-quality countries to ensure the creditworthiness of the scheme, and it would imply higher moral hazard. On the other hand, if the debt mutualization is too small, then it would limit the expected benefits from the joint debt or safe asset issuance. The extent of debt mutualization depends on the definition of debt thresholds (e.g., beyond which national public debt would be transferred to the DRF) in the DRF proposal and on the maturity of issuance in the eurobills proposition. As regards other proposals, such as the blue and red bonds, or ESBies, the optimal size is also related to how to segregate the junior and the senior tranches of sovereign securities.

10.4.2 Dearth of Political Support
The Five Presidents’ Report also outlined the roles for a euro area finance minister and treasury in joint policy making on fiscal policy with the European Parliament’s oversight. The proposed scenario in which member states would have agreed to centralize a larger part of fiscal policy at supranational level proved to lack broad political support. Support resided mainly in centrally governed member states.
It is interesting to consider to what extent such institutionalization of policy making could promote additional regional public goods. However, the country diversity arising from differences in size and structure of the economies, advancement and fiscal traditions poses challenges for alignment of interests. This could provoke conflicts on the mechanisms according to which costs and benefits are shared, and in governance. Sandler (2006) highlights these issues as general challenges for such aggregation mechanisms.

The beneficial effects of the legislation adopted so far lie mainly in raising fiscal awareness and helping voters to better understand fiscal policies and budgets, thereby supporting public scrutiny and political accountability. Even so, the International Monetary Fund (IMF) has raised incentives to improve further fiscal transparency across the membership, including the euro area.

Political support for fiscal capacity that would provide permanent transfers has been weak following the euro area crisis and there have been previous challenges to apply the agreed fiscal rules consistently. For example, Pikkarainen (2019) considers that solidarity necessary for such transfers thrives with homogeneity. He argues that the conditions necessary for a potential transfer union in the EMU include more harmonized and lower debt levels, stronger controls on budgetary expenditure by voters, and more flexible labor markets and fiscal rules. At the same time, it is worth noting that the intensity of the euro area’s regional trade has backtracked since 2007 (UNCTAD trade statistics).

The United Kingdom’s withdrawal process from the EU has been interpreted as a sign of reluctance toward weaker political control over its economy (Pereira 2016). Although the country is not part of the EMU, and it is challenging to identify ultimate sources for the economic dislocations that the European economies have faced in recent years, the so-called Brexit demonstrates the tribulations of the common institutions to respond to the prevailing variety of member states’ needs.

Consequently, the envisaged euro area fiscal arrangements have to adapt to a number of interests. The budget instrument proposal, which faces many strong redlines, should be available for the EMU members and possibly for ERM II member states. One key decision topic will be how the funds will be allocated. The general European practice is to define a distribution key. Given that the instrument would be embedded in the EU budget, its size is to be determined within the negotiation of the EU Multiannual Financial Framework for 2021–2028.

Macroeconomic stabilization function may be part of the extended reform discussions, although there seems to be no agreement to include it in the reform package to be presented to the heads of state and government in 2019. Nevertheless, the proposed budgetary instrument
may produce some countercyclical effects as a by-product and reduce vulnerabilities of the national economies.

10.5 Conclusions and Policy Recommendations

10.5.1 Same, Same—But Different

Different strategies have steered Asian and European integrations, despite the same underlying priorities: security and economic benefits. While European integration embodied in the EU and the EMU have emphasized institutionalization, Asia favors “soft integration” and an institution-light approach with few upward delegations of resources or powers. The concept of “open regionalism” represents the possibility for countries to integrate selectively in policy areas fit for their own interest (Berkofsky 2005). This may be necessary for the mechanisms to respond to current global challenges for the provision of various global and regional public goods (Fraga 2019).

Asian integration takes its most advanced form in free trade agreements and in the Association of Southeast Asian Nations (ASEAN), as well as its +3 cooperation encompassing the People’s Republic of China, Japan, and the Republic of Korea. The shrinking ASEAN trade share with non-ASEAN+3 countries since 2001 (UNCTAD trade statistics) is an indication of increasingly tighter integration in East Asia. ASEAN is largely driven by economic growth agendas. The ASEAN way is characterized by flexibility and consensus-building processes, soft law initiatives, benchmarking, and promotion of best practices (Acharya 1997, Capannelli and Tan 2012, Gaens and Ruohomäki 2018, Jetschke and Murray 2012). Instead of seeking a monetary union, the members have committed to increased financial market integration since a few years, such as by promoting national currency flows and further opening banking markets to enhance trade and direct investment in the region (ASEAN 2019).

While the EMU has packaged economic and monetary integration together, the two processes occur in parallel in Asia. At the same time, the package approach of the EMU calls for strong and efficient institutions and citizens’ trust in the institutions, which enables progress toward a more pooled sovereignty. A social policy component is also concrete in the European context, while harmonized policies are not the objective. When drawing the parallel between the European and Asian integration, one needs to control for the differences in the membership across these two regions. There are key macroeconomic and structural differences between the euro area and ASEAN+3 that merit the readers’ attention.
These differences could indicate diverging regional needs or priorities for intra-region transfers and insurance arrangements.

It is particularly striking that East Asia is more diverse than the euro area in terms of per capita gross domestic product and business conditions (World Bank 2018). The same is true for employment conditions measured by the share of vulnerable jobs and salaried workers in their economies. The IMF also forecasts the variance in per capita gross domestic product to increase further among ASEAN+3 countries toward 2024, although even the poorest economies will boost their output.

The clustering of the two regions is most pronounced in public finances. Only one of the ASEAN+3 countries approaches the euro area in the level of general government expenditure. Similarly, ASEAN+3 revenue collection remains comparatively low. Most ASEAN+3 countries’ public debt is similar to the better-off euro area member states, with Japan as an outlier. At the same time, one must take note of a rapid increase in public debt in a number of euro area member states during the sovereign debt crisis.

10.5.2 Could Some More Global Lessons Underlie the European Hard Work around Fiscal Regionalization?

The first part of this chapter focused on the key challenges and strategies to enhance the fiscal branch of the EMU. It showed that even when regional institutionalization has made important advances that have allowed great benefits from economic and financial integration, taking steps with fiscal integration beyond initial steps is a major endeavor and needs stronger political support. History shows that harmonizing direct taxes, in particular tax rates, is not fast or easy. Alignment of tax reporting or collection procedures and of tax bases has constituted a more effective investment of resources and political capital. The EU has also developed standards for the independence of national fiscal institutions, which is considered a safeguard for outward spillovers from one member to another in the current state, and a catalyst for building trust that would allow further evolution.

Integration in East Asia and Southeast Asia is challenged by important diversity in comparison to the euro area. This both calls for transfers (making a case for fiscal sharing) but also sets certain political and institutional challenges, and may reflect on the form of ultimately desirable and viable solutions. The road to revenue sharing may be long even with political will. Ensuring common standards, especially
for corporations, could represent a valuable initial investment when no electronic filing of national corporate income tax returns is currently possible in most East Asian and Southeast Asian countries (OECD 2019).

Business conditions within the euro area are relatively similar in comparison to East Asia. Public finances data depict the structural differences between the two regions but also the more negative impact of the financial crises of the previous decade on many euro area economies. It is notable that the IMF World Economic Outlook projects differences in national wealth to continue expanding in East Asia. Health-care expenditure and vulnerable jobs indicate another dividing line in the role of the government. From the perspective of health-care expenditure and old age dependency rate, the ASEAN+3 countries have better prospects with more space to raise (public) health expenditure while not having to make a trade-off with old age care, except for one country. In addition, the region’s high share of vulnerable and informal jobs may indicate a susceptibility to welfare losses under business cycle shocks, despite having more flexible exchange rate arrangements.

Given the structural differences, East Asia and Southeast Asia may consider initial steps in developing common minimum standards for basic social safety nets and providing implementation assistance to the least developed members. As the protracted Greek crisis has shown, governments should provide essential social safety nets so that the banks’ capacity to finance growth is not constrained by any social policy needs. Sustainable financing of such safety nets calls for reducing incentives for undeclared work. Pigovian taxes may represent another area where common interests for minimum standards could prove effective in the region.

In the midst of global trade tensions, the ASEAN leaders nevertheless reaffirmed their commitment to open trading systems that have underpinned their economic growth. The wealthier members also committed that no one should be “left behind.” This creates a link with fiscal solidarity. Some form of stabilization facility, unemployment insurance, or support to finance various policy or institutional reforms could be useful long-term policy debates in the region. The member countries would, however, have to agree on how strong and independent institutions are desirable at the supranational level (e.g., Kurlantzick 2012).

As in the euro area, it matters who presents the proposals and how their benefits are seen to be distributed (e.g., Bakrie 2011). The tensions related to Japan’s proposal for the Asian Monetary Fund (e.g., Lipsy 2003), and the People’s Republic of China’s recent initiatives, such as the Asian Infrastructure Investment Bank and the Belt and Road Initiative, are indications of concerns about the regional leadership of both of
these countries, and also on the persistent role of the United States in the Pacific. A recent example of working around apparent institutional constraints is a Malaysian proposal for a future common currency arrangement for the purposes of regional trade settlement. Because this currency would not be used in the domestic economies, it would impose lesser constraints for domestic policies and institutions (Reuters 2019). The efficiency of such a clearing arrangement likely requires one or more liquidity providers, which could be anchored to a regional public institution or to a private sector solution. Again, the European experience of the European Currency Unit, the predecessor of the euro, hints that there are limitations to private sector solutions.

Harmonizing sovereign bond conditions would nevertheless be another market-based strand for gradual steps toward fiscal integration. The euro area members, for example, resolved to common collective action clauses when the ESM was established. A common securities market platform for sovereign issuance, trade settlement, and registration implemented with a single set of rules and procedures would reduce transaction costs and could ultimately become a thrust to shared issuance, which could start with new initiatives to finance regional public goods, in particular climate financing to support adaptation actions.

The EU has a tradition of decision-making enabling leapfrogging to a new framework in moments of crises. The debate on the Asian Monetary Fund demonstrates the importance of process and sticky equilibria. This does not prevent the authorities to prepare alternative strands of reform. The rapidly aging population of the large two East Asian nations and indications of their slowing growth prospects in comparison to the rest of the region may nevertheless provide incentives for more balanced cooperation in the long run. Meanwhile, selected ASEAN members could consider enhanced cooperation.
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PART III
Deintegration
Analysis of Brexit and Its Policy Lessons for Asian Integration

Donghyun Park, Cynthia Castillejos-Petalcorn, and Jungsuk Kim

11.1 Introduction

The postwar period has given rise to a plethora of global international organizations, most notably the United Nations and the many organizations under its umbrella. The broader objective of these global organizations is to promote the closer integration of countries across the world. For example, the World Trade Organization (WTO), which commenced operation in 1995 as the successor to the General Agreement on Tariffs and Trade (GATT) multilateral trade system, aims to reduce trade barriers and promote freer trade among the global community of nations. At a broader level, the WTO provides the multilateral rules of the game for international trade. The two cornerstone concepts of the WTO regime are reciprocity and nondiscrimination. The most favored nation and national treatment principles reflect those concepts. Most favored nation treatment means that WTO members must grant each other the same trade privileges—for example, low tariff rates—as they grant the most favored nation. National treatment prohibits discrimination between imported and domestically produced goods in terms of internal taxation and other government regulations. Another vital function of the WTO is that it provides a systematic mechanism for resolving trade disputes among member states.

The GATT–WTO multilateral trade regime contributed greatly to the explosive growth of world trade in the postwar period. It is not possible to overstate the critical role of the GATT–WTO regime in the explosive expansion of global trade since the establishment of the GATT on 1 January 1948. There were certainly many other factors behind the postwar wave of trade globalization, in particular dramatic technological progress in trade-related transportation, which containerization and container ships epitomized. Nevertheless, the GATT–WTO regime
provided the multilateral regulatory and institutional framework—that is, the rules of the game—for countries to trade with each other, and this was a critical contribution. As of February 2019, virtually all the economies of the world—164 to be precise, including the European Union (EU)—are members of the WTO. The dramatic growth of global trade under the GATT–WTO regime helped many developing economies to catch up with advanced economies. For example, the opening up and integration into the world economy of the People’s Republic of China (PRC), which was a major catalyst in the country’s spectacular rise, received a big push from joining the WTO in 2001. More generally, the expansion of global trade under the GATT–WTO regime contributed significantly to the transformation of developing countries, especially in Asia, as a significant economic bloc in the world economy.

Economic globalization is no longer limited to the international trade of goods but increasingly encompasses services. In response to the growing role of services in global trade, the WTO developed the General Agreement on Trade in Services, which entered into effect in January 1995 and remains the only set of multilateral rules governing international trade in services. Although global trade liberalization made steady continuous progress under the GATT–WTO framework, the progress halted in 1995. More specifically, the last successful round of multilateral trade negotiations—the Uruguay Round, which led to the creation of the WTO—concluded in 1994. The next round of multilateral trade negotiations, the Doha Development Round (Doha Round), kicked off in 2001 with an ambitious agenda of extensive trade liberalization to help improve the trading prospects of developing countries. The grand bargain basically involved advanced countries opening up their markets to exports of agricultural products from developing countries in exchange for developing countries opening up to exports of services from developed countries, especially financial services. The grand bargain never materialized due to strong opposition from the farm lobby of developed countries, and the Doha Round suspended its activities in 2006. The failure of the Doha Round represented a major setback for the growth and development prospects of developing countries.

Well before the failure of the Doha Round, there was already significant movement toward the formation of regional trading blocs and, more generally, regional economic integration. The movement was most visible in Europe, which had already reached an advanced level of integration by 2006. Within the European Union, the history of which the next section briefly examines, there is free cross-border movement not only of goods but also of services, capital, and people. The main advantage of global free trade is that it encompasses trade between all countries and can thus catalyze global trade. However, a big drawback is
that reaching a global trade agreement requires the consensus of a very large number of countries. The failure of the Doha Round underlined the inherent difficulty of such a multilateral process. The strength of global free trade is the weakness of regional free trade and vice versa. That is, a key disadvantage of regional free trade is that it covers only a share of any country’s trade. On the other hand, the smaller number of countries in a region means that reaching an agreement is likely to be easier. Therefore, there is a strong economic rationale behind the proliferation of regional blocs and organizations.

At the same time, while economic factors, especially trade, have been a powerful driver of regional integration, noneconomic factors are also at play. In addition to geographical proximity, cultural affinity, similar value systems and ideologies, and a sense of familiarity all contribute to a regional sense of identity, which is ultimately the foundation of regional integration. Economic forces are the dominant drivers behind some regional institutions, such as the North American Free Trade Agreement (NAFTA), which sought to bind the economies of the United States (US), Canada, and Mexico more closely. On the other hand, some regional institutions are almost devoid of any trade or other economic content. For example, the Arab League is a regional organization of countries that share a common language and culture. It aims to foster political unity and mediate in disputes among those countries. Similarly, the Organization of American States and the African Union are primarily political forums that bring together the countries of a specific region. However, other regional organizations, most notably the European Union, combine strong economic dimensions with political and other noneconomic dimensions.

Asia too has witnessed some trends toward closer regional cooperation and integration. The Association of Southeast Asian Nations (ASEAN) has achieved the highest level of regional integration within Asia. The organization, which consists of 10 countries, promotes intergovernmental organization and facilitates economic, political, security, and other forms of cooperation (see section 11.3). One important dimension of ASEAN is the ASEAN Free Trade Area (AFTA), which seeks to foster more trade among the ASEAN countries. In fact, intra-ASEAN trade has expanded significantly to the extent that trade with other members now accounts for a substantial share of each member’s trade.

Furthermore, in recent years, ASEAN has become more integrated with the large East Asian economies of the PRC, Japan, and the Republic of Korea, known as ASEAN+3, which to a large extent is the consequence of powerful economic forces. The PRC, Japan, and the Republic of Korea are the world’s second, third, and 12th biggest economies, respectively.
As such, they have served as powerful engines of growth for the ASEAN economies in the past and will continue to do so in the foreseeable future. ASEAN+3 constitutes a tightly integrated regional production network or regional supply chain, often called Factory Asia, which has become one of the most important manufacturing hubs in the world.

Although ASEAN+3 is the most advanced form of regional integration in Asia, it lags far behind the EU level of integration. As such, the EU offers valuable lessons on how ASEAN+3 can make progress toward higher levels of integration. At the same time, the current difficulties that the EU is confronting, most notably Brexit, offer valuable lessons about the potential pitfalls that could disrupt the integration process. The central objective of this chapter is to identify both positive and negative lessons from the EU for ASEAN+3 in its own journey toward closer integration. Sections 11.2 and 11.3 provide a brief description of the economic integration process of the EU and ASEAN+3, respectively. Section 11.4 draws positive lessons from the EU’s integration success for ASEAN+3’s integration. Section 11.5 provides a brief history of the ongoing Brexit process. Section 11.6 reviews the negative lessons from the current difficulties that the EU is experiencing, while section 11.7 draws lessons from the Brexit saga for ASEAN+3’s integration. Section 11.8 concludes the chapter.

11.2 Economic Integration Process of the European Union

The EU is the cornerstone of European policy. It is the political and economic association of 28 European countries, which has common economic, social, and security policies. The EU has three governing bodies: the European Parliament, which EU citizens directly elect as their representatives; the Council of the EU, which represents the government of member countries; and the European Commission, which represents the EU as a whole.

The aftermath of the Second World War left most of Europe in ruins and experiencing economic depression, while the Cold War ensued. To prevent future wars and promote political reconciliation, six neighboring countries—France, Germany, Italy, Belgium, the Netherlands, and Luxembourg—pledged to focus on economic integration. By virtue of the Treaty of Paris in 1952, they founded the European Coal and Steel Community, aiming to integrate the coal and steel industries in western Europe (EU 2019) under a centralized authority.

After 5 years of successful operation, they expanded their cooperation to include the free movement of people, goods, capital, and
services across borders. They signed the Treaty of Rome in 1957, which paved way for the creation of the European Economic Community. By 1967, the European Economic Community, the European Coal and Steel Community, and the European Atomic Energy Community had acquired the collective name of the European Community.

The group also agreed to abolish customs duties on imported goods within the countries and applied uniform duties on their imports from other countries, which allowed free cross-border trade. In preparation for the creation of a single currency, it formed the Exchange Rate Mechanism (ERM) in 1972, whereby European Economic Community (EEC) currencies were able to fluctuate against each other within a narrow band for monetary stability.

In 1973, the group had its first enlargement, welcoming three new members: Denmark, Ireland, and the United Kingdom (UK). Greece became a member of the EU in 1981, and by 1986, Spain and Portugal had also joined. Austria, Finland, and Sweden joined the EU fold in 1995, leading to a total of 15 members. The solid gains from deepening economic cooperation attracted new EU members, which also helped to expand the territory of the EU further.

A significant development was the launching of the Single European Act in 1986, whereby EU members were to resolve and reform inconsistencies in their national regulations pertaining to goods, services, persons, and capital by January 1993. This was the major development in the bloc to further political integration and economic and monetary union (EU 2019).

Along with easing trade flows, the members signed the Schengen Agreement in June 1985 to allow easier movement of people by gradually abolishing border checks and harmonizing visa policies in the area. By 1990, this had expanded to complete removal of internal border control and a common visa policy and is now operational in 26 member countries, with only the UK and Ireland opting out of the system.

When communism fended across central and eastern Europe, this enabled Europeans to become closer and thus prompted further widening of the EU membership to include eight more countries in 2004: Czechia, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia. The Mediterranean countries Malta and Cyprus also formally joined the group. Bulgaria and Romania entered in 2007, and finally Croatia became the 28th member of the EU in 2013.

The Maastricht Treaty came into effect in 1993, transitioning the EEC to the modern-day EU. This established a single market and its four freedoms—freedom of goods, services, people, and money—a significant step toward deeper economic integration but also closer political cooperation. After a few years, the European Monetary Union
introduced a single currency, the euro, in 1999 as the bloc’s legal tender. Progressively, starting with 11 countries and eventually progressing to 19 countries, the EU adopted the euro.

The EU implemented important reforms of its institutions in 1999 under the Treaty of Amsterdam. These transferred some national government powers to the EU, covering areas of immigration, security policies, and the allocation of more resources to employment and EU citizen rights. The Treaty of Lisbon followed in 2009, forming the constitutional basis of the EU. This enhanced policies on voting, European Parliament powers, the legal personality of the EU, the creation of the President of the European Council, and a clause on secession should a member country wish to withdraw from the EU, among others.

Some challenging events have tested the strength, integrity, and stability of the EU system in the last 10 years. The global financial crisis originating in the US in 2008 presented a prominent challenge on economic and financial fronts when it hit the European continent. It severely affected many European banks and countries. By 2011, a second banking collapse threatened the EU due to the high sovereign debt of its members. The European Central Bank (ECB) then rolled out the €500 billion European Stability Mechanism in September 2012 to safeguard financial stability in the euro area through access to sovereign bond markets. The ECB, together with the International Monetary Fund, also assisted Greece, Ireland, Portugal, and Cyprus to avoid default. Greece was on the brink of economic collapse in 2015, threatening the euro’s existence, and the negotiations to secure its financial assistance caused severe disagreements among EU members on how to handle the crisis and prevent similar incidents in the future. The ECB also launched its massive asset purchase program in March 2015 to prevent EU economies falling back into recession. The ECB had spent €2.6 trillion net purchases by the end of December 2018 (Eser et al. 2019) to lift the economic growth of its member countries.

The worst refugee crisis also put the EU’s political and security cooperation to the test when it faced around 1 million migrants to the EU in 2015. Although the recent numbers have been falling, the wave is continuing (European Parliament 2017). This, among other outstanding issues, somewhat reignited the anti-EU sentiment in the UK, which led to its request for a new settlement. A referendum on whether the UK should remain in or leave the EU took place on 23 June 2016, with the British electorate voting to leave the EU. With three extensions granted, the UK finally left the EU on 31 January 2020 and entered a transition period until the end of 2020 (Table 11.1).
Table 11.1: European Union Timeline

<table>
<thead>
<tr>
<th>Date</th>
<th>Events</th>
</tr>
</thead>
<tbody>
<tr>
<td>18 April 1951</td>
<td>Treaty of Paris, creating the European Coal and Steel Community (ECSC).</td>
</tr>
<tr>
<td>August 1961</td>
<td>East Germany builds a wall across Berlin.</td>
</tr>
<tr>
<td>1 July 1968</td>
<td>The six remove customs duties on goods imported from each other, allowing free cross-border trade for the first time. They also apply the same duties to their imports from outside countries.</td>
</tr>
<tr>
<td>24 April 1972</td>
<td>The Exchange Rate Mechanism (ERM), created in 1972, is the first step toward the introduction of the euro, 30 years later.</td>
</tr>
<tr>
<td>1 January 1973</td>
<td>The first enlargement of the EU, with Denmark, Ireland, and the United Kingdom (UK) joining the original six founding members.</td>
</tr>
<tr>
<td>10 December 1974</td>
<td>EU leaders set up the European Regional Development Fund.</td>
</tr>
<tr>
<td>7-10 June 1979</td>
<td>EU citizens directly elect the members of the European Parliament for the first time.</td>
</tr>
<tr>
<td>1 January 1981</td>
<td>Greece joins the EU.</td>
</tr>
<tr>
<td>1 January 1986</td>
<td>Spain and Portugal enter the EU, bringing the membership to 12.</td>
</tr>
<tr>
<td>1 January 1993</td>
<td>The establishment of the single market and its four freedoms: the free movement of goods, services, people, and money are now a reality.</td>
</tr>
<tr>
<td>1 January 1995</td>
<td>Austria, Finland, and Sweden join the EU (total: 15 members).</td>
</tr>
<tr>
<td>26 March 1995</td>
<td>The Schengen Agreement takes effect in seven countries—Belgium, France, Germany, Luxembourg, the Netherlands, Portugal, and Spain.</td>
</tr>
<tr>
<td>17 June 1997</td>
<td>The signing of the Treaty of Amsterdam.</td>
</tr>
<tr>
<td>1 January 1999</td>
<td>The introduction of the euro in 11 countries (joined by Greece in 2001) for commercial and financial transactions only. Notes and coins will come later.</td>
</tr>
<tr>
<td>1 January 2002</td>
<td>Euro notes and coins become the legal currency in 12 EU countries.</td>
</tr>
<tr>
<td>31 March 2003</td>
<td>The EU agrees to create an area of freedom, security, and justice for all citizens by 2010.</td>
</tr>
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Table 11.1  continued

<table>
<thead>
<tr>
<th>Date</th>
<th>Events</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 May 2004</td>
<td>Eight countries of Central and Eastern Europe—Czechia, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia—join the EU. Cyprus and Malta also become members (total 25 members).</td>
</tr>
<tr>
<td>29 October 2004</td>
<td>The 25 EU countries sign a Treaty establishing a “European constitution.” The design aims to streamline democratic decision making and management in an EU of 25 or more countries.</td>
</tr>
<tr>
<td>1 January 2007</td>
<td>Bulgaria and Romania join the EU, bringing the number of member states to 27.</td>
</tr>
<tr>
<td>13 December 2007</td>
<td>The 27 EU countries sign the Treaty of Lisbon, which amends the previous treaties.</td>
</tr>
<tr>
<td>September 2008</td>
<td>A financial crisis hits the world economy. Several European banks and economies also experience difficulties.</td>
</tr>
<tr>
<td>2010</td>
<td>Several countries encounter problems with their public finances. The 16 euro area countries back a plan to help them deal with their deficits.</td>
</tr>
<tr>
<td>27 September 2012</td>
<td>Establishment of the European Stability Mechanism (ESM).</td>
</tr>
<tr>
<td>10 December 2012</td>
<td>The EU receives the Nobel Peace Prize as a recognition of its contribution to fostering peace and reconciliation, democracy, and human rights in Europe in the last 60 years.</td>
</tr>
<tr>
<td>1 July 2013</td>
<td>Croatia joins the EU, becoming its 28th member.</td>
</tr>
<tr>
<td>March 2015</td>
<td>The European Central Bank launches its massive asset purchasing program.</td>
</tr>
<tr>
<td>July 2015</td>
<td>Greece is the EU country that the economic crisis hits worst. Discussions on reforms in the country and support from the EU lead to a new deal.</td>
</tr>
<tr>
<td>13 November 2015</td>
<td>130 people die in a terrorist attack in Paris. EU ministers agree on tougher border security measures around the passport-free Schengen zone.</td>
</tr>
<tr>
<td>19 January 2016</td>
<td>Meeting of the European Council; EU leaders agree on a new settlement for the UK within the EU.</td>
</tr>
<tr>
<td>23 June 2016</td>
<td>The people of the UK vote to withdraw from the European Union by a margin of 52% to 48% in a referendum.</td>
</tr>
<tr>
<td>28 June 2016</td>
<td>Meeting of the European Council; EU leaders discuss the political consequences of the UK referendum.</td>
</tr>
<tr>
<td>30 September 2016</td>
<td>EU ministers approve the European Union’s ratification of the UN “Paris Agreement” on climate change, agreed in December 2015. This allows the agreement to enter into force.</td>
</tr>
<tr>
<td>21 December 2016</td>
<td>The European Commission adopts a package of measures to strengthen the EU’s capacity to fight the financing of terrorism and organized crime in the areas of money laundering, illicit cash flows, and the freezing and confiscation of assets.</td>
</tr>
</tbody>
</table>
Despite the setback of Brexit, the remaining 27 member countries celebrated the EU’s 60th anniversary of bringing peace and progress on 25 March 2017, as well as pledging to continue to work for unity and the strengthening of common policies. Members are committed to furthering integration by deepening the EU’s Economic and Monetary Union by 2025 in the pursuit of more concrete steps to enhance the unity, efficiency, and democratic accountability of the EMU. The EU has evolved tremendously, and the institution has promised that it will continue to ensure freedom, justice, and security, promote economic and social progress, and assert Europe’s role in the world (EU 2019).
11.3 Economic Integration of Processes of ASEAN+3

Indonesia, Malaysia, the Philippines, Singapore, and Thailand signed the ASEAN Declaration (Bangkok Declaration) on 8 August 1967 in Thailand, establishing ASEAN. The alliance aims to strengthen the bonds of regional solidarity and cooperation for peace, progress, and prosperity in the region. At that time, ASEAN cooperation centered on nonmilitary issues, focusing mostly on economic matters, to prevent untoward enmity among its members, and opposing the threat of communist-led insurgency.

The inspiration for the idea of regional cooperation that ASEAN formulated came from lessons learned from other countries’ experiences; that is, for smaller, neighboring countries with shared common interests to rely more on each other. ASEAN largely models its structure on the European Community (Khoman 1992). Shortly after its establishment, the first ASEAN–European Economic Community ministerial meeting took place in Brussels in September 1978, which marked the start of the long-standing partnership of these two dialogue partners.

The first expansion of ASEAN membership happened after 17 years, when Brunei Darussalam joined in 1984, followed by Viet Nam in 1995. In its 30th founding year in 1997, the Lao People’s Democratic Republic and Myanmar became members. Cambodia finally gained approval to join in 1999, making up the current 10 member countries of ASEAN. The region is a market of about 649 million people and had a gross domestic product worth $3.0 trillion as of 2018.

Slowly but surely, ASEAN has put in place several milestone agreements to further integration within the region, akin to the EU’s type of common market. In 1992, the group signed AFTA, which lowers and provides preferential tariffs on goods from fellow ASEAN member countries. It was a serious step for ASEAN members toward integrating into a single market, boosting export and investment sectors to increase the region’s growth potential. The ASEAN Trade in Goods Agreement replaced AFTA in 2010 and consolidated all the initiatives, obligations, and commitments on trade in goods in ASEAN. The members agreed the Bali Concord II in 2003 to convert the association into an ASEAN community by 2020. It comprises three major pillars, the ASEAN Political–Security Community, the ASEAN Economic Community, and the ASEAN Socio–Cultural Community; a blueprint guides each pillar.

The formal establishment of the ASEAN Community Agenda finally came into force in 2015, with the leaders of the 10 countries reaffirming their commitment to the ASEAN Charter and pledging to continue the
ongoing process of ASEAN community building (ASEAN 2015). In 2007, the signing of the ASEAN Charter took place, which gave the association a legal and institutional framework with a rule-based and people-oriented organization.

Integration with the rest of the world was also important for ASEAN. The region has forged seven free trade agreements, and another five are still under study or at the proposal stage with its major economic partners over the years, reaching out to Australia; the PRC; Japan; the Republic of Korea; India; Hong Kong, China; and New Zealand (ARIC 2019). It also started the East Asia Summit in 2005, in which the expanded group of ASEAN+3, Australia, New Zealand, and India have a forum to discuss various common issues. The Russian Federation and the US also joined the East Asia Summit in 2011.

For other areas of cooperation, ASEAN created the ASEAN Regional Forum as a venue for dialogues and security cooperation within ASEAN and with other countries in Asia and the Pacific in 1994. To enhance mobility, ASEAN implemented a visa exemption in 2006, which allowed ASEAN nationals to visit other member countries for up to 14 days. A single ASEAN visa is awaiting implementation in 2021; this is similar to the EU’s Schengen visa and will help to encourage tourism to boom within the region.

ASEAN’s de facto integration has intensified over the years, with about 23% of trade happening between ASEAN countries in 2016. Intra-ASEAN investments, the biggest contributor to foreign direct investment flows in the region, reached a record high of $27 billion in 2017, contributing 19% to the total inflows, mostly from Singapore, Malaysia, and Thailand (ASEAN 2018).

It has not always been smooth sailing in ASEAN. While trade and investment links have flourished, institutional integration in ASEAN is less than de facto integration due to the way in which ASEAN conducts its affairs. Its principles of noninterference, long consensus, consultations, and informality—which sometimes show shortcomings in the form of a lack of political will, trust, and sincerity toward one another (ASEAN 2017b)—resulted in prolonged decision-making processes. ASEAN seems to have a haphazard way of deepening institutional integration, maybe due to the absence of a willing and prominent political power to lead the group. It was a trickier problem with its expansion to ASEAN+3. Despite these limitations, no member country has ever left the association. ASEAN has celebrated its 53rd anniversary and is still the sole regional organization for Southeast Asian affairs.

In December 1997, the ASEAN+3 cooperation started when ASEAN leaders agreed to strengthen and deepen East Asian cooperation in the areas of economic, social, political, and other areas (ASEAN 2017a) with
the three major economies in Asia: the PRC, Japan, and the Republic of Korea. This was the first time that ASEAN expanded its cooperation within Asia at the time when globalization was firmly taking hold in the region. Against the backdrop of the Asian financial crisis, ASEAN+3 aimed to achieve financial integration through financial cooperation based on the Chiang Mai Initiative, which later morphed into the Chiang Mai Initiative Multilateralization, a single contractual agreement with a total size of $120 billion (Sussangkarn 2010) to protect the region from external financial shocks through a currency swap agreement (Table 11.2).

Other highlights of the ASEAN+3 cooperation in finance are the launching of the Asian Bond Markets Initiative in December 2002 to develop further the local currency bond markets in the region and the endorsement of a new Medium-term Road Map of the Asian Bond Markets Initiative in 2008. The presence of the three East Asian powers has reinforced the intraregional trade network as a dynamic trade zone and complementary production networks in the region as well as shifting the focus of ASEAN+3 to financial cooperation, which plays a crucial role in building an East Asian community.

Table 11.2: ASEAN Timeline

<table>
<thead>
<tr>
<th>Date</th>
<th>Events</th>
</tr>
</thead>
<tbody>
<tr>
<td>8 August 1967</td>
<td>Establishment of the Association of Southeast Asian Nations (ASEAN) between Indonesia, Malaysia, the Philippines, Singapore, and Thailand with the signing of the Bangkok Declaration.</td>
</tr>
<tr>
<td>24 February 1976</td>
<td>Signing of the Treaty of Amity and Cooperation in Southeast Asia, which provides for mechanisms for the peaceful settlement of disputes. It also commits ASEAN members to respect each other’s sovereignty mutually as well as noninterference in internal affairs.</td>
</tr>
<tr>
<td>September 1978</td>
<td>The first ASEAN–European Economic Community ministerial meeting in Brussels.</td>
</tr>
<tr>
<td>1984</td>
<td>Brunei Darussalam joins ASEAN. Total members: six.</td>
</tr>
<tr>
<td>1992</td>
<td>Member countries agree on a common effective preferential tariff (CEPT) scheme for the ASEAN Free Trade Area (AFTA) to foster economic cooperation in the region.</td>
</tr>
<tr>
<td>1994</td>
<td>The creation of the ASEAN Regional Forum (ARF), which focuses on security interdependence in the Asia and the Pacific region. The ARF serves as a venue for dialogues on political and security cooperation with other countries in the Asia and Pacific region.</td>
</tr>
</tbody>
</table>

continued on next page
<table>
<thead>
<tr>
<th>Date</th>
<th>Events</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 1995</td>
<td>Viet Nam joins ASEAN. Total members: seven.</td>
</tr>
<tr>
<td>July 1997</td>
<td>The Lao People’s Democratic Republic and Myanmar become members of ASEAN; onset of the Asian financial crisis. Total members: nine.</td>
</tr>
<tr>
<td>1997</td>
<td>ASEAN Vision 2020 charting a course to “a concert of Southeast Asian nations, outward looking, living in peace, stability and prosperity, bonded together in partnership in dynamic development and in a community of caring societies.”</td>
</tr>
<tr>
<td>December 1997</td>
<td>First meeting of ASEAN+3, comprising leaders of the 10 ASEAN members and their counterparts from East Asia—the People’s Republic of China (PRC), Japan, and the Republic of Korea.</td>
</tr>
<tr>
<td>April 1999</td>
<td>Cambodia becomes the 10th member of ASEAN.</td>
</tr>
<tr>
<td>4 November 2002</td>
<td>Signing of the Declaration of Conduct of Parties between ASEAN and the PRC.</td>
</tr>
<tr>
<td>December 2002</td>
<td>The launch of the Asian Bond Markets Initiative (ABMI) to develop local currency bond markets.</td>
</tr>
<tr>
<td>2003</td>
<td>Bali Concord II, which aims to establish a single ASEAN community with three pillars: the ASEAN Security Community, the ASEAN Economic Community, and the ASEAN Socio-Cultural Community.</td>
</tr>
<tr>
<td>December 2005</td>
<td>First meeting of ASEAN+6, also called the East Asia Summit, comprising the ASEAN countries plus the PRC, Japan, the Republic of Korea, India, Australia, and New Zealand.</td>
</tr>
<tr>
<td>23 July 2006</td>
<td>Signing of the ASEAN Framework Agreement on Visa Exemption. Visa-free travel within ASEAN for ASEAN nationals.</td>
</tr>
<tr>
<td>13 January 2007</td>
<td>Fast tracking of the implementation of the ASEAN Vision 2020 from 2020 to 2015.</td>
</tr>
<tr>
<td>20 November 2007</td>
<td>ASEAN signs a charter giving its 10 member states a legal identity, the first step toward its aim of achieving a free trade area by 2015.</td>
</tr>
<tr>
<td>24 March 2010</td>
<td>ASEAN+3 establishes the Chiang Mai Initiative Multilateralization (CMIM), which is a multilateral currency swap arrangement among ASEAN+3 members.</td>
</tr>
<tr>
<td>22 November 2015</td>
<td>The Kuala Lumpur Declaration on the 27th ASEAN Summit formally establishes the ASEAN Community, a deeper and more unified ASEAN identity by 2025.</td>
</tr>
<tr>
<td>9 February 2016</td>
<td>Establishment of the ASEAN Macroeconomic Research Office to provide independent regional surveillance in ASEAN+3 as an international organization with a full legal personality.</td>
</tr>
<tr>
<td>8 August 2017</td>
<td>ASEAN celebrates the 50-year anniversary of its establishment.</td>
</tr>
<tr>
<td>2018</td>
<td>ASEAN works on the ASEAN Single Window (ASW), e-commerce, and the ASEAN Smart Cities Network.</td>
</tr>
</tbody>
</table>

11.4 Lessons from the European Union’s Success in Integration for ASEAN+3

The EU remains the gold standard for regional integration. The EU has become a single market with free movement of goods and services, capital, and people. Furthermore, EU integration extends to political, security, diplomacy, and many other noneconomic fields. Over the last few decades, the EU’s integration has deepened to reach more advanced stages and its membership has expanded from a core group of a few western European countries to encompass much of Europe. ASEAN+3 can draw many valuable lessons from the resounding success of the EU as a vehicle for regional integration. While ASEAN+3 has made great strides in terms of regional cooperation and integration, its level of integration is far below that of the EU. More specifically, official cooperation and integration lag far behind de facto integration, which is especially evident in the economic sphere. The ASEAN+3 countries trade heavily with each other and invest a large amount in each other. For example, the ASEAN+3 countries have shown no signs of turning to the Chiang Mai Initiative Multilateralization swap agreement to protect their financial stability during times of stress, such as the global financial crisis.

Perhaps the single biggest lesson from the EU’s integration for ASEAN’s integration is the fundamental importance of political cooperation. Revilla (1984) identified political reliability and political interaction as the driving forces of the EU’s political cooperation. In-depth political cooperation between member governments is an absolute prerequisite for economic, security, and other forms of integration, a process that continues to develop and evolve. In short, politics dominates economics when it comes to regional integration. It is true that western European countries form a single economic bloc and depend heavily on each other as trade and investment partners. This is also true for the newer members from central and eastern Europe, for which it was precisely the prospect of closer economic links with western Europe that provided the motivation to pursue EU membership with such determination and enthusiasm. However, what ultimately enabled the expansion of the EU to Poland, Hungary, Czechia, Slovakia, and other new members was the political commitment and consensus among the existing members. Closer economic links can encourage closer institutional integration, but deeper ties and membership expansion are ultimately a political decision that requires conscious and deliberate political cooperation. Therefore, the EU experience suggests that it would be a mistake for ASEAN+3 to assume that closer official links would naturally follow closer de facto links, especially economic
links, in the absence of concerted political cooperation to advance the integration process.

In this context, the EU benefited enormously from the joint leadership of the two leading powers of continental Europe: France and Germany. More precisely, the success of the EU project would simply not have been possible without the two-headed French–German leadership. The EU project is essentially a political project aiming to prevent another devastating war in Europe, which was the epicenter of the two world wars of the 20th century. In a fundamental sense, the EU was the outcome of a grand bargain between France and Germany that would bind their economies closer together and link their economies more closely with those of Italy and the Benelux countries. The ultimate goal was shared economic prosperity, which would make military aggression and hence another war unthinkable. The French–German co-leadership gained considerable traction from Germany’s sense of guilt concerning its military aggression, which caused unfathomable suffering in Europe. This explains why Germany has, in effect, been funding the EU project. It has been the largest EU economy that has consistently paid substantially more into the EU budget than it has received from the EU; for example, in 2017, Germany contributed €19.6 billion to the EU budget, while the EU spent €10.9 billion in Germany (EU 2019). Analytically, one can think of Germany’s financial contributions to the EU as a kind of war reparation.

In ASEAN+3, there is no clear leading power or powers that can play a leadership role similar to the role that France and Germany play in the EU. Armstrong, Drysdale, and Tay (2019) observed that there is no hegemonic leadership in Asia. Indeed, there is no ASEAN+3 country or countries that proactively wield power. Perhaps the lack of leadership explains the biggest single criticism of ASEAN, namely that it is a toothless organization that fails to engage in any meaningful action due to its noninterference principle. The principle discourages members from criticizing each other even when they engage in, for example, widespread violation of human rights (Ramcharan 2000). For ASEAN+3, however, the picture changes dramatically. The PRC, Japan, and the Republic of Korea are among the world’s 12 biggest economies. In fact, the PRC and Japan are the world’s second- and third-largest economies, respectively. Given the disproportionate weight of the PRC, Japan, and the Republic of Korea in ASEAN+3, especially the PRC and Japan, it will be necessary to base any concerted push toward closer integration on intensive political cooperation between the PRC and Japan. In other words, there is a natural analogy between the role of France and Germany in the EU on the one hand and the role of the PRC and Japan in ASEAN+3 on the other hand. The major problem is
that political cooperation between the two East Asian giants has been notable largely for its absence.

The obvious implication is that deeper integration among the ASEAN+3 countries will have to await a comprehensive, genuine political rapprochement between the PRC and Japan. There are deep-seated historical issues that continue to divide the PRC and Japan as well as the Republic of Korea. In addition, geopolitical tensions between the PRC and Japan are to some extent inevitable for the same reason that geopolitical tensions between the PRC and the US are inevitable. The PRC is the rising power on the global stage vis-à-vis the US and on the Asian stage vis-à-vis Japan. History tells us that rising powers always collide with incumbent powers. In fact, the PRC has overtaken Japan as the dominant economic force in Asia to the extent that even Japan has become heavily dependent on exports to the PRC. In any case, the PRC and Japan must sort out their differences and join forces politically to give a big push to the ASEAN+3 project. A strong external shock that brings the region closer together could speed up the Sino–Japanese reconciliation process. For example, the current threat of global protectionism that forces outside the region have triggered may encourage the two Asian giants to settle their political differences and jointly lead a more tightly integrated ASEAN+3 economic bloc that can mitigate the adverse effects of global protectionism.

11.5 Brief History of Brexit

The UK has an on–off relationship with its continental neighbors. From a bird’s eye view, its issues with Europe centered on the extent of national sovereignty circumscribed to wider European institutions, as its political and economic dominance declined from its former heyday of the British empire (Robbins 2002). For most of its dealings with the EU, the UK has supported the union, as Margaret Thatcher’s work to complete the single market and Tony Blair’s work on European security exemplified, except in a few areas in which it has shown reservations (Cooper 2012).

Despite being the industrial center of Europe, the UK decided not to join the European Coal and Steel Community, the precursor of the European Union, in 1952. When the EEC formed in 1957 to bring about economic integration, the UK remain unaffected by the growing solidarity in Europe. However, by 1961, the UK had decided to apply for EC membership, which France’s President Charles de Gaulle strongly opposed. After more than a decade, the UK finally joined the EEC on 1973 after France dropped its objections following de Gaulle’s resignation (EU 2019).
In 1975, Prime Minister Harold Wilson, faced with splits among his ministers on Europe, decided to hold an “in–out” referendum on membership. Britons voted 67% to 33% to stay in the EEC in 1975, with most of the 68 administrative counties, regions, and Northern Island affirming their wish to stay and only Shetland and the Western Isles opposing the membership.

Despite Prime Minister Thatcher’s support in the campaign to stay in the EEC in 1975, her premiership became divided on the issue (EU 2019) and at times heated with other EU leaders as the UK started to press the bloc to reduce the British payments to the EEC budget. At that time, relative to other countries in the bloc, they were higher due to the presence of fewer farms in the UK. Farm subsidies made up about 70% of the total EEC expenditures under the Common Agricultural Policy. Thatcher negotiated the reduction of the UK’s contribution to the total budget from 20% to 12%, known as the “UK Rebate” (Pruitt 2017).

The UK also belatedly joined the European Exchange Rate Mechanism (ERM) in October 1990; this mechanism aimed to prepare the member countries prior to the full adoption of a monetary union, working as a means to reduce exchange rate fluctuations and achieve monetary stability in Europe. However, just 2 years into the ERM, the pound fell due to heavy pressure from currency speculators in 1992. The ERM forcibly removed the pound on 16 September 1992, when the UK government failed to keep it above its agreed lower limit in the ERM despite raising interest rates from 10% to 15% and authorized the buying up of the sterling pound in the market. This was called “Black Wednesday,” and it cost the UK Treasury $3.3 billion to defend the pound (Financial Times 2018). While it was a tough lesson for the UK to experience, Budd (2004) believed that the UK’s ERM membership was not a very worthy episode, but somehow helped to reduce inflation via inflation targeting.

The formation of the EU in 1993 appeared to be the means to integrate further the economic and political policies of the group. This EU policy even spanned a common foreign policy, citizenship rights, and a single currency. However, the UK opted out of four policy areas: Schengen acquis; the adoption of the euro as a common currency; the charter of fundamental rights; and the area of freedom, security, and justice.

Still in the wake of the euro debt crisis that started in 2009, several affected EU members were on the verge of defaulting again. To address this, the EU attempted to draw up a new accord to tighten the budget rules in the bloc. However, Prime Minister David Cameron vetoed a revision of the Lisbon Treaty to tackle the ongoing euro debt crisis in 2011, a first since the UK joined in 1973, to protect its financial sector.
The EU was increasing its clamp on the regulation of financial services, which had a 6.5% share in the total UK gross national product, with the largest concentration in London. Other changes included migrant payments and easier ways for the UK to block EU regulations.

Cameron’s speech in 2013 centered on the promise to renegotiate the UK’s membership of the EU and hold an in–out referendum if his party won a majority in the May 2015 general election. The rise of the UK Independence Party, the primary objective of which is to cut the ties of the UK with the EU, earned substantial support from the UK public. People viewed the in–out referendum as being more to appease the growing dissent of the populace regarding the burgeoning EU migration crisis and the trailing effects of the European debt crisis.

The Conservative Party eventually won, and Prime Minister Cameron started working on securing the special status of the UK within the EU (BBC 2016). The UK renegotiated its membership terms, in addition to the UK rebate and its four opt-outs, which the EU leaders approved on 19 February 2016. It should take effect after the UK referendum if “remain” wins. The UK set the referendum date as 23 June.

With these concessions in hand, Prime Minister Cameron still believed in the benefits of continued EU membership and campaigned for “remain,” confident that its economic ties with the EU will help to secure the campaign. More than 40% of all UK’s exports went to other countries within the UK, and around 50% of its imports came from the bloc. However, it was a significant blow to the “remain campaign” when some strategic members of his cabinet and the mayor of London supported “leave” campaigners.

In the referendum held on 23 June 2016, the majority of the UK electorate (51.9% vs. 48.1%) voted to leave the European Union, with a national turnout of 72% or more than 30 million voters participating in the referendum. The vote has also indirectly rejected the renegotiated terms of the EU–UK membership in February 2016. Both Scotland and Northern Ireland voted to remain in the EU, while England and Wales chose otherwise. Prime Minister Cameron resigned as soon as he had announced the referendum results.

Theresa May succeeded David Cameron, formally signing and lodging Article 50 of the Treaty of EU, which triggered the UK’s separation process from the EU, on 29 March 2017, starting the 2-year process for the UK’s exit from the EU, hence the coined term “Brexit” (Walker 2019).

After months of gridlock, the UK and the EU reached a draft agreement on the UK’s terms of departure on 13 November 2018. The agreement contains the highly contested backstop issue of the Irish border, which avoids having a hard border between Ireland and Northern Ireland after Brexit.
The UK Parliament rejected the draft agreement three times, and then Prime Minister May requested a second extension until 30 June 2019. However, lengthy and heated debates in the Parliament could not agree on the Withdrawal Agreement by October. The current Prime Minister, Boris Johnson, requested a third extension until 31 January 2020, and the UK-EU Withdrawal Agreement finally came into force on 1 February 2020; and the UK must pay a settlement payment, amounting £25 billion by 2057 to cover its financial commitments when it was still an EU member (Table 11.3).

As this book goes to press, we cannot ignore the possible structural challenges that the UK will face in the post-EU period. Although the Brexit deal is completed, the UK’s economic recovery will largely depend on how effectively it can tackle key structural challenges. These include implementation of the EU–UK Trade and Cooperation Agreement, negotiation of new trade agreements, and resolution of issues related to Northern Ireland. Other challenges include immigration, security, and governance. The UK government estimated that Brexit can lower long-term growth to varying degrees. The higher the barriers to UK–EU trade, the more negative the impact on the UK’s gross domestic product will be, in light of the heavy dependence of the UK economy on EU markets. Brexit will also affect investment, immigration, regulations, and EU budget contributions (Harari 2020). Other simulations done by Latorre et al. (2019) and The UK in a Changing Europe (2019) find that the UK economy will be significantly worse off if the UK fails to form a customs union or reach a free trade agreement with the EU.

Table 11.3: Brexit Timeline

<table>
<thead>
<tr>
<th>Date</th>
<th>Events</th>
</tr>
</thead>
<tbody>
<tr>
<td>1961</td>
<td>The United Kingdom (UK) applies to join the European Economic Community (EEC) for the first time.</td>
</tr>
<tr>
<td>1967</td>
<td>UK applies for membership for the second time.</td>
</tr>
<tr>
<td>1975</td>
<td>UK negotiates the UK Rebate, the reduction of its contribution to the total EEC budget.</td>
</tr>
<tr>
<td>1990</td>
<td>UK joins the Exchange Rate Mechanism (ERM).</td>
</tr>
<tr>
<td>1992</td>
<td>Signing of the Maastricht Treaty. UK leaves the ERM.</td>
</tr>
<tr>
<td>1997</td>
<td>Signing of the Amsterdam Treaty.</td>
</tr>
<tr>
<td>2011</td>
<td>UK Prime Minister David Cameron vetoes a revision of the Treaty of Lisbon to protect the British financial sector.</td>
</tr>
<tr>
<td>23 January 2013</td>
<td>UK Prime Minister David Cameron promises a referendum on UK’s membership of the European Union (EU) if the Conservative Party wins the next general election.</td>
</tr>
</tbody>
</table>
Table 11.3 continued

<table>
<thead>
<tr>
<th>Date</th>
<th>Events</th>
</tr>
</thead>
<tbody>
<tr>
<td>7 May 2015</td>
<td>UK voters elect a majority Conservative government. Prime Minister Cameron confirms in his victory speech that there will be an “in–out” referendum on European Union membership.</td>
</tr>
<tr>
<td>20 February 2016</td>
<td>Prime Minister Cameron announces that he has negotiated a deal with EU leaders that will give UK “special status.” He confirms that he will campaign for UK to remain in the 28-nation bloc. He sets the referendum date for June.</td>
</tr>
<tr>
<td>24 June 2016</td>
<td>UK votes to leave the EU. Prime Minister Cameron says he will resign in light of the results because UK needs “fresh leadership” to take the country in a new direction.</td>
</tr>
<tr>
<td>13 July 2016</td>
<td>Home Secretary Theresa May becomes prime minister.</td>
</tr>
<tr>
<td>29 March 2017</td>
<td>The UK government formally triggers Article 50, setting in motion a plan for UK to leave the EU on 29 March 2019.</td>
</tr>
<tr>
<td>7 July 2018</td>
<td>Prime Minister May and her Cabinet endorse the so-called “Chequers Plan.” Brexit Secretary David Davis and Foreign Secretary Boris Johnson resign, favoring a more complete break with the EU.</td>
</tr>
<tr>
<td>25 November 2018</td>
<td>EU leaders approve a withdrawal deal reached with UK after months of difficult negotiations. Prime Minister May urges the UK Parliament to do the same.</td>
</tr>
<tr>
<td>12 December 2018</td>
<td>Conservative lawmakers who back a clean break from the EU trigger a no-confidence vote in May over her handling of Brexit. She wins by 200 votes to 117, making her safe from another such challenge for a year.</td>
</tr>
<tr>
<td>9 January 2019</td>
<td>The House of Commons then commences the Brexit debates.</td>
</tr>
<tr>
<td>31 March 2019</td>
<td>Deadline of the second extension of Brexit.</td>
</tr>
<tr>
<td>24 July 2019</td>
<td>Boris Johnson succeeds Theresa May as prime minister.</td>
</tr>
<tr>
<td>31 January 2020</td>
<td>Deadline of the third Brexit extension. UK formally exited the EU and will be in transition until the end of 2020.</td>
</tr>
</tbody>
</table>

Sources: Thatham (2009), Walker (2019).

11.6 Growing Opposition to the European Union across the European Union

The ongoing messy Brexit highlights the growing opposition to the EU project due to economic reasons or cultural issues. However, this phenomenon is not solely happening in the UK. Broader euro skepticism, while not yet reaching the high levels of acrimony, also abounds within Europe. Schmidt (2016) attributed this resentment to the result of European integration hallowing out national politics. Over the years, various forms of disenchantment with the EU process have occurred,
especially in those countries that were experiencing nonsymmetric burdens of adjustment. While people regarded the EU as having helped to solve problems that national governments could not settle, it has somewhat watered down the authority of national governments on these matters. Schmidt (2016) believed that the EU citizens feel that they have little direct say over the policies that affect them and have turned to public displays of apathy as signs of protest to exert some influence on European-level decisions.

The issues generally center on three major strands: (i) the economic and budgetary policy crisis, (ii) the migrant crisis, and (iii) claims for sovereignty. For countries in the single currency area, EU institutions now have fiscal and monetary authority. They have to follow strictly the rules in the Stability and Growth Pact for economic stability, which mainly focus on regulating debt and deficits. The EU has stripped member countries of independent monetary policy tools that would enable them to respond in a timely manner to shocks or crises, such as raising interest rates or devaluing their currency. Taxation, however, remains the responsibility of each member country.

The Greek debt crisis is a clear example of the intricacies of navigating economic policy and sovereignty in a union environment. After disclosing in late 2009 that it had underestimated the country’s budget deficit and that this had breached the EU limits, the Greek economy lost steam and plunged into the doldrums. It approached the EU bloc for help, but it took a long time for EU leaders to act. The EU financial assistance that it forged with the International Monetary Fund came with conditions of fiscal austerity and structural reforms that resulted in hard living conditions, causing widespread anti-austerity protests against these policies in Greece.

The contagion spread through the continent, and economic hardship hit Ireland, Spain, and Portugal. As these countries approached the EU for bailouts, intense debates occurred between the so-called northern countries—Germany and France—and the southern countries, exposing a delicate issue regarding whether compliant eurozone countries have the responsibility to bail out those members that did not practice a prudent economic policy. These countries eventually received assistance, but the view was that it was too little and too late to address the underlying problems in a timely manner. Instead of bringing relief, stifling prescriptions accompanying the assistance made the burden of adjustment even harder, leaving a trail of EU member countries with still low growth and high unemployment rates. Hall (2016) argued that, while these reforms aimed to provide positive long-run effects, the short-run economic consequences are difficult and often have negative effects. There is also a mismatch of the economic prescriptions given to southern European economies, which are more domestic economy led,
and those given to export-led northern economies. As a result, public apathy and support for anti-EU political parties in Spain and in Portugal have risen. The eurozone debt crisis has exposed a weak link in an economic union: that, without the bound of a strong political union, the fruits of economic integration are not safe.

There is also a growing sentiment that it is important to leave a country’s budgetary matters to the country itself and not allow the EU to determine them centrally. In 2018, Italy’s populist government clashed with the EU bloc when it openly rebelled against the EU guidelines on fiscal deficits, citing that it needed to boost spending to stimulate its economy. The opposition of the populist government reflected the feeling of the broader population, especially younger voters, who blamed the EU for the fiscal austerity that caused them economic hardship. It has been most difficult for policy makers to pursue domestic reforms with curtailed power of the purse. France’s President Emmanuel Macron called on the EU to create a centralized countercyclical fiscal policy that all members can immediately tap into in the case of an asymmetric downturn, but this proposal faced opposition from the bloc.

Immigration policy is another thorny issue, especially the influx of migrants from outside the territory. Based on the November 2018 Eurobarometer survey, immigration ranks first in the two most important issues facing the EU at the moment (the other one is terrorism) and 53% of EU citizens have a “fairly negative” to “very negative” feeling toward the immigration of people from outside the EU.

The war in Syria saw the rise of asylum refugees and economic migrants from other parts of the world heading toward Europe (European Parliament 2017). While some EU residents welcomed migrants, particularly in Germany, which has an open-door policy, other recipient countries felt that there had not been thorough consultation on the idea of burden sharing, and, when migrants came in swelling numbers, they were unprepared to assimilate them properly into their society. This was true for Greece and Italy, the two countries that are the most accessible via the Mediterranean Sea, which became overwhelmed with huge numbers of migrant arrivals.

It also did not help that the placement of migrants among the EU member countries came at the time when most of them were still reeling from the severe effects of the eurozone crisis. The quota’s distribution across the EU members was not fair, leading to more public distress. Concerns about the influx of Muslims and rising terrorism associated with the arrival of migrants also caused immigration anxiety, adding another strain to intra-EU relations. Hungary’s current Prime Minister Viktor Orbán criticized the EU’s policy on mass immigration, as Hungary received disproportionately seven times more asylum applications
than the EU average in 2015. Austria’s Chancellor Sebastian Kurz also criticized the EU, saying that the focus should be more on securing EU borders to prevent future arrivals.

Sovereignty claims and too much intervention in national affairs are Poland’s and Hungary’s issues with the EU. The EU was hawkish about the current Polish government’s influence on its media and judiciary and Hungary’s concerns about freedom of expression, academic freedom, the rights of minorities and refugees, and other issues. The European Commission believed that these actions had breached its core democratic values; hence, it invoked Article 7 against Poland in 2017 and Hungary in 2018, which suspended their right to vote in EU decisions. Poland and Hungary have offered each other political support as they both battle with the Commission.

Within the countries of the so-called guardians of the EU, political clamors against the EU are brewing in Germany, France, and Italy. Strong populist political forces, such as Jean-Marie Le Pen’s National Front in France, have openly expressed their antipathy toward the EU. Germany expressed its displeasure about some EU members that are not following the established rules, and footing the bill of undisciplined members is creating frustration. A German euro skeptic party called Alternative for Germany complained that the government is using its taxpayers’ money to fund EU projects instead of focusing on home country needs. In France, the National Rally party is gaining ground as it campaigns for the return to nation states. The proliferation of EU rule-bending members, which seek financial support from the EU but in turn do not share solidarity with the bloc’s common goals, could stoke further anti-EU sentiment among the Germans and French. Until such time as the EU is able to resolve the political differences in running its affairs between northerners and southerners, euro skepticism could flare up and spur disintegration.

11.7 Lessons from Brexit for ASEAN+3

The Brexit experience holds a number of valuable lessons for further integration in ASEAN+3. It is necessary to emphasize that Brexit is the most dramatic and significant example of the slowdown of momentum toward ever-closer integration among European countries. As such, it is useful and helpful to think of Brexit not as an isolated one-off episode but as part and parcel of a broader trend. Of course, the UK had its own unique idiosyncrasies that separated it from continental Europe. Above all, from the outset, its commitment to the EU project was less intensive and deep seated than that of its continental neighbors. The UK always looked to its traditional transatlantic ties with the US as the cornerstone
of its geopolitical and diplomatic framework, which explains why it joined the EU relatively late and was content to play “second fiddle” to France and Germany within the EU despite its economic weight. Nevertheless, disillusionment and opposition to the concept of an ever-closer union has spread far beyond the UK to large swaths of the EU.

Indeed, hostility toward the EU project is evident even in founding member states, most notably Italy and France, as the previous section discussed. Even Germany has witnessed the emergence of an electorally significant far-right political party. To a large extent, the broad and deep erosion of popular support for the EU is directly attributable to the rise of populist, anti-globalization, anti-capitalist sentiment. As a political institution that people widely view as remote and unaccountable yet powerful and influential, the EU offers an easy target and scapegoat for angry EU voters. Fairly or unfairly, the EU is closely associated with immigration and other unpopular phenomena.

Perhaps the single biggest takeaway from Brexit for ASEAN+3 is that regional integration is reversible in the face of growing erosion of popular support for integration. Until shortly before the global financial crisis, the momentum of closer and deeper integration among European countries seemed unstoppable and inevitable. However, the Brexit saga underlines an altogether different reality—it is possible not only to slow down the momentum of integration but also to reverse it. Even though the UK was always a somewhat reluctant member of the EU, Brexit came as a complete shock to the British and European political establishments. The fact that Brexit was such a huge shock suggests that European governments are dangerously out of touch with their citizens when it comes to regional integration. In that sense, it was a wake-up call to EU governments to consult more closely with their citizens before they proceed further with the EU project. The widespread popular support for the EU at the early stages of western European integration, and the euphoria that greeted the accession to the EU of Central and Eastern Europe, has all but dissipated. Since regional integration ultimately depends on popular support, it is reversible when popular support falters.

The reversibility of regional integration, which the Brexit shock and a clear weakening of support for the EU across the EU underline, has an important corollary. More specifically, governments should consult closely with their citizens whenever they are planning a major EU-wide policy or policy coordination. Forcing major policies on voters without adequately consulting them can provoke a strong backlash. The likelihood of a backlash is stronger when there is economic hardship, which explains why the anti-EU public mood has intensified across the EU since the global financial crisis. One well-known example of the
EU failing to consult its citizens properly is the strong opposition of many EU countries to the German-led imposition of quotas for settling refugees from the Syrian civil war.

There are two interrelated fundamental implications for the integration of the ASEAN+3 countries from the Brexit shock. First, firm political commitment and consensus of the member countries are necessary for a robust ASEAN+3 integration pathway that will be relatively less vulnerable to shocks such as the global financial crisis. In particular, without a genuine and deep-seated political understanding among members as well as concrete common medium- and long-term objectives, the union is likely to unravel in the face of major shocks. Robust political consensus, especially among key members such as the PRC, Japan, and the Republic of Korea, can contribute to a deeper and more substantive ASEAN+3 and, just as importantly, promote the resilience of ASEAN+3 against shocks. Second, related to the first point, it is absolutely vital to gain ordinary citizens’ approval of the integration process and to consult them continuously as the integration project proceeds. In the absence of deep-seated and genuine popular support, it will be impossible to mobilize the political commitment and consensus required for sustainable regional integration.

11.8 Concluding Observations

Lack of progress in global integration, which the failure of the Doha Round of multilateral trade liberalization epitomized, has given a further push to the growing momentum of regional integration. Regional integration has both clear advantages and clear disadvantages vis-à-vis global integration, and the formation of regional economic blocs started well before the collapse of the Doha trade talks. The gold standard of regional integration remains the EU, which is often the benchmark for regional integration efforts around the world. One of these initiatives is ASEAN+3, which brings together East and Southeast Asian countries that have become tightly integrated economically in terms of trade and investment. Despite their rapid de facto integration into a regional production network, often called Factory Asia, official cooperation and integration lag far behind. The key takeaway from the EU’s successful integration for ASEAN+3’s future integration is that de facto integration does not automatically translate into institutional, systematic EU-style integration. What it requires is concerted political efforts on the part of the region’s governments to settle their political differences and engage in tight political cooperation.

More recently, the seemingly unstoppable momentum of ever closer and deeper integration among EU countries has given way to
widespread concerns about the future of the EU. The immediate catalyst of pessimism is the shocking referendum outcome of Brexit—that is, the majority of UK voters voting to leave the EU. The UK is not just another EU country but one of the group’s biggest economies and has long been a robust advocate of pro-market policies within the EU. Furthermore, people see Brexit not just as an isolated one-off event but as a symptom of broader discontent about the EU across the EU. The key implication of Brexit for ASEAN+3 is that it is necessary to build the regional integration process on a firm foundation of political commitment and consensus, which, in turn, should rely on continuous consultation with and proper information dissemination to the general public. Without such a foundation, which renders the group resilient against and hence less vulnerable to big external shocks, such as the global financial crisis, integration is always reversible, as Brexit has clearly shown. Regional integration is always a challenging and fraught process, but learning the right lessons from the EU and Brexit will help ASEAN+3 to achieve a deeper, more advanced stage of regional integration.
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Disintegration in the European Union and Lessons for Asia

Golam Robbani

12.1 Introduction

After a long drama, Brexit is now officially over. But the details of any possible deal have yet to be confirmed. More than 3 years after the Brexit referendum, it is still not clear exactly on what terms the United Kingdom (UK) is going to exit the European Union (EU). No matter what path it takes to leave the EU, it will undoubtedly have far-reaching socioeconomic and political consequences. The question in the 2016 Brexit referendum was simple: Should the UK leave the EU or remain? But that simple question placed an enormous decision-making burden on the UK’s citizens because the country’s membership has a long history, and Brexit will potentially have an extensive impact on their lives and livelihoods in the years to come. As a result, the people and their representatives in the House of Commons are deeply divided on this issue.

The supporters of Brexit (hereafter Brexiteers, for short) put the blame squarely on the EU for their economic, social, and political suffering. Brexiteers believe that Brexit will make them economically prosperous, socially satisfied, and politically independent. But that argument goes against the fact that, as of today, the EU is the most successful integration arrangement in the world. The aim of this chapter is to review why the disintegration process is happening in one of the most successful integration arrangements in the world and what lessons can be learned for other integration arrangements—especially in Asia.

The author uses a documentary analysis of recent debates over Brexit to examine why the majority of the UK’s citizens supported Brexit. By classifying the reasons supporting Brexit as economic, social, and political factors, the author performs a fact check on the Brexit campaign to see whether Brexiteers used a deceptive campaign to lure
voters. Finally, the chapter examines whether sovereignty and economic progress have been incompatible in the debates on Brexit. This chapter proceeds as follows. First, the chapter offers a recap of the regional integration and the history of the UK’s membership of the EU, including a theoretical background. Then, the chapter examines who voted for Brexit and why, followed by a critical analysis of the claims made by Brexiteers from economic, social, and political points of view. Finally, the chapter concludes by highlighting some lessons to be learned for other integration arrangements in Asia.

12.2 Regional Integration and the European Union

Regional integration is a formal cooperation between states on political, economic, and social issues. Contrary to common belief, regional integration is not merely an economic phenomenon. The reason for this is that the complex process of integration involves heated domestic debate (e.g., should Switzerland or Norway join the EU?); lengthy international dialogue (e.g., should Turkey be allowed in the EU?); and painstaking economic negotiations (e.g., the extent of tariff concessions—positive list, negative list, etc.). These phenomena have profound socioeconomic and political impacts on member states of regional integration arrangements.

Economists argue that free trade is not a zero-sum game. The past 200 years of experience indicates that free trade makes every country better off. But that does not mean that everybody in society will automatically be better off because of regional integration. Free trade might create winners and losers within a country. Economists, however, argue that the winners will win more than the losers lose—leaving the society as a whole better off. Therefore, countries engaged in free trade should have a redistribution mechanism in place to compensate the losers. Otherwise, there might be a social conflict between the haves and have-nots. This chapter will shed some light on whether such a divide influenced Brexit to happen.

Today’s EU was not built in a day. The historical roots of the EU lie in the Second World War. Soon after the war, Europeans were determined to prevent mass killings and destructions ever happening in Europe again. The western European nations created the Council of Europe in 1949 to stop such atrocities. This was the first step toward cooperation among them after the Second World War. But Germany, France, Belgium, Luxembourg, Italy, and the Netherlands (hereafter, the Six) wanted to go further with their cooperation, which will be elaborated later. Before that the author offers a short description on how the EU integration is explained by different integration theories.
Different integration theories have tried to explain European integration. Liberal intergovernmentalism and neofunctionalism are considered to be the most widely accepted integration theories explaining the development and progress of EU integration.

Liberal inter-governmentalists assume that states remain the main actors of regional integration. Integration happens through states searching for mutually advantageous bargains based on cooperation and competition among national governments. According to Hooghe and Marks (2019), “liberal intergovernmentalism combines a liberal theory of domestic preference formation with an institutionalist account of intergovernmental bargaining in which states are instrumental and driven chiefly by economic interests.” The formation of the European Economic Community (EEC) in the 1950s can be explained by intergovernmental action in response to the post-Second World War crisis in Europe. According to inter-governmentalists, states may delegate some kind of sovereignty to supranational or subregional authorities. But that is not necessarily to make the national governments obsolete. Instead, the proponents of intergovernmentalism argue that it strengthens governmental policy coordination via coalition building among nation states (for details, see Moravcsik 1995).

Neofunctionalism, on the other hand, assumes that sectoral actors work under the states and operate to maximize their self-interest in cooperating with other sectors or countries. Thus, neo-functionalists think that societal actors develop international relations based on their interests. Such functional actors may agree to form supranational institutions if that seems more promising than national institutions in achieving their interests. The actions of such sectoral actors might pave the way for regional integration. The formation of the European Coal and Steel Community (ECSC) is considered to be an interplay of functionalism. Although states were still the main actors, technocrats driven by interest groups supported the idea of forming a Franco-German alliance in coal and steel, which, as neofunctionalists foresaw, eventually spilled over to other areas of cooperation to make today’s vast EU.

Both theories have merits in explaining the formation and progress of EU integration. But critics argue that none of the theories explain thoroughly the conditions under which the EU could be de-integrated as has been happening through Brexit in the UK recently. Therefore, a third theory, called “postfunctionalism,” has emerged to explain the de-integration in Europe (Hooghe and Marks 2019). Postfunctionalism “emphasizes the disruptive potential of a clash between functional pressures and exclusive identity” (Hooghe and Marks 2019). The recent debate around Brexit follows this argument: It is a clash between economic interest and identity to “take back control.” To fully
understand the Brexit debate, we need to know a bit of the history of the UK's access to the EU project. But the supranational institutions of liberal intergovernmentalism and the deeper integration due to neo-functionalists' spillover effect have created an endured tension between economic progress and sovereignty—which is vividly visible in the Brexit debate. The chapter now turns to the process of the UK's integration into the EU.

The UK's entry into the EU was no less dramatic than what we witness today with Brexit. Having experienced four major wars in a single century, at the end of the Second World War, European leaders were desperately looking for a way to stop wars in Europe. As a political union was challenging to achieve in those days, the leaders in western Europe tried to unite European states in a tight knot based on economic relations. Consequently, the then French Foreign Minister, Robert Schuman, put forward a proposal to place French and German production of coal and steel under one joint high authority. The project was designed in such a way as to create common interests among European countries, hoping that gradually it would lead to a political union “to make another war impossible” in Europe. Belgium, France, Italy, the Federal Republic of Germany, Luxembourg, and the Netherlands quickly accepted the Schuman Declaration (9 May 1950). They signed the Treaty of Paris in 1951 to establish the ECSC, which ECSC paved the way for the signing of the Treaty of Rome in 1957, creating the EEC—the predecessor of today's EU.

Membership of the EEC, or any of the prior agreements that led to European integration, was open to all European states—including the UK. But in 1957, the UK decided not to join the Treaty of Rome. Instead, the UK initiated an intergovernmental organization in 1960 called the European Free Trade Association (EFTA) with Austria, Denmark, Norway, Portugal, Sweden, and Switzerland to promote free trade and economic integration among its members. Nonetheless, realizing that the significance of the EFTA is too little to counter the development of the EEC, the UK decided to join the EEC in 1963. But that intention was blocked by the then French President Charles de Gaulle twice: in 1963 and 1967. But why did the UK hesitate about joining at the beginning? What made it change its mind? And why did President de Gaulle try to keep the UK out of the European integration?

The UK was not interested in joining the EEC in the 1950s. The well-known slogan of the Brexit campaign—take back control—was not new in British minds. At the crucial conference of 1947, there were agreements on all issues except one: “The French favored a customs union, the English a free trade area” (Campos and Coricelli 2015). That disagreement has continued, albeit subtly, until now. In 1955, the UK
withdrew from the Spaak Committee due to the supranational structure of the proposed integration. The UK’s alternative proposal to form a free trade area—instead of a customs union—was rejected by the Six. The UK did not like the supranational structure of the EEC, perhaps because it was too early for them to give up their leadership role in the world, and they did not want to undermine their link with the Commonwealth. As a result, the UK decided not to be a part of the EEC process during the 1950s. But the UK changed its mind later.

Having failed to convince France and Germany to stay away from the supranational structure of the EEC, the UK established the EFTA. The initiative was perceived by many as the old “divide-and-rule” policy of the UK. Nonetheless, soon the EFTA was proved to be insufficient to counterweight the success of the EEC. Before long, the UK realized that the country’s economy was no longer competitive as it was before. The income gap between the UK vis-à-vis other comparable states was closing rapidly. In 1945, for instance, the per capita gross domestic product (GDP) in the UK was about 90% larger than the average of the six founding members of the EEC. By the time the Treaty of Rome was signed, the gap had come down to 15%. The difference had declined further to 6% by 1967. When the UK joined the EEC in 1973, the per capita GDP was 7% smaller than the average of the Six (Campos and Coricelli 2015). The continued economic decline left the UK little choice but to seek EEC membership. It is widely believed that the UK joined the European project to stop the country’s relative economic downturn. Therefore, the UK decided to join the EEC.

But the path to joining the European project was not as smooth as the British might have thought. To the surprise of many, President de Gaulle vetoed the proposal for the UK’s entry into the EEC twice: in 1963 and 1967. The Guardian (1973) notes: “General de Gaulle, on his own testimony, has never said that he wanted to see Britain enter into the Common Market stripped naked” (Roberts 1967). His denial of the UK’s entry into the European project can be explained on personal, tactical, and strategic grounds.

From a personal perspective, he was furious with the British, because, according to a secret document, “Churchill plotted to oust General de Gaulle as leader of the Free French forces during the Second World War, describing him as ‘a bitter foe of Britain’ who left ‘a trail of Anglophobia’ behind him everywhere he went.” Perhaps President de Gaulle had little trust in the British due to his personal experience and thus he blocked the UK’s entry into the Common Market.

Tactically, President de Gaulle wanted to preserve the dominance of France in the leadership of the Common Market. Therefore, when the UK opted out of the Treaty of Rome, de Gaulle used that opportunity to
preserve the leadership role of France in the Franco-German alliance by blocking the UK’s entry into the EEC.

On strategic fronts, President de Gaulle argued that the UK did not fit in the European construction. He understood the UK as an open economy and too attached to the United States. From his long experience of working with the British and Americans, he firmly believed that the British would eventually act as an American agent inside the Common Market. In a conversation with the BBC (Connolly 2017), Edith Cresson, the former French Prime Minister, noted that “[h]e [Pres. de Gaulle] had a lot of experience of the British, and he always thought that they’d be on the Americans’ side ... so I don’t think he believed that they’d play the game of Europe.” As he believed that the British might eventually use the United States as a tool for interfering, he did not want to invite American dominance in European matters via the entry of the British.

Although de Gaulle delayed the process, he could not stop the UK’s entry into the EEC. Eventually, the UK joined in 1973, and the citizens of the UK accepted the idea of shared prosperity through a referendum in 1975 when 67.2% voted to stay in the Common Market. Despite majority approvals, the British felt uncomfortable in sharing its sovereignty by accepting the superiority of EU rulings over the UK’s domestic jurisdictions. Hence, from the beginning, the UK tried to promote an intergovernmental relationship with other European states. This preference for intergovernmentalism is one of the reasons why the UK opted out of the Social Chapter in 1992 and stayed out of the common currency—the euro.

Despite its hesitations, the UK continued to be a valued partner of the EU. It took part in most of the processes strengthening the cooperation among EU member states. But following the 2008 financial crisis, UK citizens’ dissatisfaction over EU activities started to grow, and finally—40 years after the first one—the issue was put to a referendum in 2016 once again. The poll was to choose whether to leave or remain in the EU. Defying most predictions, the outcome of the referendum showed a slight majority for leave (52%) over remain (48%). This shocking result led many researchers to examine who supported Brexit and why, and whether the EU could be blamed for the bizarre outcome of the referendum.

12.3 Who Supported Brexit and Why?

It is hard to understand why the citizens of the UK decided to leave the EU in 2016 while they were desperate to join the Common Market in the 1960s and overwhelmingly supported staying in it via a referendum in 1975. While different studies came up with slightly
different reasons, the voting pattern reveals that lower-income groups, citizens with lower levels of education, voters from areas with higher levels of immigration, and those aged over 45 disproportionately voted for Brexit (Zhang 2018; Clarke, Goodwin, and Whiteley 2017). Other studies, such as Arnorsson and Zoega (2018) and Ashcroft (2016), supported these results. But what factors drove the British to support Brexit?

12.3.1 Factors Driving the Support for Brexit

Complex factors drove the outcome of the 2016 Brexit referendum. To keep this discussion simple, however, this chapter will focus on economic, social, and political factors that led to the result, because several studies indicate that the Brexiteers convinced voters by highlighting the perceived cost of EU membership (economic), too much immigration (social), and the benefits of taking back control of their country (political).

Economic arguments: For a long time, the UK has been the fifth-largest economy in the world and a leading center of global finance. Yet, 14.2 million people in the UK are in poverty, with 7.7 million (12.1%) being in persistent poverty. The child poverty rates are as high as 40% and are predicted to rise by 7% between 2015 and 2022 (Social Metrics Commission 2018). These records are disappointing to the British, who considered the EU a dysfunctional economic entity. Because of these hard facts, alternative arguments, e.g., “leaving the EU would be an economic disaster,” were not convincing enough for people to oppose Brexit (Mauldin 2016).

The disappointing figures mentioned above do indicate that EU membership might have created winners and losers in society. It is not surprising, then, that some sections of the community may have been unable to claim a fair share in open market competition. These vulnerable groups, if they exist, may require additional support (such as subsidies) from the government. This chapter will like to come back to this point later to examine whether redistribution was a problem. But economic misery was not the only reason why the majority supported the leave campaign. There were social as well as political motivations behind the support for Brexit.

Social reasons: Immigration (legal, illegal, or refugee) was one of the most contested issues during the 2016 referendum debate. Supporters of the leave campaign blamed mass migration as the root cause of their socioeconomic downfall. It is true that, due to the EU’s free movement of people, citizens of the UK had noted the massive influx of people coming to the UK without restrictions and settling down. The newcomers were
mostly from eastern European states. Although cheap labor was good for the UK economy, it was hardly noticed by citizens in general. Instead, many voters looked at its negative consequences and claimed that the immigrants were “eating up local jobs” or “importing crime.” Sensing the development of negative sentiments in the UK society, Brexiteers convinced voters to vote for leaving the EU.

Political arguments: Brexiteers vigorously used nationalism—with the slogan take back control—to convince voters to support Brexit. As indicated earlier, the sense of patriotism was not new in British minds. Since the 1950s, the UK had been hesitating about sharing sovereignty in exchange for economic integration. Apparently, the pain of losing independence was higher in British minds than the likely gain in economic prosperity because of the country’s glorious past: the fifth-biggest economy, a regional power, and a former world leader. The past glorious days of the UK made it challenging for some citizens to accept the position of an underdog. It is not surprising, therefore, that citizens of the UK feel bad about sacrificing sovereignty. But can states live alone in this globalized world?

Globalization has made it difficult and costly for countries to live in isolation. Over the last few decades, globalization has become indispensable for growth—though not without costs. Hence, globalization has been a controversial issue ever since, and is perceived differently by different generations. The younger generations, such as millennials, are more accommodating to globalization than the older generations, who may have found difficulty in acquiring the new skills required to take advantage of the fast-moving, technology-driven, globalized world. Globalization, regional integration, or free trade, is bound to create winners and losers in society. It is the responsibility of the national government to design remedial mechanisms to compensate the losers to minimize the social divide. Did the government of the UK fail to redistribute the gains from the EU common market to those who voted for Brexit?

Brexit and internal redistribution: Various studies indicate that EU membership has offered substantial benefit to the UK. The UK joined the EU in 1973 to stop its economic downturn. And it worked. Since it joined, the GDP per capita in the UK has grown faster than that of France and Germany (Oxford University 2016). Subsequently, the UK’s GDP kept increasing, and other economic indicators also improved due to greater access to the European market. According to the Confederation of Business and Industry of the UK, 71% of their members report that the EU had an overall positive impact on their business. Only 13% reported a negative effect. A Confederation of Business and Industry literature review suggests that the net benefit of EU membership to the UK could
be somewhere between 4% and 5% of GDP or £62 billion–£78 billion per year (Lewis 2016). The Financial Times (2017) stated that the EU had been a good period for the economy. The continuous rise of real GDP growth from 1958 to 2015 suggests that EU membership had been beneficial for the UK.

In contrast, various estimates indicate that there will be an income loss of up to 10% of GDP if Brexit happens. Other estimates also suggest that loss of productivity might be around 6% to 9% after leaving the EU. The estimated negative consequences of Brexit support the notion that the EU was beneficial for the UK economy. Chadha (2016, cited in Campos 2016) argues that the cost of likely disintegration via Brexit would be substantial.

In a nutshell: “History is clear: Things have gone very well for Britain as a member of the EU” (Oxford University 2016); “Brexit will make the United Kingdom poorer than it would otherwise have been...” (Sampson 2017). Nevertheless, it is still puzzling why the extent of the poverty is so high in the fifth-largest economy in the world.

Poverty–prosperity paradox: There is a high probability that the UK economy will suffer after Brexit. Because various studies suggest that the UK benefited from EU membership and several studies (e.g., House of Commons 2016) also indicated that the UK economy would be worse off in the case of Brexit, the effect might be devastating if the UK crashed out without a deal. This gloomy prediction is not entirely fabricated. The sharp devaluation of the pound sterling after the referendum, a tendency of capital outflow, and relocation of some (big) businesses out of London indicate what might happen after Brexit. But, despite positive effects, why are so many people in the UK living in persistent poverty?

This paradox raises another question: Does the source of the dissatisfaction indicate an internal redistribution problem? We may recall that, theoretically, free trade is a positive-sum game: Every country engaged in free trade should benefit. Free trade, however, cannot guarantee that all the sectors of an economy will enjoy equal benefits. An open trade policy, for instance, might offer enormous benefits to the businesses and workers involved in export-oriented industries, but it may hurt stakeholders engaged in import substitution industries. In short, free trade makes an economy well off but may create winners and losers in society. This likely economic discrepancy creates a significant burden on the government to design appropriate policies (taxes and subsidies) to compensate the losers. As the author has been alarmed by credible studies (Social Metrics Commission 2018) that there is widespread poverty under the UK’s prosperity, it is crucial to investigate whether the government of the UK failed to
The Gini coefficient indicates the income disparity of a country. It measures how the wealth of a country is distributed among its citizens, with zero meaning perfect equality, and 100 meaning that all resources are concentrated in one hand. As highlighted in the Standardized World Income Inequality Database, the Gini coefficient of the UK started declining from 1970 and has continued to rise since 1980. The Gini coefficient of the UK began to increase and continued up to 2000, indicating higher inequality, which could be a potential cause of Brexit. But it should not be because, since 2000, the income inequality of the UK has declined to 34 (Dabrowski 2016). The UK’s Office for National Statistics (2019) provides similar results. As a side note, comparatively, the income inequality of the UK is much less than that of the United States. Therefore, if incomes had been increasing during the period of EU membership and income inequality was not that high, then economic factors cannot be blamed for Brexit. But if not economics, what then?

So what actually went wrong? The analyses so far suggest that EU membership was good for the UK. As an argument for Brexit, income distribution was not a big problem. Immigration was a problem, but it was hardly big enough to change the result, and sovereignty was an issue, but the UK has been able to live with that for the last 40+ years. So what was the real problem that led to Brexit? Did Brexiteers oversell Brexit during the 2016 referendum campaign?

The leave campaign was based on wrong assumptions. Economic progress was not the only objective of EU integration. The overall aim was to achieve a political goal—“to make another war impossible.” The desire, therefore, for the UK to be a part of the EU without accepting the superiority of the European Commission, or the European Court of Justice (ECJ), was misleading. Likewise, the presumption that the UK would get a good deal despite leaving the EU has proven to be an illusion, because the EU is not going to allow the UK a free ride as it would set a bad precedent for others to follow, particularly at a time of rising populism in Europe, for such a free ride might threaten the very existence of the EU.

Membership fee: The argument about a huge membership fee was a clear exaggeration. It appears that the Brexit supporters used fiction rather than fact in regard to the EU membership fees. The politicians supporting the leave campaign exaggerated the cost of EU membership. One particular instance is that the UK’s well-known member of parliament, later Prime Minister Boris Johnson, was ordered to appear in court over a £350 million claim made during the Brexit campaign.
Johnson’s claim makes little sense if one considers the actual net contribution of the UK.

The claim that the UK paid £350 million per week to the EU as a membership fee was fabricated. The net payment was nowhere near that claim. Actually, it was only £8.9 billion in 2017, which turned out to be less than £175 million per week. This exaggeration of the membership fee indicates that the leave campaign misinformed and misled the voters. Apart from misleading information about the cost of the membership fee, the leave campaign created panic around the influx of immigration to attract voters.

Fear of immigration: Immigration was indeed a big problem in the eyes of UK citizens. But it was not as big as had been propagated. During the campaign, Brexiteers tried to convince young local people by presenting fabricated information. Admittedly, there have been some problems at the UK borders with illegal immigrants. But the problem was not as big as demonstrated during the 2016 Brexit campaign. The UK is not part of the Schengen Agreement. Therefore, an excessive number of illegal migrants could not enter the UK by crossing the vast water around the country’s borders. Apart from this, the Brexiteers also used misleading information to scare young voters who might be looking for jobs. For example, the Brexiteers highlighted that millions of EU citizens were looking for jobs in the UK to make Britons jobless—which was not entirely true because the EU area was also open for jobs for UK citizens.

Islamophobia: The Brexiteers were not shy about using Islamophobia to appeal to voters. Islamophobia is fear, hatred of, or prejudice against the Islamic religion or Muslims. During the 2016 referendum campaign, Brexiteers tried to use Islamophobia to create panic among the British voters. For example, Brexiteers used Turkey’s entry into the EU as a weapon to create Islamophobia. Turkey’s entry into the EU caused lengthy debate. There was hardly any possibility that Turkey was going to be accepted into the EU, given that the consensus of all members is necessary. It was not unknown, therefore, that Turkey’s entry into the EU was unlikely. Nevertheless, Brexiteers used that issue to create fear among British voters. The purpose of the fabricated and misleading information used during the Brexit campaign was to paint a gloomy picture of the UK’s future. Brexiteers demonstrated how deadly the impact would be for the British if they did not leave the EU. Many believe that Brexiteers exaggerated those issues to blackmail the voters emotionally.

But deceptive campaigns are not a rare event in politics because, according to this author, what could be a bigger lie than that politicians do not lie? The misleading campaign, therefore, could hardly be a
sufficient factor to convince millions of British voters to vote for Brexit. There must have been something more. One such thing appears to be the debate between political sovereignty (or self-government) and economic progress.

Sovereignty versus economic progress: At shallow levels of regional integration (such as a preferential trading arrangement, free trade area, or customs union), the pain of losing sovereignty is less visible than the gain in economic progress. Any step forward beyond a customs union leading to a common market or an economic union, however, requires acceptance of some kind of supranational authority. Rodrik (2016) has explained this situation with the “globalization trilemma,” when states can accept only two of the three elements of hyper globalization (deep integration), national sovereignty, and democratic politics. The complexity of Brexit suggests that the British might have been facing the globalization trilemma described by Rodrik, because deeper integration is only possible if the UK is willing to sacrifice national sovereignty by accepting some kind of control from the supranational authority of the European Council and ECJ.

For instance, the superiority of the European Commission and the ECJ over national jurisdictions is an essential part of ensuring the EU’s four freedoms: the free movement of goods, services, capital, and people set out in the Treaty of Rome in 1957. Likewise, several other agreements, such as the Schengen Agreement (1985), the Single European Act (1986), the Treaty of Maastricht (1992), and the Treaty of Lisbon (2007), were aimed at deepening the relationship among EU member states. All these treaties involved explicit or implicit acceptance of the superiority of EU institutions. Thus far, the UK had used its “opting out” strategies (e.g., from Schengen and the euro) to defend its sovereignty. That strategy, however, appeared not to be tenable or sufficient anymore. Therefore, during the 2016 referendum, the citizens of the UK had a stark choice: either to give up the right to self-government for economic progress or to take back control at a high economic cost. The results from 91 polls (from 28 June 2016 to 30 November 2019) summarized by What UK Thinks (2019) suggest that the remain vote might get a slight majority if another referendum was offered. The Conservatives, however, proved that prediction wrong by winning the December 2019 election with a big margin. But it is not clear whether the voters chose the Conservatives in order to leave the EU soon, to get rid of the Brexit uncertainty at all costs, or because of the Labour Party’s (mainly Jeremy Corbyn’s) indecisiveness between leave and remain. Nevertheless, the outcome of the 2019 general election suggests that the British might have preferred national sovereignty over economic continuity. Therefore, it is not fair to blame the EU for Brexit.
12.4 Conclusion and Policy Recommendations for Asia

The objective of EU integration was clear: to make another war impossible in Europe. To achieve that political objective through economic means, EU leaders pursued deeper economic integration with a supranational structure. But that progress toward deeper integration became incompatible with the British agenda. From the beginning, the British were hesitant about giving up their sovereignty. But they stayed in due to the substantial economic benefits of being part of the Common Market. When the integration became too deep to preserve independence, the UK government offered a Brexit referendum where the majority supported leaving the EU.

Analysis of the voting pattern reveals that white, Christian, and older UK citizens overwhelmingly supported Brexit, whereas minority groups—including blacks and Muslims—predominantly voted to remain in the EU. This divide suggests that when British were trying to get back control of their economy, the “outsiders” must have felt comfortable in the hands of global circumstances, rather than living in a country with nationalistic sentiments. But if one looks at the fact that cities were overwhelmingly against Brexit, whereas towns were for it, this variation between cities and towns (rural areas) highlights again that regional disparity might have played a role. Older people and pensioners voted to leave because they were the old guard—often driven by nationalistic sentiments. Also, the older British might have seen that the UK was creating more opportunities for outsiders and city dwellers, whereas their children, who were engaged mostly in low value-added sectors such as agriculture, were suffering from joblessness. One frequent target of all the sufferings is immigration. Therefore, many old, less-educated, and financially less well-off people supported Brexit. But analyses do not seem to suggest that those factors were big enough to obtain a majority for Brexit. The arguments indicate that citizens’ ignorance and the misleading campaign were a cause of the bizarre outcome of the Brexit referendum. But another major issue was the mutually exclusive choice between sovereignty and economic progress. The citizens of the UK might have chosen to take back control of their economy despite substantial likely economic costs. Therefore, the EU cannot be blamed for the disintegration via Brexit.

12.4.1 Lessons from the Brexit Experience for Asia

Following the unprecedented success of the EU, countries in Asia, Africa, and Latin America tried to emulate the EU integration and replicate the EU’s success. The outcome, however, was not that electrifying, except
for a few organizations like the North American Free Trade Agreement (NAFTA) and the Association of Southeast Asian Nations (ASEAN) established in 1967 by Indonesia, Malaysia, the Philippines, Singapore, and Thailand.

Comparatively speaking, ASEAN—an intergovernmental organization—is a success story in Asia, albeit not without its challenges. Gradually, the number of member countries grew to 10 when Brunei Darussalam (1984), Viet Nam (1995), the Lao People’s Democratic Republic (1997), Myanmar (1997), and Cambodia (1999) joined the group. The aims of the association are economic growth, social progress, and cultural developments, as well as the promotion of regional peace and stability (ASEAN 2019). ASEAN is extending its cooperation on many fronts, but the ASEAN Political-Security Community, the ASEAN Economic Community, and the ASEAN Socio-Cultural Community are particularly worth noting (ASEAN 2019). While all these communities sound nice in words, they might face difficulties while being implemented in full. ASEAN, for instance, might find it challenging to go beyond the ASEAN Free Trade Area because of geographic distance, and differences in socioeconomic, religious, and political structures. Hence, at any point beyond the free trade area, there might be severe setbacks.

Size disparity could also be a barrier to deeper integrations. The economic and military power of the UK is a factor in why Brexit is happening. Powerful states like the UK can decide to go alone as they have economic and political abilities. The same might be true for India in the South Asian Association for Regional Cooperation (SAARC). Because of its geographic size and economic weight, India is a big brother in the SAARC. Critics maintain that SAARC’s slow progress in terms of further integration is mainly due to India’s unwillingness to strengthen SAARC due to the country’s ability to go it alone. As the UK’s strength is a factor in it pulling out of the EU, similarly large states like India might break up prematurely. Policy makers from all sides should bear these issues in mind in formulating policies for further integration in Asia.

Going too far into deeper integration might open up ground for disintegration. For example, the South Asian Free Trade Area in SAARC is already an overambitious plan because intraregional trade is still insignificant (less than 10%). Despite this, some scholars are hoping for a SAARC Economic Area or Economic Community. This kind of overly optimistic view might backfire. Member states should find a common denominator before planning something big.

For ASEAN, for instance, given the huge disparity among member states, it is not clear whether it will be able to go as far as it wishes. The principle of nonintervention in each other’s issues and the so-called “ASEAN way” might be working now, but such soft tactics might
not be enough to address critical political problems. It is not always possible to draw a clear line between economic and political issues in managing regional integration. Precautionary plans at the beginning of any integration process might minimize the damage at later stages.

Brexit has some valuable lessons for the People’s Republic of China and its Belt and Road Initiative as well. The Belt and Road Initiative is a megaproject covering many countries across several continents. Its ambition is economic as well as political. Therefore, going further than trade integration might create sufficient skeptics to disrupt the operationalization of the project at later stages. Thus, the People’s Republic of China’s leadership needs to consider the socioeconomic and political sensitivity before going deep into another territory. But mass education may help reduce skepticism around cross-border projects.

Citizens’ knowledge is an essential factor in the success of deeper integration. If citizens are well educated about the causes and consequences of regional integration, then politicians are less likely to be able to mislead them. During the Brexit referendum, without sufficient knowledge, making the right choice was not that easy for British citizens. Politicians could have deceived the citizens through systematic propaganda because citizens were not aware of the consequences of Brexit during the 2016 referendum. The Brexit saga taught us that leaders in other integration arrangements should take note that citizens should be involved in the integration process and be sufficiently informed about it. Ironically, collective knowledge about regional integration is often uncommon among the citizens of most countries. In South Asia, for instance, very few know about what is going on in SAARC. The situation is not that different in other parts of the world. The lack of knowledge about regional integration is more apparent in Asia and Africa than in Europe.

Citizens should also understand that there is no such thing as a “free lunch.” Regional integration is a concept of shared prosperity—with the principle of giving and taking. As a rich country, the UK did indeed have to pay high membership fees, but, as a predominantly trading nation, the country also benefited more from being part of the Common Market. If the general population of the UK had understood this equation correctly, the Brexit referendum result could have been different. Furthermore, analysis of the costs and benefits of regional integration should be done from a holistic point of view. In some sectors, a country might be sacrificing more than other partners, but in some other areas, a country may be benefiting more than its counterparts. It should also be noted that it is easy to see the costs, but not every benefit is visible or quantifiable. If citizens considered the intangible benefits of regional cooperation, it is highly likely that every country would be happy to
be a part of regional integration, and no nation would be in a situation like Brexit. Therefore, to educate citizens about regional integration, the issue should be included in educational curricula. There is hardly any country in the world that is not part of any regional integration. Nevertheless, the question remains: How many countries are teaching regional integration in schools and colleges?

In a nutshell, the most crucial lesson Brexit offers for other integration arrangements is that there is a limit to regional integration. The idea that “once started the regional integration would obviously spill over to other sectors and continuously go deeper” is not always the case. At shallow levels of regional integration, it is not necessary to sacrifice national sovereignty. At higher levels, however, the acceptance of some kind of supranational authority is inevitable. Therefore, leaders must take into consideration the limits of regional integration before making overambitious plans to integrate and expand regional integration.
References


13

Disintegration of the European Union and the Implications for ASEAN

Hooman Peimani

13.1 Introduction

Europe and Asia have had different experiences in many areas over the course of their existence and have developed into two distinct regions with differences in terms of their industrial, agricultural, and scientific capabilities as well as political and economic developments. Lagging behind Europe for a few centuries until the end of the 20th century, Asia has without doubt caught up and surpassed Europe and, in fact, all other regions in terms of gross domestic product ($30.635 trillion, Statistics Times 2019) to secure first place in the global ranking, although there are major differences among and within its regions in terms of economic development, which is also true in the case of Europe.

Despite their differences, Asia and Europe have gone through similar experiences since the end of the Second World War. The creation of a regional grouping is one of them in the form of the Association of Southeast Asian Nations (ASEAN) and the European Union (EU), respectively. Of course, various factors of varying significances make them different from each other. These range from simple quantitative and geographical factors, such as the number of countries participating in these experiences (i.e., the majority of the European countries versus a small number of Asian ones) and their geographical extent (i.e., most of Europe versus a fraction of Asia), to qualitative ones, primarily their level of economic and industrial development granting their respective members the rank of developed and developing countries. Their level of integration is yet another factor. The EU has taken concrete steps toward full integration based on its membership’s perceived sharing of common European values and destiny to justify forming a united
European entity run by a series of universally accepted and observed rules and regulations with common foreign and defense policies, among others, run by a supranational political entity.

This objective has proven to be easier to dream about than build. While the EU has become far more integrated than it used to be and there is a high degree of cooperation among its members over many issues (e.g., intelligence and military cooperation and free movement of their nationals, goods, and services within the EU boundaries), the European regional grouping is not heading toward a fully cohesive European state. On the contrary, its recent history suggests that such an objective is not feasible. In fact, the EU’s continuity as a regional grouping operating as a united entity with its current level of integration is questionable, given that it has been experiencing certain developments heralding the disintegration of the regional grouping, which has taken around 70 years to reach its current level of integration.

The signs of disintegration are not confined to Brexit effective 31 January 2020, although that is the most obvious case. The ascension to power of right-wing political parties in Austria, Czechia, Italy, Poland, and Hungary, which are pursuing their own policies in certain areas in clear opposition to those of the EU, is another case. The EU’s so-called “heavyweights” (France and Germany) defying the official EU policy on energy aimed at reducing reliance on the Russian Federation as manifested in their building of the Nord Stream 2 gas pipeline to increase their gas imports from the Russian Federation is yet another case. To these, the rise of “New Europe” consisting of certain EU countries taking sides with the United States (US) on various regional and international issues should be added.

Despite the high degree of integration in the EU covering not just economic issues but also many others (e.g., environment, foreign relations, security, and defense), further consolidated by the membership of the majority of the EU members in the North Atlantic Treaty Organization (NATO) and the lack of major ideological differences and territorial disputes between and among its members, the emerging disintegration in the EU suggests that ASEAN, which is far less integrated, is not immune to this phenomenon.

ASEAN was established in 1967 for different reasons from those of the EU. It expanded in the 1980s and 1990s as mainly a union of the Southeast Asian countries to promote peace, stability, and prosperity through economic and political cooperation among its members. Although efforts have been made under the ASEAN Community to turn it into a more integrated regional grouping, ASEAN is still a loose economic union of 10 Southeast Asian countries pursuing their own individual national interests, which may well be opposite to those
of the rest, while having a degree of economic, political, and security cooperation. The ASEAN members have unresolved issues and historical mistrust still exists between many of them, which could escalate to crises and political and even military conflicts, as happened before.

ASEAN has not enjoyed common political and ideological orientations as a unifying factor, which have shaped the EU as a regional grouping established in the early years of the Cold War. Additionally, unlike the EU, it has not been developed to act as a power bloc to preserve the interest of its members, which are, individually, too weak to face the established and rising Asian and non-Asian powers and superpowers.

The rise and expansion of the centrifugal forces in the EU region has raised questions about the feasibility of a united Europe as a sustainable entity. Despite 7 decades of efforts, the EU as a well-integrated grouping of Western countries is facing disintegration should the current trend continue. This ongoing development has an implication for efforts for regional integration in other regions, in particular Southeast Asia, where its forming states have been engaged in creating a regional grouping, albeit with less ambitious objectives. Hence, if the EU is not immune to disintegration notwithstanding all its efforts and the existence of many factors in favor of integration, then ASEAN with its very limited degree of integration and the existence of seeds of conflicts and unresolved issues between and among its members can and will possibly encounter disintegration, unless major efforts are made to address its root causes in the near future. Apart from setting another negative precedence to discredit regional integration as a realistic and useful undertaking for other regions, such a scenario, if it becomes a reality, will likely negatively affect the impressive development of Southeast Asia since the 1960s. By strengthening the existing mistrust and discouraging cooperation in the region, such development will create a suitable ground for the re-emergence of old and unsettled issues and conflicts to exhaust the region’s potential for growth and development. Preventing such a possible scenario is a necessity for ensuring the continuity of the region’s political, economic, and social development and the prosperity of its peoples. This chapter seeks to contribute to this objective through its identification of the existing blatant manifestations of such a possibility and by making recommendations to eliminate it.

In elaborating on this argument, section 13.2 deals with the historical context of the EU’s formation. Section 13.3 focuses on its current situation and the challenges to its continuity as a united entity. The possible scenarios of the EU’s disintegration are discussed in section 13.4. Section 13.5 provides a brief historical context for the creation of ASEAN to serve as a background for section 13.6, which deals with the evolution of this regional organization to its current
form. Section 13.7 elaborates on ASEAN’s current situation, including the elements of disintegration that will enable further study of the possible scenarios for such a disintegration. Finally, section 13.8 serves as the chapter’s conclusion, and makes policy recommendations aimed at avoiding ASEAN’s disintegration.

13.2 The EU Experience

As the second-largest Western economy after the US and one of the two pillars of the Western alliance, the EU owes its existence, expansion, and consolidation to certain factors that necessitated its creation in a certain historical context. Over time, these factors have disappeared or lost their significance as unifiers while the promised united and prosperous Europe of equal Europeans led by a supranational leadership in Brussels has proven to be unrealistic. The existing union of 27 European countries has continued in the wake of the departure of a European heavyweight (the United Kingdom [UK]). Its members are surely far more integrated than they were prior to their joining the European grouping. However, the EU of 2020, formerly seen as a successful model of regional integration to be emulated by other regions, notably Africa, which now has its own version of it (the African Union), faces disintegration as a distinct possibility.

While this outcome is not due to a deliberate and orchestrated process set in place by any number of EU members, the prospective disintegration is surely the logical result of the EU’s development over the last 70 years within the existing regional and global contexts planting the seeds of disintegration to be discussed. In a nutshell, certain realities explain this undesired and unplanned prospect, particularly the following. The circumstances and necessities that helped conceive and made possible and facilitated the EU’s creation no longer exist for the most part, namely the Cold War, the division of the world into two distinct hostile blocs, and the fear of a Communist takeover of the Western countries, especially the European ones. The world of the 21st century is different from and more complicated than that of the post-Second World War. In particular, the expanding economic, financial, and/or energy dependence of the EU countries on other regions and countries have turned their Cold War enemies (the Russian Federation and the People’s Republic of China [PRC]) into what they consider as “necessary evils,” while they are also seen as major challenging powers to the EU.

Moreover, the promises of the EU as a necessary and capable entity to foster growth for all its members, end disparities among them, and secure prosperity for all of them have largely not been realized and,
in fact, have proven to be unrealistic, as discussed in detail by many scholars, including Offe (2015). Among others, this reality is evident in the debt crisis in the eurozone with its devastating economic, financial, and social impacts on many EU countries, specifically, but not exclusively, the less developed and less prosperous ones (e.g., Greece, Spain, and Ireland). In fact, as discussed elsewhere, the global financial crisis of 2008 “morphed into the euro crisis” in 2010 to affect all of the 19 eurozone countries, which have since been “rocked by economic stagnation and debt crises” (Stiglitz 2016).

This development has raised serious questions about the merits and, in fact, the idea of an EU-united Europe, which had long had its skeptics among the EU members both on the right and the left of the European political scene (Vollaard 2018). Added to this, certain major challenges for the EU helped bring disintegration to the surface as a possibility after decades of efforts toward integration: the migration crisis, as millions of African and Middle Eastern people left their war- and crisis-torn countries for Europe; the Ukraine crisis involving the Russian Federation’s annexation (or, according to Moscow, reunification) of the Crimea; and, of course, Brexit. All of these have practically divided the EU. These developments helped foster the rise of opposition to EU policy as formulated in Brussels in the aforementioned cases, and, in general, the EU policies shaped mainly by its heavyweights (Germany and France), while prompting the rise of nationalism, including right-wing, xenophobic, and extremist movements, particularly, but not exclusively, in small and/or less prosperous EU members, as discussed extensively (e.g., Wodak, Mral, and Khosravi 2013). More importantly, they paved the way for the ascension to power of right-wing parties in Austria, Hungary, Poland, and Czechia and the growth of populist/ extreme, right-wing parties/groups in other countries, including France, as evident in the rapid expansion of its xenophobic and anti-EU National Front (now known as National Rally) to challenge the mainstream parties over governing France, as discussed in detail by many scholars, including Jan-Werner Müller (2016).

There is, of course, a range of views as to why the EU has reached a point that disintegration is now a distinct possibility. Although it is not clear as to how it could happen, apart from one obvious scenario as validated by Brexit, that is the EU countries leaving the union, there is now enough evidence to make this possibility credible as manifested in the rise and expansion of centrifugal forces in the EU that challenge the leadership of the EU over its member states in different forms. This is not an accidental development to be attributed to this or that factor, ideology, or individual, but the natural outcome of the EU’s creation process and the unachievable goal of creating a united Europe of
equal, developed, and prosperous nations led not by its forming state leaderships but by a supranational European leadership in Brussels. To shed light on this development, the creation process of the EU and the factors necessitating, prompting, facilitating, and consolidating the EU are discussed briefly. The focus will be on the factors behind disintegration and the possible shapes that it could take.

13.2.1 Emergence and Consolidation of the EU

The EU started as an economic agreement among France, Germany, Italy, Belgium, Luxembourg, and the Netherlands to integrate their coal and steel as France’s proposed initiative was accepted by the rest and approved by the Council of Europe as the Schuman Plan, leading to the creation of the European Payments Union on 19 September 1950 (European Union 2019a). Yet, the initiative had the undeclared objective of preventing another war between France and Germany that would divide Europe into hostile alliances and drag its countries into devastating wars as experienced during the First World War and the Second World War. The consolidation of the organization into a cohesive, integrated, and multidimensional union of 28 European countries (before Brexit) covering a wide range of areas, including political, economic, security, foreign policy, and environmental, with executive, legislative, and judiciary structures to unite its members, has taken another 70 years.

Certain conditions have helped foster the evolution of an economic grouping of a few European countries into a supranational entity of just about all the European countries with many of the remaining ones waiting to join. In particular, there has been a historical context for such an evolution. Apart from the war prevention objective, the EU is a child of the Cold War era, which divided the world into mainly two major hostile camps led by the Soviet Union and the US and affected Europe dramatically as the main arena for East and West rivalry pitting NATO against the Warsaw Pact. The EU’s creation was therefore a measure to remove the main sources of conflicts among the European NATO members and consolidate their economic power and resources. Such a context was more important than the widely advertised common culture, common values, and, therefore, common destiny of the European countries. In fact, the envisioned union of European countries functioning as a group of close partners observing certain rules and regulations and acting as one entity all the time is yet to happen. It has proven to be a utopia as, in one form or another, all the EU members have clearly demonstrated their desire to preserve their individual identities while working more closely with each other. As concluded by many EU
observers, the existing “high levels of socioeconomic interdependence and institutionalization” among the EU members have failed to secure “an ever-closer union” (Webber 2018).

The latter is especially evident today when differences between the EU members are not only apparent with regard to cultures and associated norms and people’s attitudes, but also in terms of how each EU country is governed and how its citizens are treated. In reality, apart from paying lip service to the EU-promoted values of European heritage, belief in democracy and freedoms, and the superiority of free enterprise as a fair and fully functional economic system serving as the necessary foundation of their political systems, the emerging and expanding blatant shift towards authoritarianism and human rights abuses in Austria, Czechia, Hungary, Italy, and Poland clearly reflect the lack of such commonalities among the EU members. Apart from the rise in antisemitic and antiforeigner incidents caused by extremist groups (neo-Nazi, right wing, and xenophobic), there are reports on governmental abuses and discriminations and/or restrictions of rights and services in different forms targeting social and religious minorities, women, environmental activists, foreigners, and asylum seekers in these countries, for example (Human Rights Watch 2019; Barley, Biggs-Davison, and Alderton 2018).

The Polish government’s efforts to undermine the independence of Poland’s judiciary are a recent example of an emerging authoritarian trend in the aforementioned countries. Among other things, it is reflected in its plan to fire Polish judges who question the legitimacy of its judicial reforms (Reuters 2019). The adoption of those reforms will eventually lead to exiting of Poland from the EU for their contradicting the EU laws, according to the Polish Supreme Court (Reuters 2019).

13.2.2 Major Factors and Milestones in the EU’s Consolidation

Known as the Treaties of Rome or Common Market, the two treaties establishing the European Economic Community and the European Atomic Energy Community of 25 March 1957 are especially important agreements for the EU’s foundation for setting the stage for a more integrated economic community among its six founding members (European Union 2019a). Added to various political, economic, and social agreements, the Maastricht Treaty on European Union of 7 February 1992 officially created the EU in its current form by setting “clear rules for the future single currency as well as for foreign and security policy and closer cooperation in justice and home affairs” (European Union 2019b). This was followed by two other related milestones meant
to further consolidate the EU: the introduction of the euro in 12 EU countries (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain) on 1 January 1999 (European Union 2019d) and its subsequent expansion to Cyprus, Estonia, Latvia, Lithuania, Malta, Slovenia, and Slovakia (European Union 2019e).

While sharp differences among the EU members in many foreign and security policy matters (e.g., ties with the Russian Federation) raise doubts about the EU members’ implementation of the EU rules in these areas, the wisdom of having the single currency, the euro, is now seriously challenged. Promoted as a major measure for fostering economic growth and securing financial stability, especially for the less developed members and for addressing southern Europe’s competitiveness challenge, the euro and its associated economy and politics are now assessed as doing the opposite by causing deep political, economic, and social problems (Offe 2015). It is also argued that the euro caused “huge capital flows from the northern to the southern countries of the eurozone” resulting in “an inflationary credit bubble” in these countries, such as Greece, while depriving them of competitiveness and making them vulnerable to the US financial crisis of 2007–2008 that spilled over into Europe (Sinn 2014). Similarly, some scholars argue that the euro has acted against its promise of bringing Europe together and promoting prosperity. As persuasively argued by Stiglitz (2016), the eurozone financial crises revealed the euro’s shortcomings, and that Europe’s “stagnation and bleak outlook” are a direct result of the fundamental challenges in having a diverse group of European countries share a common currency when their economic integration is outpacing their political integration (Stiglitz 2016).

Laying down plans to “reform the EU institutions with the objective of giving Europe a stronger voice in the world and devoting more European resources to employment and the rights of the EU citizens,” the Treaty of Amsterdam of 17 June 1997 is another milestone (European Union 2019c). Even though the EU as a grouping of now 27 countries, after Brexit, has potentially a stronger say in global affairs than any single EU member has individually, its practical exclusion from many major global affairs (e.g., Syria’s civil war) where Iran and Turkey, as regional powers, and the Russian Federation and the US, as global powers, are the players questions the EU’s achievement in “giving Europe a stronger voice in the world.” This is also evident in its practical following of the US policy toward Iran regarding the nuclear deal of 2015 despite its official opposition to the US withdrawal from it in 2018.

The period between 1957 and today has been the period of expansion for the EU to become a large regional grouping. Today, it has 27 members
and the world’s second-largest economy after the US as reflected in its gross domestic product of €15.3 trillion in 2017 (European Union 2019f). It has political clout and a claim to superpower status, although it cannot function as such due to its internal division. The Soviet Union’s fall paved the way for its rapid expansion as just about all the forming states of the Soviet bloc found the EU to be the right vehicle for addressing their numerous economic, financial, and technological shortcomings while protecting them from the reemerging Russian Federation. Yet, today, there are valid arguments as to the negative implications of the EU economic and financial policies in these countries’ post-Communist era dominated by the “neoliberal ideas” and the economic theories of Reagan, Thatcher, and the Chicago School (Ther 2016). According to Ther, their implemented liberalization, deregulation, and privatization plans had catastrophic effects on former Soviet bloc countries (Ther 2016). Although these countries are today certainly better off economically than they were when they started their post-Soviet era, Ther rejects the notion that the EU–US-supported and -introduced economic shock therapy laid the foundation for their eventual economic growth by arguing that what determined their success or failure in this regard was human capital and the “transformation from below” (Ther 2016).

This issue aside, the ex-Soviet bloc European countries were concerned about a predictable reemergence of the Russian Federation in its post-Soviet era to motivate it to seek the restoration of its lost power and influence among its former European allies, in one form or another. Joining the EU and NATO (as an interrelated and practically inseparable grouping of Western countries from the EU due to its almost identical membership and the main geographical field of operation) seemed an absolute necessity for them, not only for addressing their aforementioned difficulties but also for their survival as independent weak states. Of course, this is a valid argument given their countries’ historical experiences.

13.2.3 Other Major Factors in the EU’s Creation and Consolidation

There were other important factors that contributed to the EU’s creation and expansion. This process has become easier due to the commonalities of its members. They include their being economically developed, albeit with major differences in the scale and scope of such status, their adoption of a version of the same style of government, and their mainly settled political and territorial disputes while their remaining ones have been contained, although they have not disappeared, as evident in the existence of separatist movements in the UK and Spain, for instance.
Undoubtedly, the memories of the devastating two world wars in Europe pitting the rival hostile groupings against each other amounted to a major factor, particularly the most recent one. The desire to prevent such wars in the European territories has been a major factor in paving the way for the EU and keeping it together.

The European countries’ individual inability to claim and sustain a global power status on their own, or a superpower status in the case of the heavyweights, due to their weaknesses (e.g., small land size, lack of strategic depth, small and/or limited domestic markets, and limited and/or rapidly depleting mineral and energy resources) inclined them all to join a European organization with certain objectives in mind. Their combined resources enabled them to address most of these shortcomings and protect their independence and national interests while providing a superpower clout for the grouping as a whole to help them all meet the challenge of the then Soviet Union and later its major successor state, the Russian Federation. Operating globally, this Eurasian country is the only regional power operating in Europe that can claim to have superpower status on its own due to its lack of the aforementioned shortcomings, despite having challenges of its own. The prospect of this superpower joining the EU was and still is nonexistent, given its lack of interest in becoming a junior or an equal member of the grouping when it has the option of operating as a superpower.

The EU has sought superpower status to withstand not just the re-emergence of the Russian Federation but also the US, the only fully fledged superpower since the former Soviet Union’s fall. The disappearance of the Soviet Union’s threat in the 1990s as the main reason for hushing up differences within the US-led Western bloc has since allowed major disagreements between the EU and the US to surface over regional and international issues. Major examples include the US-led invasion of Iraq in 2003, the US withdrawal from the 2015 multilateral nuclear deal with Iran and the US imposing sanctions on the Nord Stream 2 gas pipeline doubling Russian gas exports to many EU countries, including heavyweight Germany, which halted its completion in December 2019. The ascension to the US presidency of Donald Trump, who publicly referred to the EU as a competitor (Congressional Research Service 2018) and initiated a trade war with the EU in 2017 covering a range of items (e.g., steel and aluminum), yet to be lifted in the second half of 2021 under his successor (Joe Biden), has also disclosed trade and thus economic disagreements between the two Western powers, previously kept out of the public realm as much as possible. As two rival powers despite their common interests in certain areas such as dealing with the rising challenging powers (e.g., Iran), their disagreements and competition will not disappear. This is notwithstanding the
possible removal or moderation of some or all of these sanctions by
the Biden Administration to end the Trump Administration's policy of
antagonizing friends and foes simultaneously to help it focus on the PRC
and the Russian Federation as the major strategic challengers to the US,
given his adopting a conciliatory tone toward the EU on his ascension to
power in January 2021.

Undoubtedly, the PRC, a rising superpower accused by the EU of
unfair trade practices, has been, since the 1990s, another major factor
in the EU integration, especially due to its expanding exports and global
market share. The EU's unhappiness with this reality has manifested
itself in many ways, including its major trade disputes with the PRC,
which have negatively affected their ties. As a recent example, in June
2018, the EU initiated "legal proceedings against China before the
World Trade Organization (WTO) .... over what it says is a violation of
intellectual property laws" (DW 2018).

The rise of Asian economic, industrial, technological, and/or military
powers (e.g., India; Iran; Japan; the Republic of Korea; and Taipei, China)
with claims to regional, global, or superpower status has further helped
the EU’s expansion, integration, and continuity. To varying extents and
in different forms and beginning at different points in time since the
1960s, these powers have challenged the EU membership’s interests
in various fields such as competing over the global markets (especially
Japan; the Republic of Korea; and Taipei, China) and expanding their
spheres of influence in the regions of strategic importance for the EU
and the US. Iran is the obvious example of the latter, which has been
under various types of EU sanctions since 1979. In short, certain factors
and specific historical circumstances created the ground for and helped
the development of the EU from an economic grouping of six European
countries to its current status.

13.3 Current Status

13.3.1 Evolution of the EU

The Cold War was a major factor contributing to the formation,
expansion, and transformation of the EU. It is now a regional grouping
of the majority of the European countries with a significant degree of
cohesion covering a wide range of sectors and activities as reflected in
its having a governing structure that operates based on certain rules
and regulations while seeking to act as a superpower. The Cold War
provided a common cause, which was fighting Communism and thus
preventing its proliferation primarily, but not exclusively, in Europe
through uniting the European countries outside the Soviet bloc against
the common enemy, i.e., the Soviet bloc. This common cause helped the creation and development of the regional grouping by hiding various differences among its members in terms of economic, political, social, technological, and military capabilities and suppressing disagreements between and among them as unimportant, given the magnitude of the threat they were all facing. Their common objective kept them united and inclined to work together.

Similarly, the end of the Cold War made a major contribution to the regional grouping by removing the obstacles to its expansion and setting the ground for its evolution to a much more cohesive and stronger organization, while also removing the common ideological orientation of the grouping, which kept it united until 1991. Being itself eager to expand its territories, markets, and resources for their obvious benefits and also as a necessity for the superpower status to which it aspired, the EU, which, like the ex-Soviet bloc European countries, was concerned about the reemergence of the Russian Federation, assisted these desperate countries with their immediate problems, of course to a varying extent as justified by their importance to it. The EU also set a range of criteria (Copenhagen criteria) for their future membership, including “a free-market economy, a stable democracy and the rule of law, and the acceptance of all EU legislation, including of the euro” (European Union 2019g). Croatia joined in 2003, followed by Czechia, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia in 2004 and Romania and Bulgaria in 2007 (European Union 2019h). Europe’s remaining Western countries joined the EU prior to 1991 (Denmark, Ireland, and the UK in 1973, Greece in 1981, and Portugal and Spain in 1986) or after it (Finland and Sweden in 1995 and Cyprus and Malta in 2004) (European Union 2019h).

As a result, today the EU has united the overwhelming majority of European countries mainly under the leadership of its two heavyweights: France and Germany. Apart from Eurasian Russia, the only European countries outside the EU territories are Switzerland due to its neutrality status, the two Slavic republics of the former Soviet Union (Belarus and Ukraine) as well as its non-Slavic republic of Moldova, the remaining components of former Yugoslavia (Bosnia-Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia), small European city states with no interest in joining the EU as tax havens (Monaco and San Marino), a religious center (Vatican City), and Albania. While Albania, Serbia, North Macedonia, Montenegro, and Turkey are EU candidates, the remaining three European countries (Norway, Iceland, and Liechtenstein) are members of the EU’s internal market enjoying free trade with the EU membership (European Union 2019i). In short, the EU now accounts for the bulk of Europe in terms of land, population, resources, and economy.
13.3.2 Limited Power

Despite such impressive achievements, the EU picture is not all rosy. Without a doubt, the EU is now the single major actor in the European theater owing to its combined membership’s economic and political strength, even though its military strength is dwarfed by that of the Russian Federation. It is also a player on the global scene, but without the clout and capability to act on its own as a superpower. In fact, it has been overshadowed by the US and has acted on many major issues along the lines set by Washington (e.g., sanctions on Iran, Syria, and Venezuela). Its various ongoing differences with the US, including over trade as manifested in the US imposing tariffs on its various products (especially steel and aluminum) and the 2015 nuclear deal with Iran, reflect the limits of its power manifested in its members practically limiting their ties with Iran to diplomatic relations and very insignificant amounts of trade for fear of violating the US unilateral sanctions on Iran. Additionally, the EU is facing growing disunity that will undermine its achieved integration should its current divisions persist and expand. The main examples of this, as identified by various observers of EU development, include, but are not limited to, deepening divides between the German-dominated “core” and the southern “periphery,” the winners and the losers of the euro, the advocates of greater integration and the anti-Europeans, and the technocrats and the populists (Offe 2015).

13.3.3 Rise of Centrifugal Forces

Among the other factors detracting from the EU as a sustainable successful experience of regional cooperation, the one that stands out is the challenge from within the EU. This is by far the most dangerous threat to the EU’s continuity as a united regional grouping capable of operating as such in the European and global theaters. This challenge has practically, but not officially, eroded to a significant extent the ability of the EU to lead and represent its entire membership in not only major global matters but also those of internal importance to its membership collectively.

This threat is severe enough to create grounds for assessing the EU’s current state of unity in terms of declining from “a unified global power to a fractious confederation of states” (Soros 2014). In harsh terms, it reflects the reality of the EU, although it may sound exaggerated, given the EU’s overall appearance as a solid and fully functional union. The threat from within has manifested itself in various forms, four of which in particular are serious enough to question the continuity of the EU as
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A united and integrated European grouping. These are Brexit, the EU heavyweights-led defiance of the EU policies, the growing defiance of the right wing-run EU countries of the EU rules and regulations, and the rise of New Europe.

**Brexit**

Brexit is the most obvious case due to its significance as one EU heavyweight that has decided to leave the regional grouping. This has been discussed by various scholars of European affairs, including Webber (2018) and Vollaard (2018). However, its significance could be argued as being limited, short-lived, and of no long-term consequence for the EU’s integration for a certain reason. Thus, the UK has always been considered a half-hearted EU member with its clearly demonstrated lack of any desire to accept the EU’s authority and reduce its power in favor of that of the EU in many major EU issues, such as refusing to join the eurozone and the Schengen Area. The latter is “an area without internal borders, an area within which citizens, many non-EU nationals, businesspeople, and tourists can freely circulate without being subjected to border checks. Since 1985, it has gradually grown and encompasses today almost all EU countries and a few associated non-EU countries” (European Union 2019i). The UK’s lack of enthusiasm for the EU has been especially evident in its conduct of foreign policy. On many important occasions, it has sided with the US against the will of other EU members, particularly its heavyweights (France and Germany), as it did in the case of the US-led invasion of Iraq in 2003 when it joined the US-led coalition of the willing.

However, despite the validity of such an argument, Brexit is still a major blow to the EU. It shattered a taboo by revealing the feasibility of leaving the EU for its members as an option if they have second thoughts about the benefits and wisdom of EU membership and believe they can do better outside the regional grouping, as two prosperous European countries with no interest in joining the EU (Switzerland and Norway) have concluded. Consequently, the UK’s decision to leave the EU could potentially have a domino effect on the dissatisfied EU countries, which have shown their unhappiness with Brussels on many occasions to be discussed shortly. Nevertheless, as stressed by Vollaard, while it is not likely to be followed by the other EU members, the UK’s departure has undermined “from within” the regional grouping (Vollaard 2018).

**The EU Heavyweights-led Defiance of EU Policies**

Serving as another case, the so-called EU heavyweights have shown clear defiance of EU policies in major issues of importance to the regional grouping. Their defiance has shown their lack of recognition of the
EU’s authority and therefore its collective interests when their national interests are at stake. Moreover, such behavior has demonstrated their lack of interest in accepting the EU as a supranational entity and, therefore, in further integration of the union with the effect of empowering the EU leadership in Brussels to act as the government of all its members according to the collective interests of the union. Acts of defiance have reflected the fact that the EU members have nonnegotiable national interests. Consequently, the EU idea of a totally united Europe with one governing body is quite unlikely to become a reality despite the existence of large and growing executive, legislative, and judicial entities in Brussels.

A major recent example is Nord Stream 2, a Russian project aimed at doubling the Russian Federation’s annual piped gas export capacity to the EU region from its current 55 billion cubic meters through Nord Stream 1 via the Baltic Sea. In connecting the Russian Federation to Germany as the project’s main stakeholder through which other Western and Northern EU countries receive Russian gas as well, the project mimics Nord Stream 1 (Nord Stream 2 2019a). Despite the EU policy of decreasing the EU region’s dependency on Russian oil and gas for political and strategic considerations, five major energy companies from Austria, the UK, Germany, Italy, and the Netherlands (ENGIE, OMV, Royal Dutch Shell, Uniper, and Wintershall) joined the Russian Federation’s Gazprom and signed the financing agreement for its construction in April 2017 (Nord Stream 2 2019b). Other EU countries—namely Denmark, Finland, and Sweden—have also joined the project by allowing the construction of the pipeline in their exclusive economic zone in the Baltic Sea.

Led by the heavyweight Germany as the largest consumer of the project’s gas, the aforementioned EU members’ participation in Nord Stream 2 was notwithstanding the EU energy policy, as repeated many times by its officials such as EU Commission spokesman Alexander Winterstein on 31 March 2017 when he unambiguously said: “In a nutshell, we don’t like [the] Nord Stream 2 project” (Euro Observer 2017). The President of the European Council, Donald Tusk, clearly stated the reason for the EU’s opposition to the project in his June 2017 letter to European Commission President Jean-Claude Juncker by saying that the project “goes against the aims of the European Union to reduce its energy dependency on Russia. The EU needed to insist on more control over the project” (err.ee 2017). Additionally, the opposition of eight EU members to the project, as clearly expressed in their joint official letter to Mr. Juncker in March 2016 signed by their prime ministers (Czechia, Estonia, Hungary, Latvia, Poland, Slovakia, and Romania) and the President of Lithuania, had no impact on its continuity (Sytas
The resulting disunity in the EU following the EU heavyweights’ activities has also been discussed by other scholars of EU affairs such as Claus Offe in the context of the EU’s financial crisis as he refers to the increasing disunity in the form of deepening divides between the German-dominated “core” and the southern “periphery” (Offe 2015).

**Growing Defiance of the Right Wing-Run EU Countries of the EU Rules and Regulations**

The growing defiance of the right wing-run EU countries of the EU rules and regulations is another case of centrifugal forces challenging the EU’s continuity. The ascension to power of the right-wing and xenophobic political parties with clear right-wing policies in Austria, Italy, Czechia, Hungary, and Poland has been an alarming development for the EU, prompting warnings about their destructive impact on the EU (Soros and Schmitz 2014). Their governments have openly opposed and defied EU policies on some or all of the following areas, immigration, gender equality, freedom of media, rule of law, and independence of judiciary, with the effect of prompting the EU leadership to openly criticize them with practically no effect. Poland making efforts to totally ban abortion and all of them opposing the EU immigration policy are just two clear examples, as discussed extensively by many other scholars (e.g., Ehmsen and Scharenberg 2018; Greven 2016). Their open opposition to certain EU policies and their moving ahead with their own policies have surely reflected the emerging extremist nationalism in the EU countries in paving the way for potentially fascist and Nazi-like governments. The EU has long sought to prevent such a scenario by promoting its concept of a common European identity to ensure peace and stability in the EU region.

**Rise of New Europe**

Finally, the rise of New Europe is another blatant case. The term was used for the first time by US Secretary of Defense Donald Rumsfeld prior to the US-led invasion of Iraq in reference to the EU countries that broke ranks with the rest of the EU countries led by France and Germany to join and support that invasion. They were mainly ex-Soviet bloc countries (e.g., Bulgaria, Poland, and Romania) with strong pro-US foreign policy despite their stakes in the EU membership as major beneficiaries of EU-provided assistance in various forms, which helped them reorganize themselves as Western countries after decades of membership in the Soviet bloc. The EU helped them survive the sudden collapse of the Soviet bloc, which, while still quite harsh, especially economically, on the majority of their populations, was comparatively far less painful than the experience of the 15 ex-Soviet republics as
newly independent states in the post-Soviet era, as discussed elsewhere by this author (Peimani 1998, 2002, 2009).

By and large, these countries have officially or practically taken sides with the US, as became obvious in their above-mentioned policy. Their activities in support of the US operation in Iraq and Afghanistan have continued to this day in areas that have not been approved, at least publicly, by the EU. Examples include their hosting of US secret camps in countries such as Poland (Goldman 2014). Although they have not initiated any process for leaving the EU, their closeness to the US and willingness to break ranks with the EU in support of US policies have certainly served as indicators of EU weaknesses, which could pave the way for its weakening and potentially its disintegration.

13.4 Disintegration: A Distinct Possibility

The aforementioned cases suggest that disintegration of the EU is a distinct possibility. Based on the available information about the developments in the EU region, it cannot be stated with certainty as to how and when this possibility could become a reality. Within this framework, at least three scenarios are conceivable.

One scenario is disintegration as a result of a wave of leaving of a significant number of EU members. Brexit provides grounds for this scenario, even though the difficulty of reaching a mutually acceptable agreement for the UK and the EU for their future relations could be a discouraging factor for those EU members that could consider leaving the union. Nevertheless, while leaving the EU is not very likely, as pointed out by many scholars (e.g., Vollaard 2018), those EU countries dissatisfied with the direction of the EU could see leaving it as an option in the post-Brexit era, which was a taboo in the pre-Brexit era. As mentioned earlier, the emerging dissatisfaction in the form of clear defiance of EU policies, rules, and regulations by Austria, Czechia, Italy, Hungary, and Poland indicates that at least some EU members do not accept the EU leadership governing their countries and thus could see a merit in leaving the union should their current attitude towards the EU continue and deepen.

The growth of the existing extreme nationalist, right-wing, and xenophobic groups in the EU region could also prompt disintegration. Various versions of such groups are already in power in Austria, Czechia, Italy, Hungary, and Poland, while similar groups are gaining strength in other EU countries. France is a major example of this phenomenon where its populist, right-wing, and xenophobic National Rally (previously known as the National Front) poses a serious challenge to the country’s mainstream parties, as noted by other concerned
researchers as well (Müller 2016). Having negative views about the EU over its perceived weakening of France’s sovereignty, its ascension to power could potentially prompt France’s exit from the EU, although this is unlikely in the foreseeable future. Yet the same political parties are mushrooming in other EU countries as a result of a decline in their living standards caused by their poor economic performance. Such situations usually give rise to and reinforce extreme nationalism and xenophobia to challenge the merits of EU membership, which erodes their state power by requiring them to operate within the EU rules and regulations and be accountable to it.

Finally, practical disintegration is a possible scenario. In this case, the growing nationalism in the EU countries could weaken their enthusiasm for the EU and discourage their further integration into the European grouping at the expense of losing part of their national power and authority. Some EU countries could even reduce their EU commitments by pursuing their own policies and abiding by their own rules and regulations to a varying extent. In such cases, they could still see merits in membership of the EU as it enables them to have access to the other EU members’ markets and facilitates the movement of their people within the EU zone, added to the EU’s collective power, which could help them preserve their interests once challenged by non-EU countries. Consequently, they might opt to stay in the EU and selectively follow its policies, rules, and regulations whenever they serve their national interests, while having a free hand at home. In this case, the EU continues as a united grouping in appearance as a matter of convenience with much less power over its membership.

This is a distinct possibility and has also been discussed by other scholars in a slightly different form but based on the same assumption as follows. Cooperation among the European countries is necessary and thus will continue within a more realistic setting because of their economic interdependence, historical ties, and their need for political pragmatism. Zielonka (2014), for example, argued that the EU’s survival is only possible as a qualitatively different organization deprived of many real powers. Dismissing the notion of equating the EU with a Europe that will grow stronger as an integrated entity without a strong EU, and thereby rejecting the view that the EU is the only model for European cooperation, he argued about the EU’s evolution into a different and more realistic entity corresponding with its membership’s objectives (Zielonka 2014).

He elaborated on an evolutionary path for the EU’s transformation from crisis to disintegration, reintegration, vision, and a new European entity (Zielonka 2014). Named polyphony, his suggested appropriate organizational form is a flexible decentralized Europe with a hybrid
governance model called neo-medievalism, after rejecting the other suggested alternatives, including the United States of Europe, as unpractical and undesirable (Zielonka 2014).

13.5 ASEAN: Historical Context

ASEAN is the well-known Asian regional grouping whose history of foundation and the factors prompting it have been discussed extensively, including by Severino (2006). Yet briefly, on 8 August 1967, the foreign ministers of Indonesia (Adam Malik), Malaysia (Tun Abdul Razak), the Philippines (Narciso R. Ramos), Singapore (S. Rajaratnam), and Thailand (Thanat Khoman) signed a document in Thailand's Department of Foreign Affairs building in Bangkok to create ASEAN. Known as the ASEAN Declaration, the document stipulated ASEAN’s aims and purposes as being “cooperation in the economic, social, cultural, technical, educational, and other fields, and in the promotion of regional peace and stability through abiding respect for justice and the rule of law and adherence to the principles of the United Nations Charter” (ASEAN 2019a). The ASEAN Declaration left the door open for the participation of the other Southeast Asian countries “subscribing to its aims, principles, and purposes” (ASEAN 2019a).

What prompted its creation were efforts to settle disputes between and among Indonesia, Malaysia, and the Philippines conducted in Thailand to end disputes and hostilities among them. This motivation is similar to that of the EU but with major differences, such as the absence of major wars among the ASEAN countries. However, they received their fair share of war in the 1940s as their region was dragged into the Second World War only to become a major scene of fighting between Japan and the UK and France as the region’s two main colonial powers dragging mainland Southeast Asia, Malaya, Myanmar, Singapore, the Philippines, and Thailand into the bloody conflict. The division of Viet Nam into two countries taking sides with the two protagonists of the Cold War (the US and the former Soviet Union) pulled Southeast Asia into the Cold War. The Viet Nam War, which then spilled over into its neighbors Cambodia and the Lao People’s Democratic Republic (Lao PDR), pushed the region into a long and devastating conflict pitting the US and its allies against the former Soviet Union and the PRC supporting their respective allies.

Unlike the EU, the Southeast Asian countries, both the founding five and the remaining five (Brunei Darussalam, Cambodia, the Lao PDR, Myanmar, and Viet Nam), which joined ASEAN in the 1980s and 1990s, were and still are developing countries. Singapore is the only exception to the rule as it has since changed itself into a developed country. Similarly,
the founding countries of ASEAN established a regional organization with clearly stated, wide-ranging aims and purposes unlike those of the EU, which started their regional organization initially with a limited and focused economic objective of gradually including many others as their organization evolved.

Yet, these differences aside, ASEAN was founded for, more or less, the same broad objectives that prompted the creation of the EU. Hence, it aimed to end historical hostilities among its region's countries and unite them over their common denominators to prevent the expansion of Communism while preserving the interests of its membership. While fighting Communism was not mentioned as an objective by its founding fathers, as was the case with the EU, it was certainly one of their common objectives given the growth of Communism in mainland Southeast Asia and the ongoing war between North Viet Nam and South Viet Nam. This reality created a fear among the regional countries concerned about a potential Communist takeover of their countries as their underdevelopment and low living standards created a fertile ground for a rapid expansion of Communism with its egalitarian claims among their dissatisfied populations. Hence, ASEAN's founding members, like their EU counterparts, considered the creation of a regional organization to be a necessity in order to achieve that objective. In short, the Cold War's division of the world helped create ASEAN as it did in the case of the EU. However, it was not the only factor as there were other strong ones stipulated in the Bangkok Declaration to reflect the aspiration of the ex-colonies of the European powers to address their underdevelopment, lift their people's living standards, and build strong, stable, and peaceful countries.

13.6 The Evolution of ASEAN

Without a doubt, ASEAN has evolved significantly since its foundation in 1965. The grouping of the five Southeast Asian countries representing half of the regional countries has grown to include all of them. As discussed in detail by many scholars of ASEAN affairs (e.g., Jones 2004), this process has proven to be difficult for various reasons, including the subscription of three regional countries initially out of the regional grouping to opposing ideology (Communism) and their taking sides with the Eastern bloc in the divided Cold War era's world when the founding states were firmly on the opposite side. Although the organization was supposed to promote unity and cooperation in Southeast Asia, two of its members (Thailand and the Philippines) actively took sides, including by contributing troops, with the US in its war with the three Communist countries of mainland Southeast Asia (Cambodia, the Lao PDR, and
Viet Nam) during the Viet Nam War, which spilled over into Cambodia and the Lao PDR, while Malaysia and Indonesia sought neutrality. Singapore firmly supported the US war efforts (e.g., by making its country available to off-duty US troops) without directly entering the conflict.

This abovementioned reality kept Viet Nam, the Lao PDR, and Cambodia out of ASEAN to prevent the realization of the founding countries' vision for Southeast Asia for quite some time. Thus, the three mainland Southeast Asian countries joined the regional grouping after the end of the Cold War when the former Soviet Union, their main supplier and protector, was no longer around and the PRC, as the challenging Communist power to the former Soviet Union, was changing its posture with the ascension to power of Deng Xiaoping in the post-Mao Zedong era. Having helped the three countries to varying degrees and at different points in time, it thus shifted its stance as a staunch Communist power challenging the West to a cooperative Communist country seeking normal and tension-free relations with the West as a necessity for addressing its extensive underdevelopment and poor economic performance.

In the absence of willing supporters with means, the three mainland Southeast Asian Communist countries needed to broaden their horizon to survive economically and avoid military threats on their own through normalizing their ties with all the regional countries, including their Cold War era’s foes. Consequently, Viet Nam, the Lao PDR, and Cambodia joined ASEAN, respectively, in 1995 (ASEAN 2007), 1997 (Gates and Than 2001), and 1999 (ASEAN 2008). Of the two remaining non-Communist regional countries, Brunei Darussalam joined the regional grouping in 1984 (MFA 2018) and Myanmar joined in 1997 (Gates and Than 2001).

ASEAN has achieved one of its main objectives by absorbing all 10 Southeast Asian countries with their various and opposite ideological orientations, albeit in a loose grouping (Ba 2009). Nonetheless, it is only one requirement, though a major one, for achieving the envisioned goal of the full integration of the regional countries. To this end and as another major requirement, ASEAN adopted a charter on 20 November 2007 in Singapore, which came into force on 15 December 2008 (ASEAN 2008) with the objective of specifying goals and providing structures to achieve the full integration objective.

As stated by the regional grouping itself, the charter is meant to serve “as a firm foundation in achieving the ASEAN Community by providing legal status and institutional framework for ASEAN. It also codifies ASEAN norms, rules, and values; sets clear targets for ASEAN; and presents accountability and compliance” (ASEAN 2007).
summarizes the importance of the charter toward the full integration objective as follows:

- New political commitment at the top level
- New and enhanced commitments
- New legal framework, legal personality
- New ASEAN bodies
- Two new openly-recruited deputy secretaries-general
- More ASEAN meetings
- More roles for ASEAN foreign ministers
- New and enhanced role of the secretary-general of ASEAN
- Other new initiatives and changes (ASEAN 2019c)

The charter sets out 15 purposes for ASEAN amounting to the full integration of its region and the practical creation of a united states of Southeast Asia, although the charter itself does not spell it out in such words (ASEAN 2019c). Yet, this is their essence as these purposes cover all the conceivable requirements for such objectives, including maintaining and enhancing peace, security, and stability in Southeast Asia, creating a single market and production base for the region, alleviating poverty, strengthening democracy, enhancing good governance and rule of law, responding effectively in accordance with the principle of comprehensive security to all forms of threats, and promoting an ASEAN identity.

Serving as a summary of what is expected to be achieved through these purposes, Purpose 15 implies that the result of these purposes should be a united Southeast Asia acting as a single unit representing and preserving the interests of all its 10 forming countries as follows:

To maintain the centrality and proactive role of ASEAN as the primary driving force in its relations and cooperation with its external partners in a regional architecture that is open, transparent, and inclusive. (ASEAN 2019c)

The charter also sets two principles. They cover a series of rules of conduct to ensure the achievement of the 15 purposes and provide for a peaceful region where its forming members operate with full respect for each other’s sovereignty, independence, and territorial integrity as stipulated in Principle 2’s 14 codes of conduct (ASEAN 2019c).

The charter also provides for a governing body. It consists of various entities as follows: the ASEAN Summit (twice yearly summit of the ASEAN heads of states), functioning as the ASEAN supreme decision-making and policy making body; the ASEAN Coordinating Council, consisting of its foreign ministers with a range of duties, including
coordinating the implementation of agreements and decisions; and
ASEAN Community Councils, consisting of three councils in charge of
ASEAN's full integration by covering the major areas of its activities,
i.e., ASEAN Political-Security Community Council, ASEAN Economic
Community Council, and ASEAN Sociocultural Community Council
(ASEAN 2019c).

Finally, the charter provides for many other bodies, including
ASEAN Sectoral Ministerial Bodies and ASEAN Secretariat (ASEAN
2019c). They are meant to ensure the proper operation of the regional
organization in all major sectors and full cooperation of its member
states in preserving and promoting the regional interests and in ensuring
its peace, stability, and security.

13.7 Current Situation and Future Outlook

Without a doubt, ASEAN is more integrated and cohesive in 2021 than
it was in its early days, although with many challenges as discussed,
especially with respect to economic, trade, and regional development
issues (Kobayashi et al. 2017; Chia and Plummer 2015). As mentioned
above, it has various structures to enable its member states to work more
closely in political, economic, security, and social realms. ASEAN is now
a better-organized regional grouping whose members act together on
specific issues (e.g., fighting piracy), but, by and large, not on all the
major issues of significance to their region based on well-defined, region-
wide rules and regulations. That is why its members act in accordance
with their national interests on many such issues and, therefore,
practically take sides with, or at least tolerate the behaviors of, other
states toward their fellow ASEAN members. This reality constitutes a
major shortcoming and, in fact, a problem for the regional organization,
which intends to act as a united regional grouping. Given this objective,
its 10 members are expected to act in concert and pursue their national
interest while taking into consideration the common interest of all the
regional countries. Thus, they should refrain from acting in a manner
that could undermine the interests of other ASEAN members.

Examples in this regard include the territorial disputes in Southeast
Asia where the majority of the ASEAN members have refused to clearly
take sides with their two fellow members, the Philippines and Viet
Nam, in their disputes with the PRC, as discussed by many scholars
such as Gamas (2014). Consequently, the ASEAN leaders attending the
ASEAN Regional Forum meeting under the Cambodian chair in July
2012 failed to issue a joint communiqué at the end of the meeting, which
was unprecedented. Reportedly, that was the result of Cambodia’s
refusal to “cater for Manila’s demands that the statement concerning
[the territorial] disputes ... should mention its standoff with China at
Scarborough Shoal” (Hunt 2012). The vested interest of the majority of the ASEAN members in ties, especially economic ones, with the PRC has inclined them to keep themselves out of those disputes.

Such attitudes exist, although many consider ASEAN to be not just an alliance of individual states but a community, which implies a group of states with close ties and common objectives in important issues heading toward full integration. Hence, all its members should act in concert and support their individual interests challenged by non-member states. The Kuala Lumpur Declaration on ASEAN 2025: Forging Ahead Togeth...
between its correct principle of noninterference in the internal affairs of its member states and the necessity of its constructive interference in disputes between these states for their satisfactory settlement according to clearly defined and acceptable terms to all the ASEAN countries. ASEAN's following of the principle has justified abstaining from involvement for the sake of de-escalating and helping settle disputes in the bilateral disputes of its member states as well as in its member states' disputes with other countries. ASEAN has adhered to the principle notwithstanding these disputes' negative impacts on ASEAN's peace, security, and integration.

Hence, ASEAN should especially pay attention to the unresolved territorial claims with the potential for escalation into armed conflicts. An example is a border dispute between Cambodia and Thailand, which led to short-lived skirmishes along their borders a decade ago. This should serve as a reminder of the necessity of being vigilant about such disputes to prevent their escalation with the distinct potential of damaging ASEAN's integration. Reportedly, the unresolved dispute gradually escalated from 2008, only to lead to an outbreak of fighting, "most seriously over several days in February and April 2011, causing many casualties, destroying houses, and sending tens of thousands of people living near the combat zones into evacuation centers" (Ngoun 2012).

Another example of a territorial dispute with the potential for escalation to weaken ASEAN includes that between Malaysia and Singapore over the sovereignty of an island situated between the two countries, which the International Court of Justice ruled to be part of Singapore in 2018 (Cornelius-Takahama 2018). Unless ASEAN encourages and facilitates the settlement of all the territorial disputes, their continuation, even if they do not lead to major political disputes or armed conflicts, will surely help discourage and, logically, damage ASEAN's members' cooperation, and thus their integration only to prevent ASEAN from acting as a united bloc in regional and global affairs.

As a by-product of the large and small unsettled issues, suspicions in the bilateral relations of the ASEAN countries are another problem for ASEAN, which will continue in the foreseeable future unless those issues are settled. To strengthen regional cooperation, it is necessary for ASEAN to build trust and reduce animosity among its members by advancing dispute settlement for the existing political and security disputes within the region.

The weaknesses of ASEAN are also evident in its inability to realize major ASEAN-wide projects. An important example in this regard is the Trans-ASEAN Gas Pipeline (TAGP), which is aimed at interconnecting
the existing and planned gas pipeline infrastructure within the ASEAN region for transporting gas across borders to ensure greater security of gas supply for the ASEAN countries. It is yet to become a reality about 18 years after its emergence during the 20th ASEAN Ministers on Energy Meeting on 5 July 2002 in Bali, Indonesia when the participating ministers signed the ASEAN memorandum of understanding (MOU) on the TAGP project. As reported by the ASEAN Centre for Energy, the MOU sets out the “cooperative framework for greater public-private partnership and collaboration in the implementation of the TAGP. Under the TAGP MOU, ASEAN countries should study the regulatory and institutional frameworks for cross-border supply, transportation, and distribution of natural gas in the region involving multilateral countries” (ACE 2019). The idea of connecting all the bilateral gas pipelines to make a region-wide pipeline network is yet to be realized as the project has remained at the bilateral interconnecting pipelines between the ASEAN gas suppliers and consumers as stated by the ASEAN Council on Petroleum, which is the ASEAN entity responsible for the effective implementation of the TAGP project. According to the council, as of 2019, while the TAGP’s “ultimate aim is to have multilateral pipeline projects,” the 13 operational connections are bilateral in nature, with pipelines linking Singapore–Malaysia, Myanmar–Thailand, West Natuna–Singapore, West Natuna–Duyong, South Sumatra–Singapore, Malaysia–Thailand, and Singapore–Malaysia (ASCOPE 2019). It is not yet clear when the pipeline project will be fully realized.

ASEAN’s mentioned principle of noninterference has been apparent in the case of territorial disputes between its member states and other states. Several ASEAN countries (Brunei Darussalam, Indonesia, Malaysia, the Philippines, and Viet Nam) have been engaged in disputes between and among themselves as well as with the PRC and Taipei, China. On occasion, these disputes have escalated into low-intensity military conflicts in the case of the Philippines and Viet Nam pitting them against the PRC. Examples of such conflicts include a limited naval clash between the PRC and Viet Nam on 7 May 2014 over the PRC’s setting up of an oil rig in a disputed area during which a coast guard vessel from the PRC used its water cannon against a ship from Viet Nam attempting to prevent the oil rig from being set up (Brummitt 2014). Yet, the ASEAN countries have refused to take sides and defend Viet Nam, for instance, facing territorial disputes with the PRC as became evident in 2012 when the ASEAN leaders failed to issue a communiqué over their disagreements on this issue, as mentioned earlier. This refusal was repeated in July 2016 when the ASEAN foreign ministers’ meeting in the Lao PDR failed to accept the request of the Philippines and Viet Nam to include in
their communiqué the ruling of the Permanent Court of Arbitration in favor of the Philippines on its territorial disputes with the PRC because of Cambodia's opposition (Mogato, Martina, and Blanchard 2016). Although all the ASEAN countries are not involved in these territorial disputes, their continuation of these disputes could pose a problem for all the 10 ASEAN members as such disputes have the potential to undermine the unity of the regional organizations and weaken its ability to function as a meaningful regional organization to preserve all its members’ interests. In the absence of any realistic prospect for their resolution in the foreseeable future, they could get worse, especially because of the growing involvement of the US in the regional territorial disputes in favor of Viet Nam and the Philippines and its expanding military presence in the region, despite the growing opposition of the PRC. This negative trend could potentially pose a major challenge to the unity of ASEAN by expanding the existing mistrust among its members.

In short, when it comes to integration, ASEAN is certainly behind the EU. Integration demands a high degree of cohesiveness requiring a sense of common interest and trust, which are still too weak in the case of ASEAN. Given that the EU, with its far greater degree of integration, faces disintegration as a clear possibility, disintegration is certainly a conceivable possibility for ASEAN, which is far behind the EU in terms of integration.

This development could take different shapes depending on how ASEAN evolves. The possible scenarios include the following two. One is leaving the regional grouping as a distinct possibility, especially for countries such as the Philippines and Viet Nam, which face the challenges of the rising superpower, the PRC, without receiving any support from ASEAN. Against a background of the growing US presence in the Asia and Pacific region, their expanding ties with the US, including in the military and security fields, hint at their realizing ASEAN’s inability to protect them against the PRC over their mentioned disputes and hence the merits of their bilateral alliance with the US for such a purpose. Should this trend continue, ASEAN will gradually lose its importance for them and prompt their departure from the regional grouping.

Another scenario is the continuation of ASEAN as a loose coalition of the regional countries. It is basically the current reality as reflected in the regional grouping’s aforementioned lack of cohesion. Accordingly, ASEAN members will see merits in remaining in ASEAN for whatever it can offer them while focusing on their bilateral relations with ASEAN and especially non-ASEAN countries for their needs, which cannot be secured within the context of ASEAN.
13.8 Conclusion and Policy Recommendation

Europe and Southeast Asia are different in many respects, including their geographical specifications and histories. They have also gone through different political, economic, military, and security experiences since the 20th century with major impacts on shaping their societies. Yet, Europe and Southeast Asia have both created regional organizations in their respective territories with ambitious plans going far beyond the creation of simple regional groupings. Apart from helping to expand ties and cooperation among their members, they have both set the objective of regional integration for their respective regions with the ultimate goal of acting as united groups on the regional and global stages.

Today, the EU is without doubt more integrated than ASEAN, even though it is still far from being its founders’ envisioned fully functional, supranatural state operating as a superpower in global affairs. In fact, it operates more as an umbrella organization of its now (in the post-Brexit era) 27 European countries enjoying close political, economic, security, and social ties, free movement of their nationals, and free trade, while maintaining their sovereignty and pursuing their individual national interests in their conduct of foreign relations. Hence, the EU speaks for them only in certain areas of common interest, not all. In comparison, ASEAN is far behind the EU in terms of structural cohesion and integration and yet to achieve its desired degree of political, economic, security, and social closeness, although there is a varying degree of cooperation among its members in these areas. Certainly, it is yet to speak for its 10 members on any issue of significance.

Against this background, if the EU still contains seeds of disintegration despite about 7 decades of efforts to the contrary, ASEAN cannot be immune to this phenomenon. Given the existence of major sources of conflicts and disputes and the history of mistrust between and among its members, disintegration is a distinct possibility for ASEAN, but it is not an inevitability at all. In fact, as a major developing region with many underutilized resources, its membership can and will have an advanced and prosperous future should they overcome their disagreements and fully utilize their vast resources in a coordinated manner within the framework of their regional organization, while preserving their identities and interests.

Removing the sources of disintegration will not be an easy task to fulfill in a short period of time, given the existence of a long history of mistrust in some cases and the complicated nature of some of the disputes, such as the mentioned territorial ones, also claimed by non-ASEAN regional powers. However, ASEAN can take the initiative to
prepare the ground for encouraging further cooperation among its members as a prelude to settling their disputes, which is a necessity for their sustainable economic and social development and prosperity. To this end, a feasible recommendation of practical use for all ASEAN members is an ASEAN-led initiative for a negotiated code of conduct to be used in conducting their foreign relations. Such a code could help them avoid suspicion and further strengthening of historical mistrust in the region while expanding their ties with the regional and nonregional powers, especially the PRC and the US. This is a necessary measure as continuation of their current pattern of foreign relations will likely lead to a regional polarization pitting the ASEAN members against each other as a result of their existing pattern of relations with the two aforementioned powers.
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PART IV
Regional Initiatives and Case Studies
14

Swedish Economic Integration into the European Union as a Latecomer: Policy Recommendations for Asian Economic Integration

Sang Chul Park

14.1 Introduction

The process of European integration has lasted more than half a century since the Treaty of Rome in 1958. The core motivation of European integration, which stems from the Second World War, is the prevention of war on the European continent. It started for political and security reasons. Nevertheless, its economic benefits have always been the most important issue for all member nations. Therefore, there have been extensive debates about the economic benefits generated by the process of European integration, which are measured by economic growth, productivity, trade liberalization, the single market, the common currency of the euro, and so on. In reality, however, it is an extremely difficult challenge due to endogeneity problems, omitted variables, and measurement errors, among others (Martin, Mayer, and Thoenig 2012; Campos, Corricelli, and Morretti 2013).

So far, the European Union (EU) has created the most advanced regional economic integration in the world. It is absolutely true that the Single European Market (SEM) is regarded as the core architecture of European economic integration. The EU adopted the Single European Act (SEA) in 1986 and created the SEM. It enabled the free movement of people, products, and capital in the European Economic Area (EEA) to be guaranteed. The EU has continuously been modified to develop its economic structure since it was launched as an economic union in 1993.
As a result, all member nations have agreed that the SEM has generated substantial positive economic growth effects, although the EU’s target predicted by the Cecchini Report in 1988 has not been met (Vetter 2013; Park 2017).

More than 2 decades have passed since Sweden became a member nation of the EU in 1995. Since then, the country has been integrated into the EU’s internal market under the SEA. Before Sweden’s accession to the EU, the country’s economic integration into the EU market was composed of three different stages. The first stage was to establish a bilateral free trade agreement (FTA) with the European Economic Community (EEC) in 1972. The second step was the inclusion of the Swedish economy in the European Economic Area (EEA). The EEA was an agreement ensuring participation in the Single Market Programme of the European Community (EC) for nonmember nations. In 1992, Sweden signed an agreement to join the EEA, and this came into force in 1994. Last, Sweden became a full member of the EU in 1995 when the EU implemented its third enlargement (Murayama 2017).

When Sweden became a member of the EU in the 1990s, Europe was overwhelmed by regionalism—and this turned into federalism in the 2000s. It was a totally different economic and political situation compared to the EU skepticism in the 2010s. Under this state of overwhelming regionalism, Sweden decided to participate in the EU with public opinion divided between those who were pro and those who were anti the EU. In fact, Swedish participation in the EU was based on a marginal vote in a membership referendum in 1994 with 52% voting yes and 47% no (Petersson 2000; Statistics Sweden 2007).

The accession of the Swedish economy to the EU was mainly based on the national economic interests, particularly for large-sized companies operating globally and playing important roles in the Swedish industry. It was an inevitable choice for Sweden as a small-sized nation within Europe to become a full member of the EU in order to expand its market because the EU as an economic union excludes nonmember nations from all economic benefits. This means that the EU is regarded as protecting its internal market from outsiders and has thus become a members-only economic club. It is the reason why other nations such as Austria and Finland became members of the EU along with Sweden during the third enlargement of the EU.

Although Sweden became a member of the EU, it rejected the proposed membership of the eurozone in a referendum in 2003. Since then, Sweden has developed a twin strategy of being an outsider, yet also on the inside in order to implement its European economic integration. As regards membership of the eurozone, the Swedish public was considerably more cautious than the elite group, and this has lasted until
now due to the global financial crisis in 2008 and the EU’s sovereign debt crisis in 2010/11. This chapter looks at the economic benefits for the Swedish economy after its full accession to the EU. It also illustrates the impacts of the EU on the Swedish economy and answers the question of why Sweden became a member.

The motivation for choosing to research Sweden’s economic integration into the EU is crystal clear. The Swedish case has positive implications for Asian economies in general, and latecomers and relatively small economies joining the Asian economic integration process in particular. The Swedish integration into the EU indicates that a nation possessing strong industrial competitiveness can generate more economic benefits than others that are less industrially competitive in the process of economic integration.

14.2 Theoretical Debates on International Economic Integration

The notion of international and regional economic integration means that economic integration is a process of removing discrimination in markets taking place at the national level. It ends discrimination between economic actors. Economic integration is the creation of the most desirable structure for the international economy that removes all artificial hindrances to the optimal operation and introduces all the desirable elements of coordination. Countries participating in the process start from a free trade zone that is rather a simple form of economic integration. Later, they implement more advanced forms such as a customs union, a common market, and an economic union. In practice, however, the sequence of economic integration does not always occur because the achievement of the final stage needs a high level of political integration that causes a loss of sovereignty in the member nations (Tinbergen 1954; Balassa 1961; Hosney 2013; Park and Pasierbiak 2018).

Countries participating in economic integration must consider the benefits and costs of the process, which are based not only on economic but also on political and social perspectives. In economic terms, benefits must be larger than costs. However, it is also worth emphasizing that an efficient integration process requires a fair division of political and social benefits and costs between member nations. Based on the economic sphere, the benefits of economic integration are regarded as a growth of trade turnover among the member nations in the short run, while they rely on increasing production and improving productivity in the long run. This results in economic growth among the member nations.
When implementing the integration process, a reduction of barriers enables wider openness among member nations to foreign companies, which leads to increased competition and efficiency. Furthermore, a larger market attracts new business activities, including investment, and existing companies make a greater effort to compete with foreign companies. As a result, this increases productivity and allocates resources and technology transfer efficiently, which generates a positive effect on the demand side and wealth among the member nations (Molle 1990; Siddique 2007).

Theories of economic integration discuss the benefits and costs of regional economic integration and also explain the effects of integration. The traditional economic group presents a model for free trade and estimated welfare gains that reduces or eliminates trade barriers. It is a static approach based on the short term. The dynamic economic group takes into account the ever-changing economic conditions so that free trade generates societal benefits through gaining quality and variety. It also strengthens industrial competitiveness through technology transfer and innovation. It is a dynamic approach based on the long term (Bhagwati and Panagariya 1996; Krugman 1979; Krugman and Obstfeld 2009; Broda and Weinstein 2006).

This study adopts a dynamic model rather than a static model because the former can explain the long-term benefits of free trade more precisely than the latter. Moreover, the dynamic model based on long-term efficiency gains and economic growth can be emphasized in order to justify Sweden’s economic integration into the EU. It can also be adopted to Asian economies for implementing a regional economic integration.

### 14.3 Swedish Economic Integration into the European Union

#### 14.3.1 Background

Sweden was a latecomer to the industrialization process in Europe that started at the end of the 19th century. It began with a complete transformation from an agrarian society in the 19th century to an industrialized nation in the early 20th century. Sweden's industrialization process presents a classic course based on the movement of labor forces from the countryside to the urban areas for industrial development that generated a rapid economic growth. As a result, Sweden became
a new urbanized, industrialized, democratized, and modernized nation (Rojas 2005).

In terms of economy, Sweden is a small country and has been open to foreign influences. Therefore, it relies heavily on the world economy. Accordingly, successive economic structural changes generated high economic growth at the end of the 19th century and during the 20th century. In particular, the 100 years from the 1870s to the 1970s were the most successful period for Swedish industrialization and economic growth because the Swedish economy had been integrated rapidly into the European and world economies based on free trade. The average economic growth rate was 2.4%, which was higher than in Western Europe and the United States (US). During this period, only Japan performed equally well. From the 1970s to the middle of the 2000s, Swedish economic growth started to slow down compared with that of Western Europe, the US, and Japan. However, it increased again from 2006, and its growth rate from 2006 to 2018 was higher than in any other industrialized nation in the world. As a result, Sweden became one of the highest-income nations in Europe and the world in the 1970s, having been one of the poorest nations in Europe in the 1870s (Maddison 2006; Krantz and Schön 2007; World Bank 2001, 2020; Lobell, Schön, and Krantz 2008) (see Table 14.1).

The Swedish economy was severely hit by the two oil crises in the 1970s, which caused an economic stagnation in the 1980s. In order to overcome this economic stagnation, the Swedish government carried out several reforms in the 1980s and 1990s, including financial, taxation, and welfare reforms. Since the 1960s, Sweden has been involved continuously in economic cooperation with European countries as a member of the European Free Trade Association (EFTA), which the country joined in 1960, and the EU from 1995.

### Table 14.1: Average Economic Growth Rate in Various Industrialized Nations and the World Economy, 1871–2018

<table>
<thead>
<tr>
<th>Period</th>
<th>Sweden</th>
<th>Rest of Western Europe</th>
<th>United States</th>
<th>Japan</th>
<th>World Economy</th>
</tr>
</thead>
<tbody>
<tr>
<td>1871/1875–1971/1975</td>
<td>2.4</td>
<td>1.7</td>
<td>1.8</td>
<td>2.4</td>
<td>1.5</td>
</tr>
<tr>
<td>1971/1975–2001/2005</td>
<td>1.7</td>
<td>1.9</td>
<td>2.0</td>
<td>2.2</td>
<td>1.6</td>
</tr>
<tr>
<td>2006–2018</td>
<td>1.98</td>
<td>1.02</td>
<td>1.55</td>
<td>0.52</td>
<td>2.18</td>
</tr>
</tbody>
</table>

14.3.2 Process of Economic Integration into the European Union

The Swedish economy was on a growth trajectory after the Second World War because the demand for reconstruction in Europe was very high. Compared to other European countries, Sweden did not suffer from the war because of its political stance as a neutral country along with Switzerland. As a result, the country’s economy was booming in the 1950s and 1960s. During this period, Swedish companies obtained a better position in terms of technological competitiveness and forged ahead, which sped up the pace of industrial structural change in the economy. In addition, new conditions had arisen during the period of rapid economic growth. It required profound adaptation, renewal of entrepreneurial activity, and new economic policies (Lobell, Schön, and Krantz 2008; Murayama 2017).

After the Second World War, the “inner six” nations, namely France, Germany, Italy, and the three Benelux countries (Belgium, the Netherlands, and Luxembourg), created the European Coal and Steel Community (ECSC) to regulate their industrial production under a centralized authority, which was formally established in 1951 by the Treaty of Paris. The ECSC was the first international organization based on the principle of supranationalism. It started the process of formal economic integration that led to the EEC, the EC, and ultimately the EU more than 4 decades later (König 2014).

As a response, the “outer seven” nations, namely Austria, Denmark, Norway, Portugal, Sweden, Switzerland, and the United Kingdom (UK), created their own economic cooperation mechanism established by the EFTA in 1960. The EFTA member nations generated high economic growth based on the framework of their economic cooperation in the 1960s, while the EEC member nations continued their economic integration process and upgraded their level to the Common Market in 1967 and built the EC. This meant that the EC expanded faster than the EFTA and built a higher economic integration than the EFTA. The rapid and comprehensive policy of trade liberalization generated high economic growth, particularly in the 1960s in the context of both the EC and the EFTA. It is worth noting that the process of European economic integration has progressed and never reversed since the 1950s. Moreover, both the EC and the EFTA memberships generated a positive and significant effect on economic growth. Therefore, regional economic integration affects not only resource allocation but also the long-run growth rate (Campos, Coricelli, and Morretti 2013).

In the 1970s, the Swedish economy started to slow down. The economic growth of other nations declined in the 1970s only in relation
to growth rates in the high economic growth period after the Second World War, while Swedish economic growth fell clearly below the long-run economic growth trend, which was very low even at the international level. This meant the end of the growth trajectory for the Swedish economy. At the same time, new growth forces emerged with electronic technology and the advance of a more service-oriented economy. This structural change damaged the Swedish economy more than other economies, particularly in Europe. Therefore, Sweden was forced to transform its industrial structure and political economy in the 1970s and 1980s more profoundly than in most other Western countries. As a result, the total factor productivity (TFP) played a more important role in the economic growth during this period. At the same time, the growth in TFP increased continuously and the role of labor in the economic growth declined heavily from the middle of the 1970s (Lobell, Schön, and Krantz 2008; FRED Economic Data 2020) (see Table 14.2).

### Table 14.2: Contribution of Total Factor Productivity in Economic Growth and Its Growth Rate, 1870–2017

<table>
<thead>
<tr>
<th>Period</th>
<th>TFP Growth (%)</th>
<th>Capital</th>
<th>Labor</th>
<th>TFP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1870–1910</td>
<td>0.7</td>
<td>50</td>
<td>18</td>
<td>32</td>
</tr>
<tr>
<td>1910–1950</td>
<td>1.0</td>
<td>39</td>
<td>24</td>
<td>37</td>
</tr>
<tr>
<td>1950–1975</td>
<td>2.1</td>
<td>45</td>
<td>7</td>
<td>48</td>
</tr>
<tr>
<td>1975–2000</td>
<td>1.0</td>
<td>44</td>
<td>1</td>
<td>55</td>
</tr>
<tr>
<td>2000–2017</td>
<td>0.93</td>
<td>42</td>
<td>1</td>
<td>57</td>
</tr>
</tbody>
</table>

**TFP** = total factor productivity.

Sources: Krantz and Schön (2007); FRED Economic Data (2020).

Furthermore, the Swedish economy was hit by the two international oil crises during the 1970s and was damaged heavily because its main industries were steel and shipbuilding, which were sensitive to the high energy costs. The Swedish government supported major companies with subsidies in order to overcome the crises. However, the Swedish economy was unable to recover fully. In addition, Denmark and the UK withdrew from the EFTA and joined the EC in their national economic interests at the beginning of the 1970s, which contracted the market of the EFTA. As a result, the remaining member nations of the EFTA concluded bilateral FTAs with the EC in 1972. The Swedish economic
recovery took longer than expected and continued into the 1980s, which resulted in several reforms in the 1980s and 1990s, including financial, taxation, and welfare reforms.

After the reforms, the Swedish economy recovered at the end of the 1980s and generated successive economic growth again, which led to an economic boom from 1987 to 1990, as well as a lending boom from the financial institutions. The Swedish economy peaked in 1990. However, this positive economic environment turned to negative growth between 1991 and 1993 and Sweden faced a severe economic crisis caused by the banking crisis in 1991. During this period, the economic integration between Sweden and the EU changed rapidly as well. The agreement on the EEA was completed in 1992, and it came into force in 1994. A year later, Sweden joined the EU, instigating its third enlargement after deepening its single market policy substantially (Englund 2015; Campos, Corricelli, and Morretti 2013; Murayama 2017).

14.3.3 Reasons for Economic Integration into the European Union

Sweden’s economic integration into the EU comprised three stages: the Sweden–EEC FTA, the EEA, and EU membership. The Sweden–EEC FTA was to build a pure free trade area between the two economies that was the loosest economic integration and dealt basically with the movement of products. In the free trade area, a common trade policy toward external trade was not possible, but the discretionary imposing of tariffs remained. Additionally, rules of origin were introduced in order to prevent possible cheating on tariffs while trading. The main reason for the Sweden–EEC FTA was based on the trade strategy of both sides aimed at increasing their exports. In particular, the Swedish economy has been heavily dependent on trade because its internal market is extremely small. The EEC was a larger market than the EFTA for Sweden. Therefore, the Sweden–EEC FTA was needed.

Despite the Sweden–EEC FTA in 1972, the Swedish economy had entered a phase of slow and difficult growth by the middle of 1970s. It was obvious that the Swedish economy had started to lose ground to other industrialized nations. This economic slowdown continued in the 1980s and became an economic stagnation. This motivated the Swedish government to implement several economic reforms, including financial reform, taxation, and the welfare system in the 1980s and 1990s. Among these, the financial reform was based on the deregulation of the capital market, which led to the liberalization of the markets. Since the 1970s, many industrialized nations had carried out processes of liberalization...
of the financial market, and the Swedish financial market could not ignore such a global market trend because of increasing globalization of its economy. In order to minimize the negative effects of the market liberalization, the process started gradually in the 1970s and 1980s as active markets started to develop and regulations were modified. Finally, in the mid-1980s, regulations were largely abolished (Rojas 2005; Englund 2015; Murayama 2017).

Financial deregulation caused domestic credit expansion, which led investments into the real estate market due to the lending boom. After the currency regulations were fully abolished in 1989, the deregulation stimulated bank lending and increased credit market competition. In order to counter these effects, the Swedish central bank (Riksbank) increased the cash reserve requirement for banks from 1% to 3% without changing monetary and fiscal policy. As a result, the financial institutions, such as banks, mortgage institutions, and finance companies, entered a new environment to compete freely on the loan market. After the peak of economic growth in 1990, the economic boom turned into an economic contraction, which led to the bankruptcy of some banks due to nonperforming loans. In addition, the Swedish currency crisis in 1992 affected the national economy negatively, and the fixed exchange rate policy was abandoned (Jennergren 2002; Rojas 2005; Englund 2015) (see Figure 14.1).

The Swedish economic crisis caused by the currency crisis was the worst since the Great Depression in 1929/30. Owing to the economic crisis, more than 500,000 jobs were lost between 1990 and 1994,
which represented about 10% of the total workforce. As a result, the unemployment rate rose from 1.7% to 12.6% in the same period. The economic crisis began in the private sector. However, it spread rapidly to the public sector because weak tax collection deepened the crisis. The unemployment compensation and other social benefits paid by the government increased rapidly, while tax revenue declined. As a result, public spending hit a record high of 72.8% of gross domestic product (GDP), and the public deficit accounted for 12.3% of GDP in 1993. However, the government could not raise the tax rate because it had already reached high levels before the crisis. Overall, it damaged the Swedish economy heavily, which resulted in a negative economic growth from 1991 to 1993 (IMF 2015; Rojas 2005; Murayama 2017) (see Figure 14.2).

In order to overcome the economic crisis, the Swedish government completed the agreement of the EEA in 1992 that enabled a closer economic integration into the EU than the Sweden–EEC FTA. The agreement of the EEA came into force in 1994 and allowed the Swedish economy to gain access to the EU’s single market governed by the same basic rules. These rules aim to enable free movement of labor, goods, services, and capital within the EU, including the freedom to choose residency within any EU member nation, although there are limited opportunities to cooperate with the EU compared with the EU member nations. Despite this limitation, the Swedish private sector became competitive by implementing deregulation processes. Thus, Sweden
became a member of the EU a year later. Sweden’s entry into the EU in 1995 resulted in lowering tariff barriers between Sweden and other EU member nations, which increased competition from abroad. It enabled Swedish companies to boost their efficiency and strengthened their competitiveness in the EU market (EFTA 2017: McKinsey Global Institute 2006; Noren 1994) (see Table 14.3).

### Table 14.3: Areas of Cooperation between EEA Agreement and EU Membership

<table>
<thead>
<tr>
<th>Areas</th>
<th>EEA Agreement</th>
<th>EU Membership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free movement of goods, services, capital, and people</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Elimination of technical barriers</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Common competition law</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Access to government procurement</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Common rules for state aid</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Participation in the SME program of the EU</td>
<td>Partly</td>
<td>Yes</td>
</tr>
<tr>
<td>Abolishment of border control</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Participation in VAT operation of the EU</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Customs union</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Common trade policy</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Common regional policy</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Common agricultural and fishery policy</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Participation in environmental policy of the EU</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Economic and political cooperation</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Participation in institutions and decision-making organizations of the EU</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

EEA = European Economic Area, EU = European Union, VAT = value-added tax, SME = small and medium-sized enterprise.

The international political situation also influenced Sweden’s accession to the EU. The end of the Cold War changed the political landscape fundamentally at the end of the 1980s. In particular, Europe was experiencing political turmoil with the collapse of the Soviet Union and Eastern European countries, German unification, etc. Under
these circumstances, Sweden’s traditional policy of being a neutral nation was not a sufficiently good reason for being outside of the EU. Furthermore, Sweden took into account the possible membership of transition countries due to the EU’s enlargement policy in the 1990s. At the same time, Swedish trade was highly dependent on the EU market. Therefore, public opinion turned toward accession to the EU. Despite the positive public opinion of the EU, the Swedish internal Euroskeptic political arena continued with its pro EU membership but anti-euro positioning toward the EU, which was the “twin faces” and a selective supranationalist mixed policy portfolio (Alvstam 2015; Beiler 2000; Lindahl and Naurin 2005; Miles 2011).

14.4 Analysis of the Swedish Accession to the European Union

14.4.1 Cost Analysis

The costs of the EU Single Market are mostly due to overregulation, inefficient bureaucracy, and deficient allocation of tasks among the administrative levels in the EU’s federal system. This leads to direct costs for companies of the member nations. Moreover, the market opening increases adjustment costs for member nations. These burden less competitive companies in particular more than their foreign rivals. Standardized regulations in the EU are able to simplify many national administrative matters, and many of them have been abolished. Certainly, the European Stability Mechanism (ESM) has caused additional bureaucratic and regulatory costs. Despite the additional costs, it is fully dependent on how efficiently a national administrative system operates and how a member nation adapts to the transfer of the competences in the EU (Park 2017).

It was estimated in 2005 that the total administrative costs for companies in the EU accounted for around 3.5% of the EU’s total GDP, with member nations’ specific differences among the various member nations. The share of some member nations with efficient regulations such as Finland, the UK, and Sweden was only 1.5% of their GDP, while it was over 5% in most of the Eastern European member nations. This means that Sweden belonged to the most efficient group among the EU member nations, and the administrative costs after their accession were the lowest in the EU. The less competitive member nations and regions were supported by the EU Cohesion Fund in order to lessen the negative effects of liberalization in the ESM (Kox 2005; Vetter 2013) (see Table 14.4).
In addition to the administrative costs in the ESM, local incumbents having market power, local regulations, weak connected infrastructures, subsidies, language and local barriers, and significant information asymmetries among market players generate costs. Due to these, a majority of companies in the EU cannot participate actively in the internal market. Many Swedish companies are not exceptional, although the Swedish industry and workforces are comparatively competitive in the EU market compared to those of other member nations. This shows that the integration of the Single Market is still regarded as below standard despite the comparatively low additional cost to the Swedish economy as a whole (Mayer and Ottaviano 2007; Pelkmans 2012).

Sweden is used to maintaining a higher standard of its welfare system than those of the EU member nations. In addition to the welfare system, the standard of the Swedish labor market environment has been higher than in the other EU member nations. Therefore, the accession to the EU has not caused additional costs in these areas. However, the global financial crisis in 2008 and the euro crisis caused by the sovereign debt crisis in 2010/11 hit the Swedish economy negatively in terms of its macroeconomy. In particular, the latter has generated negative views on the EU integration due to the lack of policy tools for coping with the economic crisis in the ESM. As a result, the perception turned negative among the Swedish public, which is also an additional cost for the Swedish economy as an outsider of the eurozone.

### Table 14.4: Administrative Costs by Member Nations in Share of GDP as of 2005 (%)

<table>
<thead>
<tr>
<th>AT</th>
<th>BL*</th>
<th>CZ</th>
<th>DE</th>
<th>DK</th>
<th>ES</th>
<th>FI</th>
<th>FR</th>
<th>UK</th>
<th>GR</th>
<th>HU</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.6</td>
<td>2.8</td>
<td>3.3</td>
<td>3.7</td>
<td>1.9</td>
<td>4.6</td>
<td>1.5</td>
<td>3.7</td>
<td>1.5</td>
<td>6.8</td>
<td>6.8</td>
</tr>
<tr>
<td>IE</td>
<td>IT</td>
<td>NL</td>
<td>PL</td>
<td>PT</td>
<td>RE**</td>
<td>SK</td>
<td>SI</td>
<td>SE</td>
<td>EU</td>
<td></td>
</tr>
<tr>
<td>2.4</td>
<td>4.6</td>
<td>3.7</td>
<td>5.0</td>
<td>4.6</td>
<td>6.8</td>
<td>4.6</td>
<td>4.1</td>
<td>1.5</td>
<td>3.5</td>
<td></td>
</tr>
</tbody>
</table>

AT = Austria, CZ = Czech Republic, DE = Germany, DK = Denmark, ES = Spain, FI = Finland, FR = France, UK = United Kingdom, GR = Greece, HU = Hungary, IE = Ireland, IT = Italy, NL = Netherlands, PL = Poland, PT = Portugal, SK = Slovakia, SI = Slovenia, SE = Sweden.

Notes: * BL combines Belgium and Luxembourg; ** RE combines the Baltic member nations, Malta, and Cyprus.

Source: Based on Kox (2005).
14.4.2 Benefit Analysis

It is absolutely true that the ESM has generated enormous benefits in the Swedish economy. From the economic point of view, it created various opportunities for total utility. First of all, it reduced direct costs by abolishing border formalities and national regulations. Second, it enlarged economies of scale, which enabled high sales potential among companies by accessing the bigger market. Third, high competition due to lower entry barriers emerged. Fourth, the labor force moved freely due to free cross-border mobility. Last, lower financial transaction costs were realized because the liberalization of capital flows and the financial integration made cross-border financial transactions easier and cheaper than ever (Vetter 2013).

However, the degree of impacts across member nations of the ESM varies and the overall impact is very mixed. This means that benefits in the member nations are not equal but different. The reason for this is that a series of factors have affected individual member nations' assessment. Sweden, as one of the most competitive member nations, has gained substantial benefits. As a result, in 2018 over 70% of Swedish exports went to the Single Market, and the export industry employed more than 1.4 million people. In addition, over 80% of all new jobs have been generated in the service sectors since the accession to the EU (Regeringen 2018).

According to the analysis of Single Market integration, it progressed slowly on average across the member nations but steadily after the EU’s third enlargement. The average index of Single Market integration was only 58% in 1995, and this increased continuously up to 75.9% in 2015. During this period, it increased by 30%. The Swedish index of Single Market integration accounted for only 53.5% as it entered the EU in 1995, which was 7.8% lower than the average. It increased to 69.5% in 2015, although it was still lower than the EU average of 75.9%. This means that the Swedish economy has been more integrated in the Single Market than before becoming a member nation of the EU (Muller et al. 2017).

The economic impact of Single Market integration on GDP per capita in the EU member nations on average was 0.79% higher in 2015 than in the absence of further integration. In Sweden, it accounted for 1.13% in the same year, which was higher than the average. This means that the economic impact of Single Market integration affected the GDP per capita in Sweden more strongly than the average of the EU member nations. Only seven member nations (France, Finland, Malta, Denmark, Germany, Belgium, and Austria) felt a higher economic impact of Single Market integration than Sweden. Among these member nations, all of them except Denmark belong to the eurozone. Sweden, as a non-
eurozone member nation, had created substantial economic benefits after entering the EU (see Figure 14.3).

Most of the economic indicators show that Sweden’s macroeconomic development after the accession to the EU had been more positive than before the accession. Economic growth during the decade before entering the EU accounted for 1.4% on average and 2.8% during the first 10 years (1995–2004) following economic accession to the EU. It slowed to 1.6% during the second 10 years (2005–2014). However, it was still a higher economic growth than before the accession. Furthermore, productivity increased from 2.1% to 2.7%, while it declined to 0.3% during the second 10 years due to the global financial crisis in 2008 and the sovereign debt crisis in the EU in 2010/11. These two economic crises impacted Swedish productivity severely.

Inflation rates declined from 5.7% to 1.2% and later to 1.3%. This meant that price stabilization after the EU accession was realized. In addition, interest rates both in the short and long term declined continuously and were stabilized. However, unemployment rates increased from 3.7% to 5.8% and later to 7.6% due to high competition in the private sector. Based on these macroeconomic indicators, it is clear that Sweden’s economic integration into the EU generated various

Figure 14.3: Economic Impact of Single Market Integration on Gross Domestic Product per Capita, as of 2015 (%)

AT = Austria, BE = Belgium, BG = Bulgaria CY = Cyprus, CZ = Czech Republic, DE = Germany, DK = Denmark, EE = Estonia, ES = Spain, EU28 = European Union 28, FI = Finland, FR = France, UK = United Kingdom, GR = Greece, HR = Croatia, HU = Hungary, IE = Ireland, IT = Italy, LT = Lithuania, LV = Latvia, MT = Malta, NL = Netherlands, PL = Poland, PT = Portugal, RO = Romania, SK = Slovakia, SI = Slovenia, SE = Sweden, UK = United Kingdom.

Table 14.5: Swedish Macroeconomic Development after Its Accession to the EU Single Market, 1985–2014 (average in % per year)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth rate</td>
<td>1.4</td>
<td>2.8</td>
<td>1.6</td>
</tr>
<tr>
<td>Productivity</td>
<td>2.1</td>
<td>2.7</td>
<td>0.3</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>3.7</td>
<td>5.8</td>
<td>7.6</td>
</tr>
<tr>
<td>FDI in GDP</td>
<td>–1.8</td>
<td>0.6</td>
<td>2.85</td>
</tr>
<tr>
<td>Inflation rate</td>
<td>5.7</td>
<td>3.1</td>
<td>1.0</td>
</tr>
<tr>
<td>Interest rate in the short term (3 months)</td>
<td>5.2</td>
<td>3.1</td>
<td>1.0</td>
</tr>
<tr>
<td>Interest rate in the long term (10 years)</td>
<td>5.3</td>
<td>4.8</td>
<td>2.89</td>
</tr>
</tbody>
</table>

EU = European Union, FDI = foreign direct investment, GDP = gross domestic product.

benefits, such as economic growth, price stability, and positive capital investment (foreign direct investment), despite some negative indicators such as productivity and unemployment (Calmfors 2005; www.oecd.org 2019; www.riksbank.se 2019) (see Table 14.5).

14.5 Conclusion and Policy Recommendations

The Swedish economy grew rapidly after the end of the 19th century, although it was a latecomer to the industrialization process in Europe. As a result, it rose from being one of the poorest nations in the 19th century to one of the richest nations, not only in Europe, but also in the world, in the 20th century. After the Second World War, Sweden was on the top level in terms of income per capita in the world along with Switzerland and the US; that lasted until the mid-1970s. After that, the Swedish economy started to slow down, while other major European nations, such as Germany, France, Italy, and the UK, created high economic growth after the destruction of the Second World War. The Swedish economy experienced high inflation in the 1980s and was hit by the economic crisis at the beginning of the 1990s, which was the most severe since the Great Depression.

The Swedish economy started to be integrated in the form of the EFTA as one of the outer seven member nations in 1960, while the EEC started with the inner six member nations in 1958. Due to the UK and Denmark’s participation in the EC in 1972 with a view to accession to a bigger market than the EFTA, Sweden began to consider integrating into the SEM more than ever in order to overcome its economic hardship.
at the beginning of the 1990s. As a result, it participated in the EEA in 1992 and became a member nation of the EU in 1995. In the referendum in 1993, Sweden decided to enter the EU with a marginal vote, which was regarded as the right economic and political choice, although many stakeholders were reluctant to make their decisions. However, Sweden, as a small nation in Europe in terms of its national economy and population, cannot undermine its economic interests for its industry based on a large-sized company-oriented structure that must compete with foreign companies on the one hand and needs to direct market accession to the EU on the other. Without the accession to the EU Single Market, Swedish companies could not compete with other European or foreign companies properly and fairly in the EU Single Market due to the discrimination against nonmember nations.

There are various discussions and research analyses on the impacts of Swedish economic integration into the EU Single Market. The core question is whether the country’s economic integration has generated positive results in the national economy or not. Given the macroeconomic indicators such as economic growth, productivity, unemployment rate, foreign direct investment, and interest rate, Sweden's economic integration clearly created positive impacts on the national economy after its accession to the EU Single Market, particularly compared with the macroeconomic results before the accession, although some indicators such as the unemployment rate and productivity proved to be negative. However, these negative territories have been compensated overall by other positive indicators.

The Swedish approach to its economic integration into the EU Single Market is quite unique compared with other latecomers such as Austria and Finland. Sweden has always been ready to cooperate closely with the EU in all areas as a member nation. However, it strongly insists on keeping its own currency instead of becoming a member of the Economic and Monetary Union, although the two other latecomers have participated in it since January 1999 and used the common currency of the euro. In the euro referendum in 2003, the majority voted not to adopt the euro, and Sweden has remained as a member nation nonbinding to the euro since then. This means that Sweden is ready to cooperate with the EU closely, but it will not give up its economic sovereignty, which has resulted in limited supranational cooperation in the EU. Therefore, it is known as the “twin faces approach,” which is similar to the Danish approach. Despite its functional limitation, Sweden’s economic integration into the EU Single Market created overall economic prosperity rather than illusion.

The Swedish strategy of economic integration can provide some valuable policy implications for Asian countries. First of all, strong
industrial competitiveness can maximize the economic benefits from integrating into a large market such as the EU despite the small size of the national economy. Second, a nation can be integrated into a regional economy with a limited form accessing a single market without giving up its own currency. Lastly, a nation must establish an effective and efficient administrative system as well as good governance along with a competitive industrial structure before integrating into a regional economy that generates maximum benefits and minimum cost.
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Websites
Trade Impact of Reducing Time and Costs at Borders in the Central Asia Regional Economic Cooperation Region

Kijin Kim and Paul Mariano

15.1 Introduction

Trade facilitation has been integral to international trade because it reduces trade costs and raises the efficiency of moving goods across borders. Broadly speaking, trade facilitation simplifies, harmonizes, and standardizes trade procedures to expedite the flow of goods. Greater trade facilitation is associated with lower transaction times and costs at borders and ports, thereby promoting trade flow efficiency (Portugal-Perez and Wilson 2012; Ismail and Mahyideen 2015). It also fosters a better regulatory environment, which eventually encourages more trade, attracts foreign direct investment (Duval and Utoktham 2014), and hence creates more jobs, leading to higher income per capita (Fox, Francois, and Londono-Kenet 2003).

In landlocked regions, such as Central Asia, lower trade gains are observed relative to their coastal counterparts due to the time and cost penalties from being geographically disadvantaged (Raballand 2003). Landlocked countries have limited participation in external trade and suffer from high trade transaction costs due to a lack of access to the seas and restricted border crossings. Such countries depend on transit-providing countries for goods shipments, which may be constrained by unfavorable political environments and are vulnerable to rent-seeking activities (Arvis, Raballand, and Marteau 2010). Weak institutions and poor infrastructure quality, likewise, may leave transportation costs higher than those of coastal neighbors (Arvis et al. 2011).
Trade costs in Central Asia are also higher than in other Asian regions. Tariff-equivalent trade costs from 2011 to 2016 in Georgia, Kazakhstan, the Kyrgyz Republic, and the Russian Federation were as much as 172.9 percentage points higher than in the East Asia-3 (Japan, the People’s Republic of China [PRC], and the Republic of Korea) and 160 percentage points higher than in ASEAN-4 countries (Indonesia, Malaysia, the Philippines, and Thailand). Although intraregional trade costs in Central Asian countries have declined significantly in the last few years, they are higher by 115.4 percentage points than domestic trade costs. Considering the declining trend of tariffs, the need to address nontariff costs is becoming increasingly important. To promote harmonization and standardization across nations, the role of trade facilitation should be emphasized in addressing a number of nontariff areas: publication and administration of policies related to trade issues, rules and procedures for import and export, product standards and conformance, trade-related infrastructure and services, and goods in transit (ADB and UNESCAP 2013).

Most of the existing literature on Central Asia’s trade integration and facilitation highlights the importance of infrastructure. For instance, Grigoriou (2007) finds that imports and exports of Central Asian countries increase most when their infrastructure indicators improve. Moreover, developing the transit infrastructure among neighboring countries is essential in raising intraregional trade in the region. Shepherd and Wilson (2006) also support this conclusion and find in their study that upgrading infrastructure in Albania, Hungary, and Romania can enhance intraregional trade flows within Eastern Europe and Central Asia by as much as 50%.

A few studies have assessed the effects of trade facilitation measures on trade flows in Central Asia, and most find positive effects, with a wide range of impacts. For instance, measuring trade facilitation through the World Bank’s Logistics Performance Index, Felipe and Kumar (2012) show that facilitation reforms result in significant gains in Central Asia’s trade. Moreover, trade gains vary across countries, ranging from 28% (for Azerbaijan) to 63% (for Tajikistan). Intraregional trade is also found to increase by 100%, with the greatest gains from improvements in infrastructure.

Using trade facilitation indicators (TFIs) specific to Central Asian countries, one can analyze the impact of improved border crossing services on the regional economy and trade in Central Asia. The Corridor

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1 The differences in trade costs were computed using data from the UNESCAP (2018) report. The data are in terms of tariff-equivalent trade costs or ad valorem trade costs, which are expressed as percent relative costs of trading outside the borders (international trading) to trading within the borders (domestic trading).
Performance Measurement and Monitoring (CPMM) TFIs used in Central Asia Regional Economic Cooperation (CAREC) countries are one such set of indicators. For example, Tanabe, Shibasaki, and Kato (2016) use the data in the Multimodal International Cargo Simulation model for Central Asia and a computable general equilibrium model in estimating the effect of infrastructure development on international transportation costs and trade flows in a land transit network. Their study finds that, in the short run, improving border crossing services can considerably decrease transportation costs and hence increase the volume of trade flows.

This chapter evaluates the impact of trade facilitation activities on bilateral trade flows in Central Asian countries using an augmented gravity model that employs CPMM TFI data available at the level of border crossing points (BCPs). As the majority of Central Asia’s intraregional trade occurs by road and railway, the cost and time taken at the BCPs are expected to significantly contribute to higher trade costs, in addition to transit costs such as fuel for trucks and trains. To the best of our knowledge, this study on trade facilitation is the first to use the CPMM TFIs at the BCP level. Although Tanabe, Shibasaki, and Kato (2016) used CPMM TFI data, they only incorporated the aggregate summary data in setting up parameters for the calibration of their transport network computable general equilibrium model.

The results from the estimated gravity models support the usefulness of the CPMM TFIs in explaining trade flow changes within the CAREC region. The main findings are: (i) time in hours, not costs (in dollars) more objectively measures trade facilitation at the border; (ii) a reduction in average time taken at the importer border is more effective than a reduction in average time at the exporter border; and (iii) the estimated impact implies that reducing time at the border by 10% can lead to a 1.41% increase in intra-CAREC trade.

15.2 Background

15.2.1 Overview of the Central Asia Regional Economic Cooperation Region Program

The CAREC Program was formally established in 2001 to promote cooperation within the region that could accelerate economic growth and poverty reduction (CAREC 2019). The 11 member countries—Afghanistan, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Mongolia, Pakistan, the PRC, Tajikistan, Turkmenistan, and Uzbekistan—work with development partners. The program’s promotion and facilitation of regional cooperation focuses mostly on regional trade
expansion, transport connectivity improvement, and economic corridor development. One unique aspect of the program is the participation of six multilateral institutions: the Asian Development Bank (ADB), the European Bank for Reconstruction and Development, the International Monetary Fund (IMF), the Islamic Development Bank, the United Nations Development Programme, and the World Bank (Linn 2012). ADB is the CAREC secretariat.

The CAREC countries are linked to each other through six transport corridors intended to expand trade and improve competitiveness and thus augment regional cooperation. Agreements among countries were initiated to improve connectivity, such as the development of road and railway networks, and construct physical infrastructure. The activities of the CAREC Program are implemented through its institutional framework, which promotes active participation among the member countries and fosters partnership on policy and project initiatives. Its policy-making and strategy-setting body, the Ministerial Conference, guides overall direction. Operations are monitored by the Senior Officials’ Meeting, which also ensures the Ministerial Conference’s effective implementation of the policies and strategies (CAREC 2019).

Much of CAREC’s investment focuses on transportation—reflecting the importance of increasing connectivity—while trade facilitation has received substantial funding through technical assistance. To support CAREC’s goal of regional cooperation through transport and trade facilitation, the Transport and Trade Facilitation Strategy 2020, formulated in 2013, focuses on two of four objectives: expansion of trade and improvement of competitiveness. It aims to achieve three sector outcomes: (i) establish competitive corridors across CAREC; (ii) facilitate efficient movement of goods and people through CAREC corridors and across borders; and (iii) develop sustainable, safe, user-friendly transport and trade networks (ADB 2014a).

Progress is noteworthy in advancing CAREC’s efforts on regional integration. Using the Asia-Pacific Regional Cooperation and Integration Index (ARCII) developed by Huh and Park (2018) and Park and Claveria (2018), the CAREC region has made steady progress over the past decade, although it lags behind other subregional initiatives in Asia in terms of its level of integration with other Asian countries (Figure 15.1). The ARCII measures regional integration on a normalized scale of 0 to 1 in six dimensions: (i) trade and investment, (ii) money and

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finance, (iii) regional value chains, (iv) infrastructure and connectivity, (v) movement of people, and (vi) institutional and social integration. Compared to the Association of Southeast Asian Nations (ASEAN), the Greater Mekong Subregion (GMS), and the South Asia Subregional Economic Cooperation (SASEC) Program, CAREC is the least integrated region, driven mainly by low scores in movement of people, money and finance, and trade and investment (Figure 15.2). It performs relatively better than SASEC in infrastructure and connectivity, and institutional and social integration, while it is on a par with ASEAN in the areas of regional value chains.

Intraregional trade in CAREC has advanced slowly in the last few years and trade integration has remained subdued. The share of intraregional trade in total trade was 3.2% in 2017 compared to 3.1% in 2010 (Figure 15.3), implying that the CAREC countries benefit more from trade outside the region than from trade within. Excluding the PRC (the largest economy in East Asia), intraregional trade had slightly increased to 6.7% in 2017 from 6.2% in 2010. These numbers are relatively lower than in other regions in Asia and the Pacific. The intraregional trade
share of Southeast Asia is estimated to be 23.1% and that of East Asia about 35.5% (ADB 2019). Notably, however, Afghanistan, Mongolia, and Turkmenistan traded with other CAREC countries, with shares of more than 50% in 2017.

Four factors explain the low numbers: (i) CAREC countries have identical production structures, limiting the potential for intraregional trade, except in products such as hydrocarbons, cotton, and aluminum (Jha 2015); (ii) low export diversification and high concentration on the same set of commodities; (iii) the geographic concentration of exports is limited to those with close historical and cultural links; and (iv) geography causes high intraregional trade costs.
15.2.2 Overview of Corridor Performance Measurement and Monitoring Trade Facilitation Indicators

The CAREC CPMM TFIs are time and cost measures that are used to monitor and assess the trade and transport facilitation performance of the six CAREC transport corridors. They are based on the time/cost-distance approach developed by UNESCAP. Five TFIs are measured in either hours/days or US dollars or kilometers (km) of trading in the corridors (Table 15.1). TFI1 measures how long freight moves in or out of a border crossing point on average, while TFI2 measures the corresponding accounting costs. The costs incurred of moving freight in a corridor section is provided by TFI3. Last, the average speed of travel (in km per hour) along a corridor section is measured by TFI4 and TFI5. All of the indicators help identify transport inefficiencies and bottlenecks in the movement of goods across BCPs.
The CPMM TFIs are based on actual trade transactions and transit shipments—from origin to destination—using road and rail transport in the covered CAREC corridors. Various stakeholders are involved from the data collection stage to data reporting. For data collection, qualified truck drivers who transport shipments within and outside the CAREC region are required to fill in forms. A CPMM coordinator—the focal point of ADB and drivers—collects the forms every month from drivers. The data are standardized to address different attributes of the corridors (road development, length, cross-border protocols, etc.) and facilitate comparison. Analyses are published in quarterly and annual CPMM reports.

The CPMM TFIs are better trade facilitation measures than other available measures as they represent performance better in the landlocked developing economies. The usual trade facilitation performance indicators—such as the World Bank’s Logistics Performance Index (LPI), the World Economic Forum’s Enabling Trade Index (ETI), and the Trade Facilitation Index (TFI)—often fail to capture the complexity and inefficiencies inherent in the border crossing process. The CPMM TFIs, on the other hand, are designed to address these issues.

<table>
<thead>
<tr>
<th>TFI1</th>
<th>Time taken to clear a border crossing point (hours)</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Average length of time (hours) it takes to move cargo (20 tons) across a border from the exit point of one country to the entry point of another; aims to capture both the complexity and the inefficiencies inherent in the border crossing process</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>TFI2</th>
<th>Cost incurred at border crossing clearance ($)</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Average total cost of moving cargo (20 tons) across a border from the exit point of one country to the entry point of another; both official and unofficial payments are included</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>TFI3</th>
<th>Cost incurred to travel a corridor section ($ per 500 kilometers, per 20-ton cargo)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Average total costs incurred for a unit of cargo (a cargo truck or train with 20 tons of goods) traveling along a corridor section within a country or across borders; both official and unofficial payments are included</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>TFI4</th>
<th>Speed to travel with delay along CAREC Corridors (kilometers per hour)—SWD (Speed with Delay)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Average speed (in kilometers per hour) at which a unit of cargo travels along a corridor section (a stretch of road 500 kilometers long) within a country or across borders; the total time taken for the entire journey; distance and time measurements include border crossings; an indicator of the efficiency of border crossing points along the corridors</td>
</tr>
</tbody>
</table>

<table>
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<tr>
<th>TFI5</th>
<th>Speed to travel without delay along CAREC Corridors (kilometers per hour)—SWOD (Speed without Delay)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Traveling speed only; a measure of the condition of physical infrastructure (such as roads and railways)</td>
</tr>
</tbody>
</table>

Table 15.1: CPMM Trade Facilitation Indicators

CAREC = Central Asia Regional Economic Cooperation, CPMM = Corridor Performance Measurement and Monitoring, TFI = trade facilitation indicator.

Source: ADB (2014b).
Trade Index, and the Organisation for Economic Co-operation and Development’s Trade Facilitation Indicators— are complex measures, encompassing various dimensions, such as structural reforms, institutional characteristics, infrastructure development, and logistics quality. These indicators provide a holistic approach to assessing the trade facilitation performance of countries. However, they may have limitations in revealing important information. For instance, improvements in some key areas may not truly be reflected by the changes in the index scores. Arvis et al. (2012) point out that the low LPI scores of a landlocked country might only signify their problems in gaining access to other countries (e.g., transit difficulties) and may not sufficiently account for their domestic reforms in enhancing trade facilitation. As landlocked countries are involved in a complex cross-border transit network, advancing their reform efforts would be highly dependent on other transit countries’ reforms. In addition, most of the complex TFIs are only available at the country level, which might not be able to indicate the progress or challenges in trade facilitation at a bilateral or network level, especially for border crossing issues.

The CPMM TFIs are comprehensive measures of trade facilitation with details. The majority of CAREC’s intraregional trade occurs within the transport corridors through land transportation. The CPMM TFIs are more representative of the CAREC region than any other indicators, as data by mode of transportation (road and rail) and by BCP are available for all six CAREC transport corridors. Moreover, the frequency of the data is at quarterly and annual levels. This is in contrast to the global TFIs, which are usually released only on an annual or biennial basis, and thus limit timely analysis.

Figure 15.4 presents the recent trend of trade facilitation by mode of transportation in the CAREC countries. For road transportation, the time (TFI1) and cost (TFI2) taken at the border do not necessarily move together: time rose from 6.3 hours in 2010 to 16.7 hours in 2017, while cost declined from $192 in 2010 to $158 in 2017. Conversely, the time taken to clear a BCP for trains rose from 22.1 hours in 2010 to 26.8 hours in 2017. Costs associated with rail transportation incurred at border crossings rose as well, from $160 to $209 in 2017. CAREC (2018) finds that irregular movements of the indicators are often caused by unexpected delays at some BCPs in a particular period of time. For example, the increased average time taken at the borders in 2017 was mainly due to the delays caused by border closure and stricter control at the BCPs of Peshawar (in Pakistan) and Chaman (in Afghanistan). Methodological changes such as the inclusion of new sample BCPs may also affect temporary movement of the indicators. This makes a clear case for controlling time and locations in econometric analyses to assess precisely the trade impact of time and cost.
15.3 Impact of Border Crossing Clearance on Intraregional Trade in the Central Asia Regional Economic Cooperation Region

15.3.1 Data

To estimate the impact of trade facilitation on trade flows, quarterly bilateral data sets are used. On the one hand, data on the value of goods export and import flows between reporting countries and their trading partners are available from the IMF’s Direction of Trade Statistics database. The database covers all IMF member states and includes monthly, quarterly, and annual data. Data on trade facilitation, on the other hand, are usually generated at the country level. However, as one of the unique features of the CPMM data, measures of trade facilitation at the bilateral country level can be generated.

Although the CPMM TFIs are usually reported at the country level, country pair measures of TFIs can also be calculated to match the bilateral trade flow data. Among the TFIs, time and cost are the only indicators available with data at the BCPs. For road transportation across the six CAREC corridors, about 61 out of 76 BCP samples have complete available data across all quarters from 2010 to 2017. The data for rail transportation, however, were not sufficient to conduct analysis.
since only 11 BCPs had available data. Two types of data are used in the analysis: average time and cost measures at inbound and outbound BCPs of the CAREC countries. This directional information allows for the aggregation of time and cost taken to trade at outbound and inbound BCPs between two countries. It is straightforward to compute whether two countries are contiguous—i.e., countries sharing a common border. However, for noncontiguous countries—freight passes through multiple BCPs along one or more of six corridors—the bilateral time and cost of a country pair is an aggregation of all possible combinations of inbound and outbound time and cost.

Specifically, time and cost at the BCPs at the bilateral country level were calculated using unweighted averages of inbound and outbound time and cost. It can be argued that accuracy will be improved if transit flows at each BCP are used as weights to come up with weighted averages. However, transit flow data at most BCPs are not currently available, and hence unweighted averages are used in this study. For contiguous country pairs but with multiple BCP pairs, the time and cost to facilitate bilateral import and export of goods will be the averages in all the pairs. For noncontiguous country pairs, all possible inland routes along the six corridors are identified first, and for each route, the sum of the time and cost taken is computed. The unweighted averages of the total time and cost over all the identified corridor routes are then computed. Aside from the time and cost taken at the BCPs, the average number of BCPs is also included in the estimation, as it increases with the distance and route between noncontiguous countries.

Figure 15.5 illustrates the computation of the average time at the bilateral country level (the same applies to costs). When country A exports to its contiguous country B, \( t_A^{\text{out}} \) is the time taken at the outbound BCP while \( t_B^{\text{in}} \) is the time taken at the inbound BCP. However, trade flow from country B to country C, which are also contiguous to each other, can pass through either of the BCP pairs in corridor 1 or 2. The average time taken at the outbound BCPs is the average of \( t_B^{\text{out1}} \) and \( t_B^{\text{out2}} \), while the average time taken at the inbound BCPs is the average of \( t_C^{\text{in1}} \) and \( t_C^{\text{in2}} \). Therefore, the total (average) time taken for country B to export to country C is computed as the average of \( (t_B^{\text{out1}} + t_C^{\text{in1}}) \) and \( (t_B^{\text{out2}} + t_C^{\text{in2}}) \).

For the movement of goods from country A to C, there are two possible routes: corridor 1 or 2. The time taken at the outbound BCPs can be either (i) \( (t_A^{\text{out}} + t_B^{\text{out1}}) \) or (ii) \( (t_A^{\text{out}} + t_B^{\text{out2}}) \). The average of (i) and (ii) will be recorded as the average time taken at the outbound BCPs for the export from country A to C. The same approach is applied to the average

---

3 In mode of transport for trade, road transportation accounted for 70%, rail for 26%, and multimodal for 4% in 2016 (CAREC 2018).
time taken at the inbound BCPs. Last, the total (average) time taken is computed as the average of (i) \((t^A_{out} + t^B_{in} + t^B_{out1} + t^C_{in1})\) and (ii) \((t^A_{out} + t^B_{in} + t^B_{out2} + t^C_{in2})\).

### 15.3.2 Gravity Model

Gravity models are standard theoretical and econometric models in international economics that identify factors affecting bilateral international trade flows. Most contemporary international trade studies use the model specification of Anderson and van Wincoop (2003), which accounts for multilateral trade resistance factors. This improves on traditional gravity models, which only consider bilateral distance and the size of respective source and destination economies as determinants of trade flows.

In general, trade costs are a major factor determining the intensity of trade or resistance to trade between countries. Exogenous costs are inherent factors and independent of policy choices. Examples include geographic distance between trading partners and their similar attributes, such as language, contiguity, and common history. Other factors that could affect bilateral trade flows are specific to the origin or destination and are usually policy related. Examples include logistics performance, trade facilitation, international connectivity, tariffs, and nontariff measures.
To examine the impact of trade facilitation on bilateral trade flows in the CAREC region, an augmented gravity model is estimated, following the specification in Anderson and van Wincoop (2003). The explanatory variables include the exogenous trade costs and trade facilitation measures. Moreover, to control for exporting and importing countries’ time-varying characteristics, the interaction terms of country fixed effects and year dummies are added to the model, as in Olivero and Yotov (2012). The addition of these variables to the equation can effectively absorb all other time-varying multilateral trade resistance factors—both inward and outward—such as gross domestic product and population. “Corridor” dummies are also added to control for trade intensities within the six corridors.

The gravity model used for the estimation is defined as:

\[
\log Y_{ijt} = \alpha + \beta X_{ij} + \gamma Z_{ijt} + \delta_i F_i \cdot t + \delta_j F_j \cdot t + \sum_{k=1}^{6} \rho_{(k)} C_{ij(k)} + v_{ijt}
\]

where \( Y_{ijt} \) is the value of country \( i \)'s goods exports to country \( j \) at time \( t \), expressed as a natural logarithmic form. The independent variables on the right-hand side of the equation are (i) \( X_{ij} \), a vector of time-invariant exogenous trade cost variables; (ii) \( Z_{ijt} \), a vector of trade facilitation measures; (iii) \( F_i \) and \( F_j \), vectors of time-varying country fixed effects interacting with dummy variables for year \( t \); and (iv) \( C_{ij(k)} \), dummy variables for the country pair \( i \) and \( j \), indicating whether they are part of the \( k^{th} \) corridor (\( k = 1, 2, ..., 6 \)). Note that participation of a country pair in the six corridors is mutually exclusive—a country pair could belong to several corridors. The vectors of coefficients, \( \beta \) and \( \gamma \), are estimated and provide the magnitudes of the partial effects of \( X_{ij} \) and \( Z_{ijt} \) on bilateral trade flows. Appendix A15 lists the independent variables in the gravity model, their descriptions, and data sources.

Estimation of the gravity model equation is performed using the Heckman (1979) method. In contrast to the ordinary least squares (OLS) regression, the Heckman method addresses the sample selection bias and yields unbiased and consistent estimates. Bias in the sample selection occurs when some country pairs are included while others are dropped in the estimation. Using the OLS method, only country pairs with strictly positive values of exports will be part of the estimation, while those with no trade flows will be forcibly dropped as the natural logarithm of 0 is undefined. This results in a case of omitted variables—the regression equation lacks a variable that explains the possibility of trading between countries (i.e., including the case of no trade), and hence the error term and some independent variables (such as trade costs) will be correlated. This problem yields biased and inconsistent estimators.
The Heckman method addresses these problems in two steps. First, a selection equation is estimated using the probit regression method, which estimates an equation for a selection variable—in the gravity model case, the probability of countries trading with each other. Second, using the probit estimation results, the inverse Mills ratio is computed and added as an independent variable in the estimation of the econometric specification. The inclusion of this selection variable solves the omitted variable problem and hence estimates are unbiased and consistent. The results of the Heckman estimation are presented along with the results of the OLS pooled and panel regression estimations to check and compare the robustness of the results.

15.3.3 Estimation Results

The results of the regression estimations show that the bilateral trade flows among CAREC countries are more influenced by the average time taken at the inbound BCPs (i.e., importing countries) than that at the outbound BCPs (i.e., exporting countries) (Table 15.2). Only the coefficients of the time taken at the inbound BCPs are significant under pooled OLS and Heckman regressions (Columns 1 and 3, Table 15.2), while coefficients of the average time at the outbound BCPs are statistically significant only in the pooled OLS estimation (Column 4, Table 15.2). Moreover, the coefficient of the inverse Mills ratio is only significant under the time taken at the inbound BCPs, indicating that sample selection bias is present and Heckman is an appropriate estimation procedure. The average of the total time taken at the BCPs (i.e., both inbound and outbound) is also significant under pooled and Heckman regressions (Columns 7 and 9, Table 15.2), most likely reflecting the time taken at the inbound BCPs. The coefficients on average time at inbound BCPs (Column 3, Table 15.2) imply that a 10% reduction in the time taken at the importers’ BCPs could increase bilateral trade flows by 1.41%.

Inbound BCPs relative to outbound BCPs can be a more important factor in determining bilateral trade flows. It is at the inbound BCPs where most of the delays occur and high costs are incurred (GIZ 2011). Furthermore, as imports tend to exceed exports (i.e., trade imbalance) in most landlocked developing countries, inbound trucks face higher volume, lower freight rates (due to competition), and lower discounts on road transport than exporters’ trucks (UNOHRLLS 2007; Arvis, Raballand, and Marteau 2010). Hence, this encourages inbound trucks to overload to compensate, which leads to infrastructure deterioration, in turn posing road safety risks (UNOHRLLS 2007).
The results of the estimation on the impact of costs incurred at the inbound BCPs (Table 15.3) show that the coefficients are only significant under the pooled OLS regression, but with correct negative signs (Column 1, Table 15.3). The estimated coefficients of cost at the outbound BCPs all show negative signs, but they only show significance under the Heckman estimation (Column 6, Table 15.3).

The overall results imply that among the TFIs, the inbound BCP average time is a more significant factor than the average cost that affects the trade flows within CAREC countries. One potential explanation could be that trade facilitation measures, expressed in monetary and nominal terms, may not capture their “true” impact on bilateral trade as these measures are also influenced by inflation, foreign exchange rate fluctuations, and unofficial fees incurred irregularly to expedite the clearance from the border crossing processes.

Aside from the abovementioned independent variables, the exogenous trade cost variables have, in general, the expected direction of relationships with bilateral exports in the estimation, as in the literature. The estimated negative coefficients of distance across all regression estimations are highly significant. This finding aligns with the significance of the number of BCPs passing along the corridors, which confirms that if moving cargoes go through multiple BCPs, trade between country pairs is less likely to flow smoothly, leading to lower trade volumes. The estimated magnitude of its impact, however, is closely associated with the impact of distance. Moreover, contiguous countries tend to show higher bilateral trade than noncontiguous ones. Unlike in most studies, the results here show that having a common official language is not a significant factor of bilateral trade. In the CAREC region, only Kazakhstan and the Kyrgyz Republic share a common official language, which is Russian (and both countries share a common border). Therefore, the dummy variable for the common official language could simply represent an indicator for their bilateral trade. The coefficient of this exogenous trade cost variable can be interpreted as the difference (on average) between the bilateral trade of these two countries and that of the other country pairs.

However, the large variability in the coefficients on costs at outbound BCPs (−0.077 for pooled; −0.022 for panel; −0.244 for Heckman, Cols 4–6, Table 3) could indicate a robustness issue in the model, which may require further investigation in the future.
Table 15.2: Impact of Average Time at Border Crossing Points on Bilateral Trade in the CAREC Region

<table>
<thead>
<tr>
<th>Dependent Variable: Ln(Exports)</th>
<th>(1) Pooled</th>
<th>(2) Panel</th>
<th>(3) Heckman Pooled</th>
<th>(4) Panel</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ln(Distance)</td>
<td>-0.558***</td>
<td>-0.842***</td>
<td>-0.884***</td>
<td>-0.676***</td>
</tr>
<tr>
<td></td>
<td>(0.065)</td>
<td>(0.289)</td>
<td>(0.088)</td>
<td>(0.062)</td>
</tr>
<tr>
<td>Colonial relationship</td>
<td>0.228**</td>
<td>0.673</td>
<td>-0.071</td>
<td>0.385***</td>
</tr>
<tr>
<td></td>
<td>(0.095)</td>
<td>(0.458)</td>
<td>(0.210)</td>
<td>(0.092)</td>
</tr>
<tr>
<td>Common language</td>
<td>0.661***</td>
<td>0.459</td>
<td>0.163</td>
<td>0.637***</td>
</tr>
<tr>
<td></td>
<td>(0.116)</td>
<td>(0.532)</td>
<td>(0.195)</td>
<td>(0.116)</td>
</tr>
<tr>
<td>Contiguity</td>
<td>0.682***</td>
<td>0.734*</td>
<td>0.661***</td>
<td>0.637***</td>
</tr>
<tr>
<td></td>
<td>(0.081)</td>
<td>(0.383)</td>
<td>(0.084)</td>
<td>(0.081)</td>
</tr>
<tr>
<td>Number BCPs passed</td>
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<td>-0.197**</td>
<td>-0.187***</td>
<td>-0.227***</td>
</tr>
<tr>
<td></td>
<td>(0.022)</td>
<td>(0.095)</td>
<td>(0.021)</td>
<td>(0.022)</td>
</tr>
<tr>
<td>Ln(Avg time at inbound BCPs; hours)</td>
<td>-0.107**</td>
<td>-0.050</td>
<td>-0.141***</td>
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<tr>
<td></td>
<td>(0.048)</td>
<td>(0.038)</td>
<td>(0.051)</td>
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<tr>
<td>Ln(Avg time at outbound BCPs; hours)</td>
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<td></td>
<td>-0.078*</td>
<td>-0.021</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.042)</td>
</tr>
<tr>
<td>Ln(Avg total time at BCPs; hours)</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>18.061***</td>
<td>20.833***</td>
<td>18.593***</td>
<td>19.438***</td>
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<tr>
<td></td>
<td>(1.524)</td>
<td>(3.403)</td>
<td>(1.426)</td>
<td>(1.445)</td>
</tr>
<tr>
<td>Inverse Mills ratio</td>
<td>-0.625***</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.205)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corridor dummies</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Exporter x Year FE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Importer x Year FE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Number of observations</td>
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<td>3,045</td>
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</tr>
<tr>
<td>Uncensored observations</td>
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</table>

**continued on next page**
### Table 15.2 continued

<table>
<thead>
<tr>
<th>Dependent Variable: Ln(Exports)</th>
<th>(6) Heckman</th>
<th>(7) Pooled</th>
<th>(8) Panel</th>
<th>(9) Heckman</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ln(Distance)</td>
<td>-1.035***</td>
<td>-0.522***</td>
<td>-0.829***</td>
<td>-0.850***</td>
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<tr>
<td></td>
<td>(0.084)</td>
<td>(0.064)</td>
<td>(0.288)</td>
<td>(0.087)</td>
</tr>
<tr>
<td>Colonial relationship</td>
<td>0.256*</td>
<td>0.197**</td>
<td>0.675</td>
<td>-0.177</td>
</tr>
<tr>
<td></td>
<td>(0.189)</td>
<td>(0.094)</td>
<td>(0.457)</td>
<td>(0.210)</td>
</tr>
<tr>
<td>Common language</td>
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<td>0.745***</td>
<td>0.488</td>
<td>0.232</td>
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<tr>
<td></td>
<td>(0.191)</td>
<td>(0.116)</td>
<td>(0.529)</td>
<td>(0.194)</td>
</tr>
<tr>
<td>Contiguity</td>
<td>0.632</td>
<td>0.671***</td>
<td>0.742*</td>
<td>0.643***</td>
</tr>
<tr>
<td></td>
<td>(0.084)</td>
<td>(0.081)</td>
<td>(0.384)</td>
<td>(0.084)</td>
</tr>
<tr>
<td>Number BCPs passed</td>
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<td>-0.202***</td>
<td>-0.197**</td>
<td>-0.176***</td>
</tr>
<tr>
<td></td>
<td>(0.021)</td>
<td>(0.022)</td>
<td>(0.094)</td>
<td>(0.021)</td>
</tr>
<tr>
<td>Ln(Avg time at inbound BCPs; hours)</td>
<td>-0.045</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.054)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ln(Avg time at outbound BCPs; hours)</td>
<td></td>
<td>-0.136***</td>
<td>-0.050</td>
<td>-0.208***</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.051)</td>
<td>(0.033)</td>
<td>(0.058)</td>
</tr>
<tr>
<td>Ln(Avg total time at BCPs; hours)</td>
<td></td>
<td>-0.136***</td>
<td>-0.050</td>
<td>-0.208***</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.051)</td>
<td>(0.033)</td>
<td>(0.058)</td>
</tr>
<tr>
<td>Constant</td>
<td>20.760***</td>
<td>18.821***</td>
<td>20.822***</td>
<td>20.007***</td>
</tr>
<tr>
<td></td>
<td>(1.364)</td>
<td>(1.549)</td>
<td>(3.394)</td>
<td>(1.452)</td>
</tr>
<tr>
<td>Inverse Mills ratio</td>
<td>-0.032</td>
<td></td>
<td>-0.159</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.198)</td>
<td></td>
<td>(0.197)</td>
<td></td>
</tr>
<tr>
<td>Corridor dummies</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Exporter Year FE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Importer Year FE</td>
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<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
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<td>Number of observations</td>
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<tr>
<td>Uncensored observations</td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

BCP = border crossing point, CAREC = Central Asia Regional Economic Cooperation, FE = fixed effects.

Notes: (i) Only the People’s Republic of China and Mongolia had a colonial relationship; (ii) Only Kazakhstan and the Kyrgyz Republic use Russian as a common official language; (iii) Robust standard errors in parentheses; and (iv) Heckman selection estimation was used to account for missing bilateral economy pair data.

*** p < 0.01, ** p < 0.05, * p < 0.10.

Source: Authors’ calculations using data from International Monetary Fund Direction of Trade Statistics, CAREC Corridor Performance Measurement and Monitoring trade facilitation indicators, and Centre d’Études Prospectives et d’Informations Internationales (CEPII) Database.
Table 15.3: Impact of Average Cost at Border Crossing Point on Bilateral Trade in the CAREC Region

<table>
<thead>
<tr>
<th>Dependent Variable: Ln(Exports)</th>
<th>(1) Pooled</th>
<th>(2) Panel</th>
<th>(3) Heckman Pooled</th>
<th>(4) Pooled</th>
<th>(5) Panel</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ln(Distance)</td>
<td>-0.528***</td>
<td>-0.710**</td>
<td>-0.887***</td>
<td>-0.626***</td>
<td>-0.756**</td>
</tr>
<tr>
<td></td>
<td>(0.066)</td>
<td>(0.310)</td>
<td>(0.091)</td>
<td>(0.072)</td>
<td>(0.300)</td>
</tr>
<tr>
<td>Colonial relationship</td>
<td>0.383***</td>
<td>0.427</td>
<td>0.308*</td>
<td>0.589***</td>
<td>0.574</td>
</tr>
<tr>
<td></td>
<td>(0.091)</td>
<td>(0.503)</td>
<td>(0.226)</td>
<td>(0.107)</td>
<td>(0.449)</td>
</tr>
<tr>
<td>Common language</td>
<td>0.591***</td>
<td>0.594</td>
<td>0.017</td>
<td>0.706***</td>
<td>0.849</td>
</tr>
<tr>
<td></td>
<td>(0.121)</td>
<td>(0.541)</td>
<td>(0.208)</td>
<td>(0.136)</td>
<td>(0.552)</td>
</tr>
<tr>
<td>Contiguity</td>
<td>0.787***</td>
<td>0.786**</td>
<td>0.774***</td>
<td>0.702***</td>
<td>0.804**</td>
</tr>
<tr>
<td></td>
<td>(0.080)</td>
<td>(0.385)</td>
<td>(0.086)</td>
<td>(0.092)</td>
<td>(0.383)</td>
</tr>
<tr>
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<td>-0.223***</td>
<td>-0.209***</td>
<td>-0.178*</td>
</tr>
<tr>
<td></td>
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<td>(0.095)</td>
<td>(0.021)</td>
<td>(0.023)</td>
<td>(0.092)</td>
</tr>
<tr>
<td>Ln(Avg cost at Inbound BCPs; $)</td>
<td>-0.080*</td>
<td>-0.024</td>
<td>0.046</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.048)</td>
<td>(0.029)</td>
<td>(0.063)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ln(Avg cost at Outbound BCPs; $)</td>
<td></td>
<td></td>
<td></td>
<td>-0.077</td>
<td>-0.022</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.052)</td>
<td>(0.029)</td>
</tr>
<tr>
<td>Ln(Avg total cost at BCPs; $)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inverse Mills ratio</td>
<td></td>
<td></td>
<td></td>
<td>0.073</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.198)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(1.474)</td>
<td>(3.530)</td>
<td>(1.484)</td>
<td>(1.539)</td>
<td>(3.306)</td>
</tr>
<tr>
<td>Corridor dummies</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Exporter x Year FE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Importer x Year FE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Number of observations</td>
<td>2,931</td>
<td>2,931</td>
<td>41,205</td>
<td>2,826</td>
<td>2,826</td>
</tr>
<tr>
<td>Uncensored observations</td>
<td></td>
<td></td>
<td></td>
<td>2,440</td>
<td></td>
</tr>
</tbody>
</table>

continued on next page
### Table 15.3 continued

<table>
<thead>
<tr>
<th>Dependent Variable: Ln(Exports)</th>
<th>(6) Heckman</th>
<th>(7) Pooled</th>
<th>(8) Panel</th>
<th>(9) Heckman</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ln(Distance)</td>
<td>–0.977***</td>
<td>–0.371***</td>
<td>–0.630*</td>
<td>–0.666***</td>
</tr>
<tr>
<td></td>
<td>(0.091)</td>
<td>(0.074)</td>
<td>(0.325)</td>
<td>(0.095)</td>
</tr>
<tr>
<td>Colonial relationship</td>
<td>0.180</td>
<td>0.534***</td>
<td>0.303</td>
<td>0.073</td>
</tr>
<tr>
<td></td>
<td>(0.190)</td>
<td>(0.107)</td>
<td>(0.499)</td>
<td>(0.223)</td>
</tr>
<tr>
<td>Common language</td>
<td>–0.008</td>
<td>0.742***</td>
<td>0.985*</td>
<td>0.179</td>
</tr>
<tr>
<td></td>
<td>(0.209)</td>
<td>(0.138)</td>
<td>(0.563)</td>
<td>(0.220)</td>
</tr>
<tr>
<td>Contiguity</td>
<td>0.722***</td>
<td>0.950***</td>
<td>0.844**</td>
<td>0.933***</td>
</tr>
<tr>
<td></td>
<td>(0.088)</td>
<td>(0.094)</td>
<td>(0.385)</td>
<td>(0.089)</td>
</tr>
<tr>
<td>Number BCPs passed</td>
<td>–0.190***</td>
<td>–0.203***</td>
<td>–0.184**</td>
<td>–0.196***</td>
</tr>
<tr>
<td></td>
<td>(0.022)</td>
<td>(0.022)</td>
<td>(0.092)</td>
<td>(0.022)</td>
</tr>
<tr>
<td>Ln(Avg cost at Inbound BCPs; $)</td>
<td>–0.244***</td>
<td>(0.072)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ln(Avg cost at Outbound BCPs; $)</td>
<td>–0.092</td>
<td>–0.048</td>
<td>–0.154***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.063)</td>
<td>(0.038)</td>
<td>(0.089)</td>
<td></td>
</tr>
<tr>
<td>Inverse Mills ratio</td>
<td>0.424**</td>
<td>0.576***</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.205)</td>
<td>(0.202)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>21.142***</td>
<td>16.423***</td>
<td>20.361***</td>
<td>17.752***</td>
</tr>
<tr>
<td></td>
<td>(1.445)</td>
<td>(1.562)</td>
<td>(3.417)</td>
<td>(1.596)</td>
</tr>
<tr>
<td>Corridor dummies</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Exporter x Year FE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Importer x Year FE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Number of observations</td>
<td>41,124</td>
<td>2,618</td>
<td>2,618</td>
<td>40,936</td>
</tr>
<tr>
<td>Uncensored observations</td>
<td>2,359</td>
<td></td>
<td></td>
<td>2,171</td>
</tr>
</tbody>
</table>

BCP = border crossing point, CAREC = Central Asia Regional Economic Cooperation, FE = fixed effects.

Notes: (i) Only the People’s Republic of China and Mongolia had a colonial relationship; (ii) Only Kazakhstan and the Kyrgyz Republic use Russian as a common official language; (iii) Robust standard errors in parentheses; and (iv) Heckman selection estimation was used to account for missing bilateral economy pair data.

*** p < 0.01, ** p < 0.05, * p < 0.10.

Source: Authors’ calculations using data from International Monetary Fund Direction of Trade Statistics, CAREC Corridor Performance Measurement and Monitoring trade facilitation indicators, and Centre d’Études Prospectives et d’Informations Internationales (CEPII) Database.
15.3.4 Simulation

A simple simulation exercise is performed to calculate the estimated trade gains from CAREC-wide reduction in the average time taken at the border. Using the regression results of the Heckman model in Column 3, Table 15.2, the simulation results show that a reduction in the average time taken at the importers’ BCPs of 10% would lead to an increase of $1.03 billion in CAREC’s intraregional trade in goods (computed based on 2017 data) (Table 15.4). Relative to economic size, this increase in intraregional trade is equivalent to 0.58% of CAREC gross domestic product (GDP) in 2017 (4.6% excluding the PRC). Although the trade gains appear minimal, they are equivalent to an increase of as much as 0.01 percentage points of CAREC GDP (0.06 percentage points excluding the PRC).

<table>
<thead>
<tr>
<th>CAREC Country</th>
<th>GDP (Current Prices, 2017)</th>
<th>Intraregional Goods Exports (Current Prices, 2017)</th>
<th>Trade Gains from 10% Time Reduction at Importers’ BCPs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ billion</td>
<td>$ billion</td>
<td>% GDP</td>
</tr>
<tr>
<td>Afghanistan</td>
<td>20.24</td>
<td>0.315</td>
<td>1.56</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>41.26</td>
<td>1.064</td>
<td>2.58</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>162.89</td>
<td>8.809</td>
<td>5.41</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>7.70</td>
<td>0.547</td>
<td>7.10</td>
</tr>
<tr>
<td>Mongolia</td>
<td>11.43</td>
<td>5.272</td>
<td>46.11</td>
</tr>
<tr>
<td>Pakistan</td>
<td>304.95</td>
<td>2.949</td>
<td>0.97</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>7.14</td>
<td>0.331</td>
<td>4.63</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>37.93</td>
<td>6.577</td>
<td>17.34</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>48.83</td>
<td>3.482</td>
<td>7.13</td>
</tr>
<tr>
<td>Georgia</td>
<td>15.08</td>
<td>0.626</td>
<td>4.15</td>
</tr>
<tr>
<td>PRC</td>
<td>12,062.28</td>
<td>43.302</td>
<td>0.36</td>
</tr>
<tr>
<td>Total</td>
<td>12,719.72</td>
<td>73.275</td>
<td>0.58</td>
</tr>
<tr>
<td>Total excl. PRC</td>
<td>657.44</td>
<td>29.972</td>
<td>4.56</td>
</tr>
</tbody>
</table>

BCP = border crossing point, CAREC = Central Asia Regional Economic Cooperation, GDP = gross domestic product, PRC = People’s Republic of China.

Source: World Economic Outlook and Direction of Trade Statistics—both International Monetary Fund and authors’ calculations.
Notably, across CAREC member countries, the trade gains vary considerably. The countries with higher shares of intraregional trade in GDP seem to have higher trade gains from a reduction in time taken at the BCPs than the countries with lower shares. For instance, Mongolia and Turkmenistan are the top exporters with the highest intraregional export share in GDP and they get the highest gains, with shares in GDP increasing by 0.65 and 0.24 percentage points, respectively.

15.4 Conclusions

Using the novel data of the CPMM TFIs specific to the CAREC countries, this study investigates the extent to which reduced time and cost at the BCPs facilitates trade among the CAREC countries. By transforming inbound and outbound time and cost data at the level of BCPs into bilateral country level, matched with bilateral trade flows, the gravity model was implemented. The main findings and implications from the gravity model estimations are as follows:

- Compared to the time taken at the exporter border, the time taken at the importer border appears to be a more significant factor affecting bilateral trade, and hence it is the most relevant measure that can be used as a benchmark in facilitating bilateral trade in the CAREC region. Much of the time and cost taken at the CAREC BCPs is spent on waiting and queuing, unloading and loading, various inspections, and customs clearance (CAREC 2018). Moreover, inbound BCPs are inclined to involve higher time and cost levels than outbound BCPs. This implies that a reduction in time taken during waiting and queuing, unloading and loading, various inspections, and customs clearance at the importer BCPs could be a primary potential target to improve intraregional trade in the CAREC region.

- At the importer border, the time measure is more objective than the cost measure in explaining the changes in trade flows. The reason may be that the cost measure can be confounded by external factors such as inflation, foreign exchange rate, and unofficial payments. Thus, it may be helpful to disclose the extent to which these factors contribute to the movement of the cost measure to ensure that it properly represents the outcome of trade facilitation activities in the region.

- In particular, the estimated impact of a 10% reduction in time taken at the importer border increases CAREC’s intraregional trade by 1.41%, equivalent to about $1.03 billion.
The findings support the usefulness of the CPMM TFIs in analyzing and assessing the trade facilitation performance of CAREC countries at BCPs. The study also suggests which measures require careful examination. Indeed, as trade expansion is one of the CAREC Program’s objectives, reducing the time taken at the importer border will help achieve this goal, as the empirical evidence suggests.

However, the simulation results reveal that improving trade facilitation through a reduction in time taken at the border may not be the only factor that can lead to broader economic impact in the CAREC region. Other relevant measures, which are not captured by CPMM TFIs, can also be considered relevant factors in determining bilateral trade flows. These factors could include behind-the-border issues, such as domestic and structural reforms in facilitating trade, sanitary and phytosanitary laboratory capability and capacity, and modernization of regulations to meet international standards. In addition, inadequate investment planning for trade facilitation due to low priority and a lack of institutional coordination is considered a major challenge in conducting trade facilitation.

Ensuring complementarity between soft and hard infrastructure is also essential in fostering efficient cross-border movement of goods from the source country (exporter), through transit countries, and to the destination country (importer). Apart from streamlined soft infrastructure, such as legal or institutional frameworks for trade logistics efficiency and quality of trade facilitation, efficient hard (physical) infrastructure networks are also crucial in delivering a positive impact on trade. Especially in Central Asian countries, which are mostly landlocked, better transit country infrastructure can play a key role in boosting trade flows in the region.
References


Appendix A15: Variables Used in the Gravity Model

<table>
<thead>
<tr>
<th>Variable</th>
<th>Description</th>
<th>Expected Sign</th>
<th>Data Source</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Dependent variable: ( Y_{ij} )</strong></td>
<td>Nominal value (in $) of goods exports from source country ( i ) to destination country ( j ), expressed in natural logarithmic. The export values are in terms of free-on-board, i.e., transaction costs for the shipping of the goods are borne by the exporter.</td>
<td></td>
<td>IMF DOTS</td>
</tr>
<tr>
<td><strong>Explanatory variables:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>1. ( X_{ij} )—vector of exogenous trade costs</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Bilateral distance</td>
<td>Measure of distance between country ( i )'s capital city and country ( j )'s capital city in kilometers. This variable is expressed as natural logarithmic.</td>
<td>Negative</td>
<td>CEPII Database by Mayer and Zignago (2011)</td>
</tr>
<tr>
<td>b. Contiguity</td>
<td>A dummy variable that takes the value of 1 if country pair ( i ) and ( j ) share a common border. Contiguous countries are expected to engage more in trade, and hence have higher bilateral trade flows than noncontiguous countries.</td>
<td>Positive</td>
<td>CEPII Database by Head and Mayer (2014)</td>
</tr>
<tr>
<td>c. Common official language</td>
<td>A dummy variable that takes the value of 1 if country pair ( i ) and ( j ) share a common official language. Countries are more likely to trade if there are no language barriers, which implies easier transaction among traders.</td>
<td>Positive</td>
<td>CEPII Database by Head and Mayer (2014)</td>
</tr>
<tr>
<td>d. Colonial relationship</td>
<td>A dummy variable that takes the value of 1 if country pair ( i ) and ( j ) were ever in a colonial relationship (with one country as the colonizer and the other as the colony). Trade between two countries can also be reflected by their historical association.</td>
<td>Positive</td>
<td>CEPII Database by Head and Mayer (2014)</td>
</tr>
<tr>
<td><strong>2. ( Z_{ij} )—vector of trade facilitation measures</strong></td>
<td>Number of hours it takes to move cargoes across a BCP—exit from country ( i ) and enter country ( j ). This is an aggregation of time spent on waiting/queuing, road tolls, unloading/loading, vehicle registration, weight inspection, traffic inspection, immigration, phytosanitary inspection, quarantine, customs clearance, and border security/control. Intuitively, cargoes can easily flow across borders if clearing time is minimal, and hence there are higher bilateral trade flows. This variable is expressed as natural logarithmic.</td>
<td>Negative</td>
<td>CAREC CPMM</td>
</tr>
</tbody>
</table>

continued on next page
**Appendix A15 continued**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Description</th>
<th>Expected Sign</th>
<th>Data Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>b. Costs incurred at a BCP—<em>inbound</em> and <em>outbound</em></td>
<td>Cost (in $) of moving cargoes across a BCP—exit from country i and enter country j. All costs are taken into account, such as fees for road tolls, vehicle registration, weight inspection, traffic inspection, immigration, phytosanitary inspection, and customs clearance. More trade goods would flow among countries if costs were low. This variable is expressed as natural logarithmic.</td>
<td>Negative</td>
<td>CAREC CPMM</td>
</tr>
<tr>
<td>c. Number of BCPs</td>
<td>Number of BCPs crossed in the bilateral trade. In noncontiguous country pairs, it would take more than two BCPs to pass and move cargoes. The number of BCPs crossed affects the flow of cargoes—and hence, bilateral trade—since each point crossed can slow the speed and increase the costs.</td>
<td>Negative</td>
<td>CAREC CPMM</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>$C_{(ij)k}$—<em>corridor dummies</em></th>
</tr>
</thead>
<tbody>
<tr>
<td>Corridor 1</td>
</tr>
<tr>
<td>Corridor 2</td>
</tr>
<tr>
<td>Corridor 3</td>
</tr>
<tr>
<td>Corridor 4</td>
</tr>
<tr>
<td>Corridor 5</td>
</tr>
<tr>
<td>Corridor 6</td>
</tr>
</tbody>
</table>

CAREC = Central Asia Regional Economic Cooperation, CEPII = Centre d’Études Prospectives et d’Informations Internationales (French Research Center in International Economics), CPMM = Corridor Performance Measurement and Monitoring, IMF DOTS = International Monetary Fund’s Direction of Trade Statistics.

Source: Authors’ compilation.
16

Measuring Regional Integration in the Central Asia Regional Economic Cooperation Region

Saeed Qadir and Karlo Fermin Adriano

16.1 Introduction

The Central Asia Regional Economic Cooperation (CAREC) Program is a partnership of 11 countries, spanning across Central Asia (Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan), East Asia (People’s Republic of China [PRC] and Mongolia), South Asia (Afghanistan and Pakistan), and the Caucasus (Azerbaijan and Georgia) in Eurasia. The program has evolved into a transregional development and regional cooperation initiative spearheaded by the Asian Development Bank (ADB) since it was launched almost 2 decades ago.

Despite being a contiguous region, the intraregional trade share—calculated as the percentage of intraregional trade to total trade of the region—is a mere 2.9% for 2016, indicating a very low level of trade integration in the CAREC region. Except Mongolia, all other CAREC member countries (CMCs) are engaged in either bilateral or plurilateral trade arrangements with other members. Therefore, the CAREC region (excluding the PRC) presents a picture of fragmented and suboptimal levels of regional integration within the region and globally. In order to measure the state of regional cooperation and integration (RCI), the CAREC Institute developed the CAREC Regional Integration Index (CRII) in 2019 as a flagship research project. The composite weighted index, comprising six dimensions with 26 indicators, assesses the extent and evolution of RCI between 2006 and 2016 in the CMCs. Specific to CAREC countries, the CRII offers a menu of policy coordination and action plans to enhance regional cooperation among them, and provides a mechanism to monitor and evaluate progress, benchmarking against its set goals and targets. The research also outlines the optimal level of
the integration strategy for CMCs given their development challenges, economic and structural heterogeneities, and scale asymmetries.

16.1.1 Theory and Tools for Measurement of the Regional Economic Integration

RCI manifests in many ways and can reach its potential if the markets in the disparate regional economies integrate under a unified framework (standardized rules of engagement with regard to market access, national treatment, barriers to entry and exit, market structure) where prices determine the market interactions and exchanges (equilibrium). Another important feature of integrated markets is price convergence for factors of production across and beyond national boundaries. Such a unified market for goods, services, capital and labor; infrastructure connectivity; and financial cooperation exhibit a unique equilibrium\(^1\) and envisage an agreed set of economic, political, and technical cooperation areas for mitigating shared risks and challenges (UNESCAP 2016). In other words, RCI refers to the process of attaining a single market status for factors of production entailing a streamlined flow of goods, services, capital, and labor across the borders (Bo and Woo 2008). The RCI level and scale can be gauged by a set of indicators for such cross-border production, trade, investment, and architecture for connectivity in terms of physical and regulatory infrastructure. An array of the indicators has been suggested to measure the degree of economic integration encompassing intraregional parameters such as trade, investment, financial market linkages, economic complementarities and similarities, labor, and tourism exchanges (Capannelli, Lee, and Petri 2009). Many researchers and institutions have attempted efforts and initiatives for developing statistical measures to quantify the regional economic integration to develop composite indicators and parameters (Dreher et al. 2010).

An important criterion used in these studies is the regional price convergence or economic structural similarities (Capannelli, Lee, and Petri 2009). A review of the existing RCI indices as provided below reveals that an opportunity exists to expand the scope and scale of the socioeconomic dimensions and indices to measure accurately the level of RCI:

\(^1\) “One important criterion used in these studies is regional price convergence, under the assumption that the law of one price sets a theoretical standard for perfect market integration. Other measures include economic convergence, such as a reduction in the intraregional income gap across countries, or common structural changes, as hallmarks of economic integration” (Capannelli, Lee, and Petri 2009).
(a) A Composite Index of Economic Integration in the Asia-Pacific Region, developed by Bo and Woo (2008), includes the following dimensions and indicators. However, this index does not map the extent of economic and infrastructure connectivity for measuring RCI (Table 16.1).

<table>
<thead>
<tr>
<th>Economic Dimension</th>
<th>Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic convergence</td>
<td>i. Real GDP per capita</td>
</tr>
<tr>
<td></td>
<td>ii. Agriculture sectoral share</td>
</tr>
<tr>
<td></td>
<td>iii. Urban residents</td>
</tr>
<tr>
<td></td>
<td>iv. Total population</td>
</tr>
<tr>
<td></td>
<td>v. Life expectancy</td>
</tr>
<tr>
<td></td>
<td>vi. Education expense ratio (to GNI)</td>
</tr>
<tr>
<td>Trade share</td>
<td>i. Nominal GDP</td>
</tr>
<tr>
<td></td>
<td>ii. Exports</td>
</tr>
<tr>
<td></td>
<td>iii. Imports</td>
</tr>
<tr>
<td>FDI flow share</td>
<td>i. Gross capital formation</td>
</tr>
<tr>
<td></td>
<td>ii. FDI flows</td>
</tr>
<tr>
<td>International tourist share</td>
<td>Total international tourists’ inflow and intra-Asia-Pacific inflow</td>
</tr>
</tbody>
</table>

FDI = foreign direct investment, GDP = gross domestic product, GNI = gross national income.
Source: Bo and Woo (2008).

(b) The EU Index of Integration, developed by König and Ohr (König 2017), measures and ranks the economic integration among the European Union member countries on four distinct dimensions with differing weights (Table 16.2):

2 The European integration initiatives as embodied in the EU presents an evolutionary regional economic integration model that gradually culminates in a single market for goods, services, capital, and labor (people) with some semblance of shared sovereignty and supranational institutional architecture to coordinate, harmonize, facilitate, and regulate the market transactions in the abovementioned four spheres. However, the regional economic integration process has currently started to recede where early signs of the reversal, if not unravelling, are visible and discernible.
The EU Index of Integration is the most comprehensive composite indicator for regional economic integration, and provides wider scope and coverage in terms of convergence and integration of the markets.

c) Similarly, the **Africa Integration Index**, developed jointly by the African Union Commission, the African Development Bank, and the United Nations Economic Commission for Africa (2016), comprises five socioeconomic dimensions and 16 indicators measuring the extent of economic integration in Africa (Table 16.3). The scope of the five dimensions, especially financial and macroeconomic integration, is very limited and therefore does not capture the true extent of RCI.

ADB has also spearheaded the formulation of various measurements to enhance and quantify RCI in Asia. However, an evolutionary process has been adopted to map the RCI per ADB’s above framework to ascertain the level of market integration. The development of the Asia-Pacific Regional Cooperation and Integration Index (ARCII) by Huh and Park in 2017, which was refined in a later version published in 2018, was the culmination of ADB’s efforts to quantify and gauge the degree of RCI in Asia and the Pacific (ADB 2017, 2018, 2019; Huh and Park 2018).

### Table 16.2: EU Index of Integration

<table>
<thead>
<tr>
<th>Dimension</th>
<th>Measurement Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquis communautaire: rules, legislation, legal acts, and court decisions that constitute the body of EU law</td>
<td>EU compliance</td>
</tr>
<tr>
<td>Single market integration</td>
<td>EU openness and EU importance</td>
</tr>
<tr>
<td>Economic and monetary union</td>
<td>EU symmetry</td>
</tr>
<tr>
<td>Economic convergence</td>
<td>EU homogeneity</td>
</tr>
</tbody>
</table>

EU = European Union.

Source: König (2017).
Table 16.3: African Integration Index

<table>
<thead>
<tr>
<th>Dimension</th>
<th>Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Regional infrastructure</td>
<td>1. Infrastructure Development Index: transport; electricity; ICT; water and sanitation</td>
</tr>
<tr>
<td></td>
<td>2. Proportion of intraregional flights</td>
</tr>
<tr>
<td></td>
<td>3. Total regional electricity trade (net) per capita</td>
</tr>
<tr>
<td></td>
<td>4. Average cost of roaming</td>
</tr>
<tr>
<td>II. Trade integration</td>
<td>5. Level of customs duties on imports</td>
</tr>
<tr>
<td></td>
<td>6. Share of intraregional goods exports (% GDP)</td>
</tr>
<tr>
<td></td>
<td>7. Share of intraregional goods imports (% GDP)</td>
</tr>
<tr>
<td></td>
<td>8. Share of total intraregional goods trade (% total intraregional trade)</td>
</tr>
<tr>
<td>III. Productive integration</td>
<td>9. Share of intraregional intermediate goods exports (% total intraregional exports goods)</td>
</tr>
<tr>
<td></td>
<td>10. Share of intraregional intermediate goods imports (% total intraregional imports goods)</td>
</tr>
<tr>
<td></td>
<td>11. Merchandise Trade Complementarity Index: total absolute value of the difference between share of imports and share of exports of a member state in a REC</td>
</tr>
<tr>
<td>IV. Free movement of people</td>
<td>12. Ratification (or not) of REC protocol on free movement of persons</td>
</tr>
<tr>
<td></td>
<td>13. Proportion of REC member countries that are members whose nationals do not require a visa for entry</td>
</tr>
<tr>
<td></td>
<td>14. Proportion of REC member countries whose nationals are issued with a visa on arrival</td>
</tr>
<tr>
<td>V. Financial and macroeconomic integration</td>
<td>15. Regional convertibility of national currencies</td>
</tr>
<tr>
<td></td>
<td>16. Inflation rate differential (based on the Harmonized Consumer Price Index)</td>
</tr>
</tbody>
</table>

GDP = gross domestic product, ICT = information and communication technology, REC = regional economic community.

Source: Africa Integration Index available at https://www.integrate-africa.org/rankings/dimensions/trade-integration/

16.1.2 Measuring the Level of Economic Integration in the Central Asia Regional Economic Cooperation Region

The CRII measures RCI in six socioeconomic dimensions, and aims to assess the extent and evolution of RCI in the CMCs from 2006 to 2016 (Figure 16.1). The panel dataset of the dimensions and their 26 constituent indicators exhibit the dynamic movement of the RCI process within the subregion and each national economy. Higher index values posit increasing interdependence and cooperation, thus enhanced integration.
16.2 Methodology: Developing the Central Asia Regional Economic Cooperation Regional Integration Index

The CRII, inspired by ADB’s flagship research work on the Asia-Pacific Regional Cooperation and Integration Index (ARCII), aims to measure RCI along six dimensions with 26 constituent indicators (ADB 2017). The CRII builds upon the methodology proposed by Huh and Park (2017) and Park and Claveria (2018) for developing the ARCII (ADB 2018). It differs from the Asia-Pacific Regional Integration Index and the Asian Regional Integration Index on the second dimension of monetary and financial integration (MFI), reflecting the level of cooperation and contemporary market development stage in the CAREC region.³ CAREC is less integrated on the MFI dimension with no current bilateral, plurilateral, or regional mechanisms to facilitate such cooperation and flows. The CRII follows the procedures and steps adopted by the ARClII in developing the index, particularly with regard to data imputation, normalization, weighting, and aggregation steps.

³ Nonavailability of the data for some of the CAREC countries has been a challenge for both the ARCII and the CRII to truly reflect the state and level of RCI for all member countries.
However, the introduction of a new set of four proxy variables for the MFI dimension is an improvement to reflect the ground realities of the MFI cooperation.4

16.2.1 Construction of Composite Weighted Index: Six Dimensions and 26 Indicators

Each economy’s evolution on RCI within the subregion or beyond depends on a host of factors. The CRII’s ability to filter out the (over- or under-) dependence of some partner countries with the subregional partners and beyond is modest and may need to be improved in subsequent versions. Due to data availability constraints, similar to the Asia-Pacific Regional Integration Index and the Asian Regional Integration Index, the CAREC Regional Integration Index did not include the trade in services and services liberalization variables for the trade and investment (TI) dimension or restrictive indices in terms of nontariff and other regulatory barriers. The omission of these important variables that capture the share of trade in services, or significantly determine the level and extent of RCI bilaterally, may limit the explanatory power of the CRII and ARCII. Notwithstanding these limitations, the CRII helps to track the dimension’s contribution, its evolution, and changes in the composite index for the subregion and each economy from 2006 to 2016.

16.2.2 Variables for Dimension II: Monetary and Financial Integration

Unlike the ARCII, the CRII model introduces proxy variables for the MFI dimension to accurately manifest the money and finance exchanges and integration in the region. The MFI dimension has been developed using four variables from the International Monetary Fund (IMF) Financial Development Index—financial institutions depth, financial institutions efficiency, financial market depth, and financial market access—to ascertain the financial sector development in the CAREC region. Even resource-rich countries in CAREC experience macroeconomic vulnerabilities and face trade-offs to balance the competing objectives of achieving financial market integration and capital flow management measures, while eliminating macroeconomic and financial stability risks. The IMF in its institutional view of capital flows has cautioned the member countries that their financial liberalization should be calibrated

---

4 See Park and Claveria (2018) for detailed discussions on data normalization, imputation of missing data, and robustness checks.
against the level of financial market and institutional development. Planning, sequencing, and regulatory support policies can minimize the systematic risks and development challenges. Liberalization is an optimal policy choice once a country reaches a certain threshold of financial and institutional development (IMF 2018).

Mindful of the CMCs’ regional asymmetries and level of financial market development, the MFI dimension has been customized to mainstream the phased approach and calibrated financial liberalization, taking into account their development challenges, as well as macroeconomic and financial stability. Except for the PRC, the CAREC financial markets can be categorized as thin markets—limited number of market players and absence of an underlying market clearing mechanism and linkages that may yield inefficient or suboptimal market outcomes. The IMF’s Financial Development Index also indicates the low rankings of the CMCs, as depicted in Figure 16.2. Again, except for the PRC, all CMCs can be characterized as being at the incipient level of the Financial Development Index (Sahay et al. 2015).

![Figure 16.2: Financial Development Index](chart)

**Figure 16.2: Financial Development Index**

PRC = People’s Republic of China.

Source: Authors’ computation based on IMF (2015).

Given the Financial Development Index level and vulnerabilities emanating from volatile exchange rates, balance of payments, commodity prices, and susceptibility to transmission of global business shocks, cross-border foreign direct investment (FDI) liberalization policies, along with services sector openness carefully calibrated, may be an appropriate sequence for financial development of the monetary and
financial markets. The above policy considerations have been factored in while customizing the MFI dimension. Table 16.4 provides a matrix of the details on the four indicators used for the MFI dimension.

### Table 16.4: Indicators for the CRII Dimension on Monetary and Financial Integration

<table>
<thead>
<tr>
<th>Financial Institutions</th>
<th>Financial Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>DEPTH (Financial Institutions Depth)</strong></td>
<td><strong>DEPTH (Financial Market Depth)</strong></td>
</tr>
<tr>
<td>1. Private sector credit (% of GDP)</td>
<td>1. Stock market capitalization to GDP</td>
</tr>
<tr>
<td>2. Pension fund assets (% of GDP)</td>
<td>2. Stocks traded to GDP</td>
</tr>
<tr>
<td>3. Mutual fund assets (% of GDP)</td>
<td>3. International debt securities government (% of GDP)</td>
</tr>
<tr>
<td>4. Insurance premiums, life and non-life (% of GDP)</td>
<td>4. Total debt securities of nonfinancial corporations (% of GDP)</td>
</tr>
<tr>
<td>5. Total debt securities of financial corporations (% of GDP)</td>
<td>5. Total debt securities of financial corporations (% of GDP)</td>
</tr>
</tbody>
</table>

**EFFICIENCY (Financial Institutions Efficiency)**

1. Net interest margin
2. Lending-deposits spread
3. Non-interest income to total income
4. Overhead costs to total assets
5. Return on assets
6. Return on equity

**ACCESS (Financial Market Access)**

1. Percent of market capitalization outside of top 10 largest companies
2. Total number of issuers of debt (domestic and external, nonfinancial corporations, and financial corporations)

CAREC = Central Asia Regional Economic Cooperation, CRII = CAREC Regional Integration Index, GDP = gross domestic product.

### 16.2.3 Data Normalization

Like the ARCII, the CRII has been developed by normalizing data using a min-max rescaling method to cast various indicators with differing units of measurements and/or range of variation into the same and comparable standard. Since the data have different units of measurements and were derived from various sources, normalization was undertaken so that the indicators will be comparable to each other for the construction of the CRII. However, it should be noted that certain data imputation has been done to missing data values. Normalization of the raw data for each dimension using min-max rescaling is applied where all data values are between 0 and 1. This is done to ensure data comparability.
16.2.4 Methodology for Determining Dimension Weights: Principal Component Analysis

The objective is to determine the importance and contribution of each dimension (and its constituent indicators or subdimensions) that reflects, drives, and makes up the composite index (ascertaining how much the index is influenced by each dimension or its associated indicators). Like the ARCII, the weights for each of the six socioeconomic dimensions and their 26 indicators of the CRII are determined by employing a two-stage principal component analysis (PCA) technique: the first stage for the indicators and then the second stage for the constituent dimensions. For each indicator, PCA is employed to identify the components that exhibit the maximum variability. Again, in the second stage, weights for all six dimensions are determined using PCA to create an overall weighted index. The final weights are assigned to each dimension equal to its loadings in dimension of the PCA weighted by the relative contribution (variation) of that dimension or indicator data. The PCA technique helps to identify the first few components that explain most of the variability, say 70%–90%, to reduce the total number of variables to be analyzed. The six dimensions are then aggregated to get the index scores hovering between 0 (very low) and 1 (very high) in terms of regional economic cooperation and integration, to indicate the state of economic cooperation of each of the CMCs, as well as the subgroups CAREC with CAREC and CAREC excluding the PRC. Tables 16.5 and 16.6 provide the principal components and weights assigned to indicators and dimensions of the CRII.

The following criteria have been used to select the principal components:

a) Eigenvalue greater than 0.95 (Kaiser criterion, 1960)

b) Proportion of variance (pop) accounted for – retain a principal component if it accounts for at least 10% of the variance in the dataset of the six dimensions

c) Cumulative proportion (cum prop) of variance accounted for – retain a principal component that cumulatively explains more than 65% of the total variance.
### Table 16.5: Principal Component Analysis — Number of Principal Components (CAREC with CAREC excluding the PRC)

<table>
<thead>
<tr>
<th>Number of Principal Components</th>
<th>Dimension I</th>
<th>Dimension II</th>
<th>Dimension III</th>
<th>Dimension IV</th>
<th>Dimension V</th>
<th>Dimension VI</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>1</td>
</tr>
<tr>
<td>Eigenvalue</td>
<td>2.510</td>
<td>1.866</td>
<td>0.450</td>
<td>0.137</td>
<td>0.037</td>
<td>2.367</td>
</tr>
<tr>
<td>Proportion</td>
<td>0.502</td>
<td>0.373</td>
<td>0.090</td>
<td>0.027</td>
<td>0.007</td>
<td>0.592</td>
</tr>
<tr>
<td>Cumulative Proportion</td>
<td>0.502</td>
<td>0.875</td>
<td>0.965</td>
<td>0.993</td>
<td>1.000</td>
<td>0.592</td>
</tr>
<tr>
<td>Weight for Composite Indexes</td>
<td>I-a</td>
<td>I-b</td>
<td>I-c</td>
<td>I-d</td>
<td>I-e</td>
<td>Indicator II-a</td>
</tr>
<tr>
<td>Weight</td>
<td>0.153</td>
<td>0.209</td>
<td>0.213</td>
<td>0.212</td>
<td>0.212</td>
<td>Weight</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Number of Principal Components</th>
<th>Dimension III</th>
<th>Dimension IV</th>
<th>Dimension V</th>
<th>Dimension VI</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Eigenvalue</td>
<td>1.820</td>
<td>1.111</td>
<td>0.596</td>
<td>0.473</td>
</tr>
<tr>
<td>Proportion</td>
<td>0.455</td>
<td>0.278</td>
<td>0.149</td>
<td>0.118</td>
</tr>
<tr>
<td>Cumulative Proportion</td>
<td>0.455</td>
<td>0.733</td>
<td>0.882</td>
<td>1.000</td>
</tr>
<tr>
<td>Weight for Composite Indexes</td>
<td>III-a</td>
<td>III-b</td>
<td>III-c</td>
<td>III-d</td>
</tr>
<tr>
<td>Weight</td>
<td>0.236</td>
<td>0.240</td>
<td>0.231</td>
<td>0.293</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Number of Principal Components</th>
<th>Dimension V</th>
<th>Dimension VI</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Eigenvalue</td>
<td>1.514</td>
<td>1.261</td>
</tr>
<tr>
<td>Proportion</td>
<td>0.379</td>
<td>0.315</td>
</tr>
<tr>
<td>Cumulative Proportion</td>
<td>0.379</td>
<td>0.694</td>
</tr>
<tr>
<td>Weight for Composite Indexes</td>
<td>V-a</td>
<td>V-b</td>
</tr>
<tr>
<td>Weight</td>
<td>0.276</td>
<td>0.255</td>
</tr>
</tbody>
</table>

CAREC = Central Asia Regional Economic Cooperation, PRC = People’s Republic of China.
Source: Authors’ calculations.
Table 16.6: Principal Component Analysis—Dimensions and Subdimensions (CAREC with CAREC excluding the PRC)

<table>
<thead>
<tr>
<th></th>
<th>Trade and Investment</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td></td>
<td>0.163</td>
</tr>
<tr>
<td>I-a</td>
<td>Proportion of intraregional goods exports to total goods exports</td>
<td>0.153</td>
</tr>
<tr>
<td>I-b</td>
<td>Proportion of intraregional goods imports to total goods imports</td>
<td>0.209</td>
</tr>
<tr>
<td>I-c</td>
<td>Intraregional trade intensity index</td>
<td>0.213</td>
</tr>
<tr>
<td>I-d</td>
<td>Proportion of intraregional FDI inflows to total FDI inflows</td>
<td>0.212</td>
</tr>
<tr>
<td>I-e</td>
<td>Proportion of intraregional FDI inflows plus outflows to total FDI inflows plus outflows</td>
<td>0.212</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Money and Finance</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>II</td>
<td></td>
<td>0.129</td>
</tr>
<tr>
<td>II-a</td>
<td>Financial Institutions Depth Index</td>
<td>0.237</td>
</tr>
<tr>
<td>II-b</td>
<td>Financial Markets Access Index</td>
<td>0.235</td>
</tr>
<tr>
<td>II-c</td>
<td>Financial Markets Depth Index</td>
<td>0.238</td>
</tr>
<tr>
<td>II-d</td>
<td>Financial Markets Efficiency Index</td>
<td>0.290</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Regional Value Chain</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>III</td>
<td></td>
<td>0.197</td>
</tr>
<tr>
<td>III-a</td>
<td>Ratio between the averaged trade complementarity index over regional trading partners and the averaged trade complementarity index over all trading partners</td>
<td>0.236</td>
</tr>
<tr>
<td>III-b</td>
<td>Ratio between the averaged trade concentration index over regional trading partners and the averaged trade concentration index over all trading partners</td>
<td>0.240</td>
</tr>
<tr>
<td>III-c</td>
<td>Proportion of intraregional intermediate goods exports to total intraregional goods exports</td>
<td>0.231</td>
</tr>
<tr>
<td>III-d</td>
<td>Proportion of intraregional intermediate goods imports to total intraregional goods imports</td>
<td>0.293</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Infrastructure and Connectivity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>IV</td>
<td></td>
<td>0.204</td>
</tr>
<tr>
<td>IV-a</td>
<td>Ratio between the averaged trade cost over regional trading partners and the averaged trade cost over all trading partners</td>
<td>0.233</td>
</tr>
<tr>
<td>IV-b</td>
<td>Ratio between the averaged liner shipping connectivity index over regional trading partners and the averaged liner shipping connectivity index over all trading partners</td>
<td>0.282</td>
</tr>
<tr>
<td>IV-c</td>
<td>Logistics performance index (overall)</td>
<td>0.224</td>
</tr>
<tr>
<td>IV-d</td>
<td>Doing Business Index (overall)</td>
<td>0.260</td>
</tr>
</tbody>
</table>

*continued on next page*
Based on the above criteria, which have also been adopted in ADB’s ARCI (e.g., Huh and Park 2018), the principal components identified for the aggregation are listed in Tables 16.7 and 16.8 (selected values are highlighted for illustration purposes).

Based on Tables 16.7 and 16.8, dimension VI on institutional and social integration and dimension V on free movement of people have the highest weights (0.181 and 0.180, respectively), followed by dimension III on regional value chains (RVCs) and dimension IV on infrastructure and connectivity (0.176 and 0.168, respectively). Counterintuitively,5 dimension I on trade and investment (0.137) and dimension II on MFI

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5 Normally, the dimensions on “trade and investment” and “monetary and financial integration” envisage deeper integration and therefore should drive the composite index (i.e., should have more weight than the other socioeconomic dimensions). See the EU Index for further explanation.

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### Table 16.6  continued

<table>
<thead>
<tr>
<th>V</th>
<th>Free Movement of People</th>
<th>Weights</th>
</tr>
</thead>
<tbody>
<tr>
<td>V-a</td>
<td>Proportion of intraregional outbound migration to total outbound migration</td>
<td>0.276</td>
</tr>
<tr>
<td>V-b</td>
<td>Proportion of intraregional tourists to total tourists (inbound plus outbound)</td>
<td>0.255</td>
</tr>
<tr>
<td>V-c</td>
<td>Proportion of intraregional remittances to total remittances</td>
<td>0.250</td>
</tr>
<tr>
<td>V-d</td>
<td>Proportion of other Asian countries that do not require an entry visa</td>
<td>0.218</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>VI</th>
<th>Institutional and Social Integration</th>
<th>Weights</th>
</tr>
</thead>
<tbody>
<tr>
<td>VI-a</td>
<td>Proportion of other Asian countries that have signed FTAs with</td>
<td>0.106</td>
</tr>
<tr>
<td>VI-b</td>
<td>Proportion of other Asian countries that have an embassy in</td>
<td>0.224</td>
</tr>
<tr>
<td>VI-c</td>
<td>Proportion of other Asian countries that have signed business investment treaties with</td>
<td>0.221</td>
</tr>
<tr>
<td>VI-d</td>
<td>Proportion of other Asian countries that have signed double taxation treaties with</td>
<td>0.212</td>
</tr>
<tr>
<td>VI-e</td>
<td>Cultural proximity with other Asian countries relative to that with all other countries</td>
<td>0.238</td>
</tr>
</tbody>
</table>

CAREC = Central Asia Regional Economic Cooperation, FDI = foreign direct investment, FTA = free trade agreement, PRC = People’s Republic of China.

Source: Authors’ calculations.
Table 16.7: Principal Component Analysis Normalized for CAREC with CAREC

<table>
<thead>
<tr>
<th>Dimension I</th>
<th>Dimension II</th>
<th>Dimension III</th>
<th>Dimension IV</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Eigenvalue</td>
<td>2.485</td>
<td>1.870</td>
<td>0.545</td>
</tr>
<tr>
<td>Prop</td>
<td>0.497</td>
<td>0.374</td>
<td>0.109</td>
</tr>
<tr>
<td>Cum Prop</td>
<td>0.497</td>
<td>0.871</td>
<td>0.980</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Dimension V</th>
<th>Dimension VI</th>
<th>Overall CAREC with CAREC</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Eigenvalue</td>
<td>1.423</td>
<td>1.271</td>
</tr>
<tr>
<td>Prop</td>
<td>0.356</td>
<td>0.318</td>
</tr>
<tr>
<td>Cum Prop</td>
<td>0.356</td>
<td>0.674</td>
</tr>
</tbody>
</table>

Weight of Each Indicator for the Composite Index - CAREC with CAREC

<table>
<thead>
<tr>
<th>Indicator</th>
<th>I-a</th>
<th>I-b</th>
<th>I-c</th>
<th>I-d</th>
<th>I-e</th>
<th>II-a</th>
<th>II-b</th>
<th>II-c</th>
<th>II-d</th>
<th>III-a</th>
<th>III-b</th>
<th>III-c</th>
<th>III-d</th>
<th>IV-a</th>
<th>IV-b</th>
<th>IV-c</th>
<th>IV-d</th>
</tr>
</thead>
<tbody>
<tr>
<td>Weight</td>
<td>0.157</td>
<td>0.171</td>
<td>0.218</td>
<td>0.227</td>
<td>0.227</td>
<td>0.313</td>
<td>0.172</td>
<td>0.319</td>
<td>0.195</td>
<td>0.220</td>
<td>0.254</td>
<td>0.203</td>
<td>0.323</td>
<td>0.207</td>
<td>0.260</td>
<td>0.255</td>
<td>0.278</td>
</tr>
<tr>
<td>Indicator</td>
<td>V-a</td>
<td>V-b</td>
<td>V-c</td>
<td>V-d</td>
<td>VI-a</td>
<td>VI-b</td>
<td>VI-c</td>
<td>VI-d</td>
<td>VI-e</td>
<td>TII</td>
<td>MAF</td>
<td>RVC</td>
<td>IAC</td>
<td>FMV</td>
<td>ISI</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Weight</td>
<td>0.293</td>
<td>0.183</td>
<td>0.272</td>
<td>0.251</td>
<td>0.174</td>
<td>0.210</td>
<td>0.242</td>
<td>0.264</td>
<td>0.110</td>
<td>0.137</td>
<td>0.157</td>
<td>0.176</td>
<td>0.168</td>
<td>0.18</td>
<td>0.181</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

CAREC = Central Asia Regional Economic Cooperation.

Notes: For overall CAREC with CAREC, the first four principal components have been retained since they meet the three conditions stated above.

Source: Authors’ calculations.
(0.157) do not seem to drive RCI in the weightings tables for the CRII. This apparent anomaly explains the fact that regional cooperation in the CAREC region is still in its nascent stage and not driven by trade or financial flows or RVC connectivity. On the other hand, for the subgroup CAREC with CAREC excluding the PRC, the TI dimension carries a relatively higher weight of 0.163 (Table 16.6), but it is not deep enough, suggesting fragmented regionalism where CMCs are less integrated regionally. As can be seen from Table 16.6, the infrastructure and connectivity dimension and the RVC dimension obtained the highest weights, with scores of 0.204 and 0.197, respectively, followed by the institutional and social integration (0.185), TI (0.163), MFI (0.129), and free movement of people (0.121) dimensions.

Table 16.8: Principal Component Analysis—Dimensions and Subdimensions CAREC with CAREC

<table>
<thead>
<tr>
<th>Dimension</th>
<th>Weights</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I Trade and Investment</strong></td>
<td>0.137</td>
</tr>
<tr>
<td>I-a Proportion of intraregional goods exports to total goods exports</td>
<td>0.157</td>
</tr>
<tr>
<td>I-b Proportion of intraregional goods imports to total goods imports</td>
<td>0.171</td>
</tr>
<tr>
<td>I-c Intraregional trade intensity index</td>
<td>0.218</td>
</tr>
<tr>
<td>I-d Proportion of intraregional FDI inflows to total FDI inflows</td>
<td>0.227</td>
</tr>
<tr>
<td>I-e Proportion of intraregional FDI inflows plus outflows to total FDI inflows plus outflows</td>
<td>0.227</td>
</tr>
<tr>
<td><strong>II Money and Finance Integration</strong></td>
<td>0.157</td>
</tr>
<tr>
<td>II-a Financial Institutions Depth Index</td>
<td>0.313</td>
</tr>
<tr>
<td>II-b Financial Markets Access Index</td>
<td>0.172</td>
</tr>
<tr>
<td>II-c Financial Markets Depth Index</td>
<td>0.319</td>
</tr>
<tr>
<td>II-d Financial Markets Efficiency Index</td>
<td>0.195</td>
</tr>
<tr>
<td><strong>III Regional Value Chain</strong></td>
<td>0.176</td>
</tr>
<tr>
<td>III-a Ratio between the averaged trade complementarity index over regional trading partners and the averaged trade complementarity index over all trading partners</td>
<td>0.220</td>
</tr>
<tr>
<td>III-b Ratio between the averaged trade concentration index over regional trading partners and the averaged trade concentration index over all trading partners</td>
<td>0.254</td>
</tr>
</tbody>
</table>

*continued on next page*
Table 16.8  continued

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>Weights</th>
</tr>
</thead>
<tbody>
<tr>
<td>III-c</td>
<td>Proportion of intraregional intermediate goods exports to total intraregional goods exports</td>
<td>0.203</td>
</tr>
<tr>
<td>III-d</td>
<td>Proportion of intraregional intermediate goods imports to total intraregional goods imports</td>
<td>0.323</td>
</tr>
<tr>
<td>IV</td>
<td><strong>Infrastructure and Connectivity</strong></td>
<td>0.168</td>
</tr>
<tr>
<td>IV-a</td>
<td>Ratio between the averaged trade cost over regional trading partners and the averaged trade cost over all trading partners</td>
<td>0.207</td>
</tr>
<tr>
<td>IV-b</td>
<td>Ratio between the averaged liner shipping connectivity index over regional trading partners and the averaged liner shipping connectivity index over all trading partners</td>
<td>0.260</td>
</tr>
<tr>
<td>IV-c</td>
<td>Logistics performance index (overall)</td>
<td>0.255</td>
</tr>
<tr>
<td>IV-d</td>
<td>Doing Business Index (overall)</td>
<td>0.278</td>
</tr>
<tr>
<td>V</td>
<td><strong>Free Movement of People</strong></td>
<td>0.180</td>
</tr>
<tr>
<td>V-a</td>
<td>Proportion of intraregional outbound migration to total outbound migration</td>
<td>0.293</td>
</tr>
<tr>
<td>V-b</td>
<td>Proportion of intraregional tourists to total tourists (inbound plus outbound)</td>
<td>0.183</td>
</tr>
<tr>
<td>V-c</td>
<td>Proportion of intraregional remittances to total remittances</td>
<td>0.272</td>
</tr>
<tr>
<td>V-d</td>
<td>Proportion of other Asian countries that do not require an entry visa</td>
<td>0.251</td>
</tr>
<tr>
<td>VI</td>
<td><strong>Institutional and Social Integration</strong></td>
<td>0.181</td>
</tr>
<tr>
<td>VI-a</td>
<td>Proportion of other Asian countries that have signed FTAs with</td>
<td>0.174</td>
</tr>
<tr>
<td>VI-b</td>
<td>Proportion of other Asian countries that have an embassy in</td>
<td>0.210</td>
</tr>
<tr>
<td>VI-c</td>
<td>Proportion of other Asian countries that have signed business investment treaties with</td>
<td>0.242</td>
</tr>
<tr>
<td>VI-d</td>
<td>Proportion of other Asian countries that have signed double taxation treaties with</td>
<td>0.264</td>
</tr>
<tr>
<td>VI-e</td>
<td>Cultural proximity with other Asian countries relative to that with all other countries</td>
<td>0.110</td>
</tr>
</tbody>
</table>

CAREC = Central Asia Regional Economic Cooperation, FDI = foreign direct investment, FTA = free trade agreement.
Source: Authors’ calculations.
16.3 Central Asia Regional Economic Cooperation Regional Integration Index: Interpretations and Analysis

Across all CMCs, Kazakhstan and the PRC generated the highest degree of regional integration between 2006 and 2016, with the exception of 2012, when Turkmenistan exhibited a score of 0.467. More specifically, Kazakhstan obtained the highest score from 2006 to 2011 with an average of 0.447, while the PRC generated the highest score from 2013 to 2016 with an average of 0.459. In contrast, Pakistan and Afghanistan displayed the lowest integration within the CAREC region. In particular, Afghanistan is consistently at the bottom from 2006 to 2016 with an average score of 0.211. Meanwhile, Pakistan placed second to the bottom throughout the sample period with an average score of 0.344 (see Figure 16.3).

Figure 16.3: CAREC Regional Integration Index—CAREC with CAREC

CAREC = Central Asia Regional Economic Cooperation, PRC = People’s Republic of China.
Source: Based on authors’ compilation and calculations.
With regard to the subdimensions, as Figure 16.4 shows, all countries in the CAREC region displayed high volatility in the TI dimension. The only exception is the PRC where the TI score was consistently the lowest. More specifically, the PRC exhibited an average score of only 0.06 throughout the sample period. This means that the PRC is more integrated with the world compared with the CAREC region in terms of the TI sector. In contrast, the PRC continuously attained the highest scores for the MFI dimension from 2006 to 2016, with an average score of 0.788. Kazakhstan followed with an average score of 0.381 on the same dimension. Furthermore, Figure 16.4 shows that all CMCs except the PRC have persistently obtained low scores on the MFI indicator, which is also consistent with the IMF Financial Development Index.

Like the TI dimension, all CMCs exhibited relatively high volatility in the RVC dimension. Turkmenistan displayed the highest score for the majority of the sample period. In particular, the only exception is in 2009 when the Kyrgyz Republic obtained a higher RVC score than Turkmenistan with 0.6 versus 0.514, respectively (Figure 16.4[c]). In terms of the other three dimensions, for the infrastructure and connectivity dimension, there is an overall upward trend for all CMCs, and Georgia continuously attained the highest score, while Afghanistan consistently obtained the lowest score, with averages of 0.772 and 0.291, respectively (Figure 16.4[d]). Furthermore, movement is relatively stable across all countries, except for Azerbaijan on the free movement of people dimension from 2012 to 2013 when its score almost doubled (Figure 16.4[e]). Finally, for the institutional and social integration dimension, the countries with the highest scores are Turkmenistan, the Kyrgyz Republic, and Uzbekistan with average scores of 0.661, 0.657, and 0.653, respectively. Mongolia and Afghanistan generated the lowest scores with averages of 0.265 and 0.231, respectively, throughout the sample period (Figure 16.4[e]).

For the scores for CAREC with CAREC excluding the PRC, Kazakhstan retained the highest degree of regional integration from 2006 to 2016, with the exception of 2009, when the Kyrgyz Republic obtained a score of 0.520 versus Kazakhstan’s 0.510. In particular, Kazakhstan generated an average overall score of 0.494 throughout the sample period. In contrast, similar to when the PRC is included in the analysis, Afghanistan consistently exhibited the lowest regional integration with an average score of 0.288 for the same period (Figure 16.5).
Figure 16.4: Dimensional Subindexes—CAREC with CAREC

(a) Trade and Investment

(b) Money and Finance

(c) Regional and Value Chain

(d) Infrastructure and Connectivity

(e) Free Movement of People

(f) Institutional and Social Integration

CAREC = Central Asia Regional Economic Cooperation, PRC = People’s Republic of China.

Source: Based on authors’ calculations.
With regard to the subdimensions, all countries in the CAREC region excluding the PRC displayed high volatilities for the TI dimension (Figure 16.6). The exceptions are Pakistan and Kazakhstan; both countries continuously obtained low TI integration. More specifically, Pakistan’s and Kazakhstan’s TI dimension averages are 0.025 and 0.034, respectively, throughout the sample period. Furthermore, Afghanistan led in the TI dimension from 2006 to 2016, with the exception of 2009 when the Kyrgyz Republic scored 0.564 versus Afghanistan’s 0.373.

Similarly, CMCs excluding the PRC exhibited high volatility trends in the MFI, RVC, and free movement of people dimensions. For the MFI dimension, Kazakhstan generated the highest score throughout the sample period with an average score of 0.527 from 2006 to 2016. On the other hand, free movement of people is led by Mongolia and Uzbekistan. As shown in Figure 16.6, Mongolia obtained the highest score from 2006 to 2010 and went into a downward trend starting in 2011, while Uzbekistan generated the maximum score from 2011 to 2016. Furthermore, for the infrastructure and connectivity subdimension, there is an overall upward trend for all CMCs when the PRC is excluded from the CAREC region. In particular, Georgia continuously attained the highest score, and Pakistan consistently obtained the lowest score, with averages of 0.823 and 0.363, respectively, throughout the sample period. It is important to note that these scores are significantly higher when the
PRC is included in the analysis, which means that the CMCs are more integrated in the infrastructure and connectivity subdimension without the PRC. Lastly, for the institutional and social integration dimension,
there is stable movement across all CMCs excluding the PRC. This dimension is led by Turkmenistan with an average score of 0.659 from 2006 to 2016, while Afghanistan mostly exhibited the lowest score with an average of 0.326 in the same period (Figure 16.5).

Figures 16.7 and 16.8 provide a snapshot of the rankings in the regional integration index for individual member countries and on the regional basis with and without PRC, respectively. Figures 16.9 and 16.10 provide the dimension index for the CAREC region with and without the PRC, respectively. It is important to note that the TI and MFI dimensions for both data sets (CAREC with CAREC and CAREC with CAREC excluding the PRC) are the lowest, while the three other dimensions (RVC, infrastructure and connectivity, and institutional and social integration) perform relatively well.

As seen in Figure 16.7, Kazakhstan ranks the highest on all six dimensions with a score of 0.444 and Afghanistan trails with the lowest index score of 0.211. The average CRII for the region is 0.373, which indicates that the region’s potential for intra-CAREC regional integration is underutilized and requires some consistent policy efforts to enhance intra-RCI. The results of the CRII are consistent with the Asia-Pacific Regional Cooperation and Integration Index findings (ADB 2018).
Kazakhstan, the Kyrgyz Republic, Uzbekistan, Georgia, Azerbaijan, Tajikistan, Pakistan, and Afghanistan are relatively more integrated within the CAREC region when the PRC is excluded in the analysis (Figures 16.7 and 16.8). As seen in Figure 16.8, the average level of integration within the region when the PRC is excluded from CAREC is slightly higher than when the PRC is included, but the scores are still relatively low. More specifically, the average CRII score for CAREC with CAREC is 0.373, while the average for CAREC with CAREC excluding the PRC is 0.399 (Figures 16.7 and 16.8). These low rankings may also imply that the CMCs are more integrated with Asia and globally than within CAREC.

The two core and vital dimensions—TI and MFI—that normally reflect RCI do not drive the integration in the case of the CRII. The low values of TI and MFI at around 0.232 and 0.189, respectively, necessitate a more formal regional trade agreement to enhance the trade, investment, finance, and money market integration in the region and

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6 “Of the six dimensions featured in the ARCII, trade and investment and movement of people are the main drivers of regional integration, while the money and finance dimension were the weakest link” (Park and Claveria 2018, 9).
Another significant impediment in RCI are the low scores (with index values of 0.333 and 0.342, respectively) of the free movement of people dimension in the CAREC region for both CAREC with CAREC and CAREC excluding the PRC (Figures 16.9 and 16.10). A potential CAREC preferential trade agreement should therefore stress more liberalized movement of people under the framework of the World Trade Organization General Agreement on Trade in Services, or GATS, for all modes with emphasis on Mode 4—the presence of natural persons.7 Some CMCs are more integrated in terms of labor migration with Eurasian Economic Union member economies than the CAREC region.8 In order to establish more sustained RCI, greater liberalization of the trade, investment, and services sectors, including GATS Mode 4 or the presence of natural persons (labor migration), should also be pursued as priority measures. Considering the size, scale asymmetry, and structural and institutional heterogeneity in the CAREC region, preferential market access with special and differential treatment for the regional landlocked and balance-of-payments crisis hit economies may be beneficial to enhance RCI (WTO n.d.[c]). Figure 16.7 indicates the average percentage change in the CRII dimensions for all member countries from 2006 to 2016 (in absolute values) and indicates that the TI dimension seems to have a significant impact over the years. This demonstrates that the TI dimension is very volatile over the years with an absolute value of 51.57% for CAREC with all member countries and 55.29% for CAREC excluding the PRC.9 There is a need to focus on TI as it is very volatile. It also has the largest overall percentage decrease through the years. In addition, the level of integration in the rest of the dimensions of the CRII needs to be enhanced for meaningful and deeper RCI.

7 “The definition of services trade under the GATS is four-pronged, depending on the territorial presence of the supplier and the consumer at the time of the transaction. Pursuant to Article I:2, the GATS cover services supplied from the territory of one Member into the territory of any other Member (Mode 1 — Cross border trade); in the territory of one Member to the service consumer of any other Member (Mode 2 — Consumption abroad); by a service supplier of one Member, through commercial presence, in the territory of any other Member (Mode 3 — Commercial presence); and by a service supplier of one Member, through the presence of natural persons of a Member in the territory of any other Member (Mode 4 — Presence of natural persons)” (WTO n.d.[a]).

8 The Eurasian Economic Union aims to create single market for goods, services, capital, and labor within the union. Within the union, there is “[n]o restrictions of national labour market. Worker is not required to obtain employment permits. Labour activity is under employment contract or a civil law contract” (Eurasian Economic Union 2016).

9 However, higher percentage values of the TI dimension cannot be construed as high trade volumes. Intra-CAREC trade hovers at around 3% of their total trade.
Figure 16.9: Dimensions Normalized for CAREC with CAREC

CAREC = Central Asia Regional Economic Cooperation.
Source: Based on authors’ calculations.

Figure 16.10: Dimensions Normalized for CAREC with CAREC Excluding the PRC

CAREC = Central Asia Regional Economic Cooperation, PRC = People’s Republic of China.
Source: Authors’ calculations.

Figure 16.11(a) indicates the percentage change in the overall CRII scores and in all dimensions for CAREC with CAREC versus excluding the PRC. As shown, the CRII values for Turkmenistan (0.06%) and Mongolia (10.97%) exhibit more integration with the PRC relatively, while Afghanistan (36.73%), Azerbaijan (2.61%), Georgia (8.66%), Kazakhstan (11.31%), the Kyrgyz Republic (9.24%), Pakistan (1.45%),
Tajikistan (13.55%), and Uzbekistan (6.86%) are more integrated with
the non-PRC CAREC countries. Pakistan’s TI and infrastructure and
connectivity dimensions are heavily (dependent) integrated with the
PRC; both dimensions witness a substantial decrease by 84% and 17%,
respectively, if the PRC is excluded. Similarly, except for Georgia, all
other CMCs are heavily integrated with the PRC in the TI dimension
(refer to Figure 16.11[b]), with Mongolia’s score showing an acute dip
with 96.90%, followed by Turkmenistan (-84.76%), Pakistan (-84.28%);
Kazakhstan (-79.72%); Tajikistan (-54.23%); Uzbekistan (-50.54%); the
Kyrgyz Republic (-43.01%); and Azerbaijan (-21.46%). In contrast, only
Pakistan is dependent on the PRC in the infrastructure and connectivity
dimension with the score decreasing by 17%. Figure 16.11(d) also
shows that the scores for all CMCs, except Pakistan, increase in the
infrastructure and connectivity dimension when the PRC is omitted
from the CAREC group. Afghanistan’s infrastructure and connectivity
score has the highest change of 59.81%, followed by Turkmenistan,
Tajikistan, Uzbekistan, Mongolia, Azerbaijan, the Kyrgyz Republic,
Kazakhstan, and Georgia with average percentage changes of 42.02%,
37.34%, 36.23%, 31.11%, 27.64%, 26.90%, 26.65%, and 9.95%, respectively.

Moreover, RVC integration within the region is not significantly
integrated with the Asian and global manufacturing center, the PRC.
Figure 16.11(c) reveals that only Mongolia and Turkmenistan will
experience a decrease in terms of the RVC dimension if the PRC is
excluded from the group analysis. In particular, the scores of Mongolia
and Turkmenistan change by 26.14% and -1.14%, respectively. Therefore,
there lies an immense opportunity for the CMCs to cooperate on
enhancing RVC integration in the region. There is no significant change,
however, when the PRC is excluded from the CAREC region for the
free movement of people dimension. The exceptions are Azerbaijan
and Uzbekistan whose scores for free movement of people change by
-30.64% and 140.46%, respectively Figure 16.11(e).

Finally, except for Azerbaijan, the Kyrgyz Republic, and Uzbekistan,
all other CMCs are more integrated with the non-PRC CAREC region
on the institutional and social integration dimension. Afghanistan’s rise
is the highest at 44.02%, followed by Mongolia, Pakistan, Kazakhstan,
Georgia, Tajikistan, and Turkmenistan with average percentage changes
of 36.55%, 10.82%, 7.02%, 1.84%, 1.62%, and 0.24%, respectively, for the
same dimension (Figure 16.11[f]).

The low level of integration within and beyond the region can be
explained in terms of historical, geographical, structural, and political
economy factors. It is pertinent to note that historically the CMCs do
not constitute a subregional group. Rather, the CMCs represent a set of
diverse economies, especially in Central Asia and the Caucasus, with
Figure 16.11: Percentage Change for All Dimensions and Overall—CAREC with CAREC vis-à-vis Excluding the PRC

CAREC = Central Asia Regional Economic Cooperation, PRC = People’s Republic of China.

Source: Based on authors’ calculations.
historical cultural and economic relations with the former Soviet Union having been part of it. The PRC is more integrated with East Asian economies and globally. In South Asia, Afghanistan and Pakistan are more connected regionally and globally. In addition to historical and economic linkages, the CMCs present wide disparities and asymmetries in terms of the following characteristics:

- economic endowment: Azerbaijan, Kazakhstan, Uzbekistan, and Turkmenistan are resource-rich economies; Tajikistan and the Kyrgyz Republic are endowed with hydro potential and agricultural resources
- size, scale, and scope asymmetries among the CMCs:
  (a) GDP of the PRC constitutes more than 95% of the CAREC GDP
  (b) imports from the PRC constitute more than 94% of the CAREC imports
  (c) exports to the PRC constitute more than 93% of the CAREC exports
  (d) for the Kyrgyz Republic, Mongolia, and Tajikistan, each of their GDP shares is only about 0.1% of the CAREC region’s GDP
  (e) for CAREC excluding the PRC, Pakistan, Kazakhstan, and Uzbekistan are relatively large in terms of their GDP size, representing a combined GDP of 80% (with country shares of 47.2%, 22.2%, and 11.1%, respectively)
  (f) of 11 CMCs, Azerbaijan (WTO n.d.[b]), Turkmenistan, and Uzbekistan (WTO 2018) are still not members of the World Trade Organization
  (g) eight CMCs are landlocked and need freedom of transit rights under the Convention on International Transport of Goods Under Cover of TIR Carnets, or TIR Convention, and the World Trade Organization Trade Facilitation Agreement
  (h) market structure, state-owned enterprises, small and medium-sized enterprises, and the private sector are at varying stages of development—with the exception of Georgia, the PRC, and Pakistan, the CMCs are at varied levels of institutional development of both their public and private sectors
  (i) economic integration process has not been driven by either competitive trade liberalization as pursued in East Asia in the early 1990s or to facilitate RVC integration.
16.4 Challenges of Integration in the Central Asia Regional Economic Cooperation Region: Optimal Level Of Integration

In his seminal analysis “Winners and Losers from Regional Integration Agreements,” Anthony J. Venables (2003) posits that the benefits and costs of economic integration among countries with different endowments (comparative advantage of members, relative to each other and relative to the rest of the world) may vary depending upon income and economic structural levels. The author postulates that the countries’ endowments matter and suggests that developing countries are likely to be better served by a north–south, complementary integration, than by a south–south, competing integration. Given the asymmetrical and uneven economic endowments, comparative advantages and domestic market competitiveness, and institutional and bargaining capacity, the analysis by the author suggests that low-income countries are better served by integration with high-income countries. Apart from economic and structural complementarities and synergies, the gains or losses of the regional economic integration may also depend on the domestic margins—the capacity of the host country to exploit and leverage the benefits arising from the economies of the scale, scope, and size of the enlarged market arrangement, as well as preferential terms and conditions. The nations with higher domestic margins—that is, vibrant and efficient firms, institutions, markets, and regulatory regimes—are likely to benefit more, subject to other factors such as the size of domestic economy (products and services sectors), industrial capacity and innovative ability, competitiveness, logistics, and geographical and bargaining power or asymmetry. Smaller and nondiversified economies with low domestic margins engaging with relatively big (more efficient and competitive) economies need innovative policy measures to maximize dynamic gains and ward off losses.

The United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP 2016) outlines a framework for channeling trade and investment into the Agenda for Sustainable Development (Figure 16.12). Regional integration combined with complementary domestic policy may maximize the scale benefits and minimize

10 “To focus on comparative advantage, we have abstracted from all differences between economies except in endowments or technologies. We have also abstracted from other mechanisms that are undoubtedly important in determining the outcome of regional integration agreements. These include policy stance, technology flows, foreign direct investment and agglomeration forces” (Venables 2003).
disruptive effects. These policies include a robust institutional setup, human development (education, health care, infrastructure), competition, unfair trade practices (anti-dumping, countervailing, and safeguards), taxation, and trade facilitation policies.

Thus, policy makers need to balance costs and benefits of economic integration on income inequality, employment, exchange rate, and fiscal and balance-of-payments sustainability, despite its stated objectives of expanding the overall economic pie as a result (UNESCAP 2016). The Sustainable Development Goals, especially Goal 8 (Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all); target 8a (Increase Aid-for-Trade support for developing countries, in particular least developed countries, including through the Enhanced Integrated Framework for Trade-related Technical Assistance to Least Developed Countries); and Goal 10 (Reduce inequality within and among countries) may be mainstreamed to align national development policy objectives in the trade agreements. There are genuine concerns facing member countries especially with macroeconomic instability due to current account imbalances, balance-of-payments crises, and exchange rate fluctuations. With regard to the distribution of benefits among the member countries; unsustainable trade deficits and skewed investment policies may not lead to balance and fair trade regimes and cooperation.
16.5 Policy Recommendations: Optimal Level of the Regional Economic Integration for the CAREC Member Countries

Economic theory provides a framework to assess the benefits and costs of economic integration (Balassa 1962), which broadly can be explained as follows:

(a) Domestic margins: Economic integration can trigger competitive effects if the host country institutions and entrepreneurs are able to improve product portfolio, attract FDI, integrate in the value chain, and manage sectoral adjustment to allocate resources to potentially competitive sectors. The trade adjustment schemes along with social safety net programs may be initiated to lower the transition pains of vulnerable sectors (import competing sectors that have become uncompetitive) and associated workforce (Roland-Holst and Qadir 2018).

(b) Policy makers may adopt a balanced and calibrated approach for reciprocal opening up and preferential market access factoring in national developmental challenges. Market-based price interactions can ward off any anticompetitive practices by rent-seeking firms, whether domestic or foreign (multinational or state-owned enterprises). Nondiscriminatory and transparent market transactions may be embedded in these agreements.

(c) Preferential market access for partner countries may be negotiated without prejudice to the competitive (low-cost world price) producers to minimize trade diversion for yielding positive effects of integration. The objective is to source from the most competitive supplier irrespective of source of origin. The greater the per unit price differential, the greater would be the margin to attain the economies of scale, induce higher foreign investments, and yield larger potential gains from such a union (Appleyard, Field, and Cobb 2010, p. 400).

11 “Domestic margins refer to take off stage or readiness of communities or countries to reap benefits from particular policy or projects. It includes institutional quality and governance, transparency and accountability, productive workforce, efficient infrastructures and alignment of diverse systems. Higher domestic margins entail likelihood to reap optimum benefits from infrastructure investments” (Roland-Holst and Qadir 2018).
(d) Tariff, nontariff, and trading costs across the borders should be minimized to encourage balanced and optimal trade exchanges.

(e) Technology transfer, value chain integration, and innovation enhancing FDI and services sector liberalization will have more pronounced development impact and job creations for the partnering countries.

(f) The partnering framework should be compatible with the multilateral trade regime under the World Trade Organization, ensuring adherence to rule-based, open, and transparent economic integration.

(g) A level playing field for partnering member countries and issues of growth-retarding subsidies, as well as other forms of trade-distorting economic activities, may be regulated to ensure competitive and open market interactions.

(h) A trade facilitation and electronic trading regime can significantly help trade exchanges.

(i) Commitments and obligations related to the Sustainable Development Goals and the United Nations Framework Convention on Climate Change must be mainstreamed in domestic and global policy objectives for sustainable development.

16.6 Conclusion

RCI is a dynamic process envisaging deeper collaboration on various socioeconomic aspects and dimensions for shared prosperity and economic growth. The CAREC Program offers an open regional platform for member countries to scale up their level of economic connectivity and cooperation. Starting from infrastructure connectivity through transport corridors, the program has steadily been evolving to promote economic corridor development among its member countries. As a subset of the ARCII, the CRII is an attempt to quantify the level of RCI on six socioeconomic dimensions covering aspects from trade to people-to-people exchanges with an objective to identify triggers, drivers, and policy measures. Notwithstanding index construction constraints and data limitations, the CRII provides a dynamic analysis and evolution of RCI on (1) trade and investment, (2) monetary and financial integration, (3) regional value chain, (4) infrastructure and connectivity, (5) free movement of people, and (6) institutional and social integration for each of the CMCs from 2006 to 2016. Besides the focus on CMCs, the CRII improves RCI assessment in the MFI dimension, by introducing a set of new proxy variables to reflect the...
peculiar financial and money market development stage and level of the CMCs.

The CRII reveals a lower level of RCI in the CAREC region and identifies the weak areas that need the attention of policy makers. In particular, concerted efforts are needed to scale up RCI in the TI and MFI dimensions. Size and scale asymmetries among the CAREC members call for special and differential treatment for landlocked and crisis-vulnerable economies in the region. Also recommended is to scale up the level of institutional cooperation from an informal arrangement to a more formal CAREC economic integration model compatible with the development challenges that beset the region. Leveraging its RCI potential, the CMCs will require political commitment to negotiate a framework for economic integration for a win–win and shared prosperity, which envisages deeper and meaningful regional connectivity (trade facilitation and streamlining the rules and procedures governing market access and reducing trade-distorting practices; cooperation for cross-border movement of goods, services, and capital), as well as a reduction of costs and regulatory burden for cross-border trade. Cooperation on the regional public goods, including shared water and energy resources, environment challenges that transcend national frontiers, and regional peace and security, can enhance the economies of scale and scope and reduce the distortions and vulnerabilities for promoting sustainable cooperation and regional integration in the CAREC region.

Regional integration should not be a policy objective per se but a means to fast-track the economic growth and increase the income and employment opportunities within and across the countries. Advocating regional cooperation and economic integration in an era of populism and fragmented trade policy is a real challenge and an opportunity to demonstrate that globalization is good for the region and the world. The Sustainable Development Goals, climate change commitments under the United Nations Framework Convention on Climate Change, and regional development challenges can be mainstreamed and embedded in development-friendly and sustainable RCI without compromising the fundamental principles of nondiscriminatory and nondistorting economic cooperation and regional integration among the CMCs.
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17

Barriers and Solutions for Economic Integration of Caspian Sea Countries

Ulviyye Aydin

17.1 Introduction

“Integration among countries is a multinational transaction by which states abolish the obstacles to free trade and to free movement of people across national borders, with the aim of lowering the disputes that can cause to conflict between them” (Garza 2006). According to Balassa (1961: 174), “economic integration encompasses measures designed to abolish discrimination between economic units belonging to different national states; it can be represented by the absence of various forms of discrimination between national economies.” Depending on varying degrees of economic integration, economic integration can take several forms: a free trade area, a customs union, a common market, an economic union, and complete economic integration (Balassa 1961: 174).

The trend toward regional integration, aimed at stimulating deeper and comprehensive economic cooperation between countries, accelerated after the Second World War. In this context, there have been several integration models, such as the European Union (EU) (formerly the European Community [EC]), the United States–Mexico–Canada Agreement (USMCA) (formerly the North American Free Trade Agreement), and the Association of Southeast Asian Nations (ASEAN), respectively representing three major regions of the world—Western Europe, North America, and Southeast Asia.

With its unique structure, the EU is a better model of integration between nation-states, having achieved more than removing the barriers to free trade and free movement of people. In recent years, other blocs, such as ASEAN, USMCA, the Southern Common Market (MERCOSUR for its Spanish initials), and the Asia-Pacific Economic Cooperation
Economic Integration in Asia and Europe: Lessons and Policies

forum, have presented different integration structures because of the geographical, political, economic, social, and cultural features of the regions that they represent. However, economic integration is still a preferable cooperation option between states.

The region surrounding the Caspian Sea has attracted attention around the world in recent years mainly due to its geopolitical location and natural resources. The dissolution of the Soviet Union and increasing global trade movements created new opportunities for the region’s economic development. In this context, the newly emerged states of the region have adapted to the free market economy and opened up to the world. However, these individual achievements could not be transformed into an initiative to establish regional economic integration. Considering the characteristics of the region, there are clear barriers for economic integration between the Caspian states following the EU model. However, significant opportunities also exist for the Caspian states to come together to address common concerns and to benefit from a type of regional economic integration like ASEAN.

This chapter examines the possibilities and barriers of economic integration among the Caspian countries, reviewing the existing cooperation platforms and discussing the opportunities and challenges of deeper integration in the region.

17.2 Methodology

Using a literature review, this study aims to synthesize research findings to determine the current level of integration in the Caspian basin, barriers for integration and possible solutions to deepen integration. It is based on primary sources, academic research articles, policy documents, scholarly journals, working papers, workshop reports, interviews, political speeches and declarations, as well as newspaper articles in four languages: English, Russian, Turkish, and Azerbaijani. Preference was given to examining the topic from several perspectives in different languages, referring to the academic research articles indexed in prevalent and reputable databases. The empirical data collected from the abovementioned sources aim to measure the potential level of integration between Caspian states and to determine specific obstacles. The study first examines the existing cooperation platforms between the Caspian states and then tries to define the concrete barriers for integration in the Caspian basin. While the focus is on the years after the 2000s, important events of the 1990s, the first years after the dissolution of the Soviet Union, are also covered.

The study has been limited to the five Caspian littoral states (Azerbaijan, Iran, Kazakhstan, the Russian Federation, and
Turkmenistan), Georgia, and Uzbekistan. Armenia, the Kyrgyz Republic, and Tajikistan have been left out of the research scope. Territorial disputes between Armenia and Azerbaijan, which is one of the leading economies of the region, make economic interaction unlikely in the near future. The Kyrgyz Republic, with its landlocked position and poor economy, would benefit more from building close relations with its neighbor and cheaper People’s Republic of China (PRC) rather than with distant Caspian countries. In order to participate in any economic integration, Tajikistan first needs to improve its basic internal political and legal structures. Further, existing sources mainly address the regional cooperation between the abovementioned Caspian states rather than their integration. More importantly, access to national economic data as well as data about bilateral and multilateral economic transactions is extremely difficult. These form the limitations of the study.

17.3 Existing Cooperation Platforms of Caspian Sea Countries

Drawing a picture of the Caspian basin in terms of any possible economic integration requires understanding the current situation in the region. Excluding Iran, the other countries that are the subject of the study (Azerbaijan, Georgia, Kazakhstan, the Russian Federation, Turkmenistan, and Uzbekistan) were a part of a unique state-controlled economic system for approximately 70 years. A type of “obliged integration” existed between these states, allowing them free movement of people, goods, and services inside what was formerly the Soviet Union, isolating them from the outside world. During the same period, relations between the Soviet Union and Iran continued in a restrictive cooperative environment clouded by political issues.

The dissolution of the Soviet Union changed the map of the Caspian basin, increasing the number of states in the region that gained an opportunity to act independently. Iran was among the first states to recognize the independence of the newly emerged countries around it, namely, the Azerbaijan, Georgia, Kazakhstan, the Russian Federation, Turkmenistan, and Uzbekistan. Ever since, the countries have been developing relations. Contacts were certainly not limited to bilateral relations between these states, with some attempts undertaken for common action.

The Russian Federation, Ukraine, and Belarus created the Commonwealth of Independent States (CIS) before the collapse of the Soviet Union to help ease the dissolution of the union and coordinate interrepublican affairs. Azerbaijan, Georgia, Kazakhstan, Turkmenistan,
and Uzbekistan also joined to CIS in the 1990s. However, later in the 2000s, Turkmenistan and Georgia left the organization due to several reasons. Nine principal cooperation spheres have been defined under the CIS umbrella, with the major goal being to deepen the multilateral collaboration among the member countries in the economic, humanitarian, military, and political areas. However, the organization has been perceived as a Russian attempt to collect the post-Soviet states under a single framework in order to preserve its influence in the region and in the world rather than an integration initiative, leading members to keep a distance from the organization. Another widespread view is that a priority of Russian foreign policy was the establishment and development of Eurasian integration in the post-Soviet region, mainly aimed to overcome the destructive results of the collapse of the Soviet Union in the geopolitical and socioeconomic context (Bykov 2016:285). However, existing serious problems, especially ethnic tensions between the member states inherited from the Soviet era, are seen as the major reason of the organization’s ineffectiveness. As early as the late 1990s, the Russian Federation had already recognized that the CIS could not be turned into an effective integration tool. About 90% of all decisions made by CIS institutions are simply not implemented. The CIS was created as an interstate organization in which decisions are made on the principle of consensus among its members. The absence of supranational institutions predetermines that the integration of the CIS takes place on ad hoc and selective principles—i.e., only between member countries interested in a particular policy. For example, Azerbaijan clearly expressed its official attitude on this matter: “Azerbaijan’s collaboration with CIS member countries has been established on a two-sided principle. However, Azerbaijan keeps on cooperating in the context of the CIS according to its national priorities and recognizes the aforementioned body as an opportunity for communication” (Azerbaijan Ministry of Foreign Affairs 2018).

Another very important factor that predetermines the inefficiency of the CIS is the lack of a driving force for integration. The EU experience shows that the driving force of a political organization is a growing economic dependence between member countries. The role of the CIS for economic integration is limited. Between the 1998 Russian financial crisis and the 2008 global financial crisis, the countries of the CIS enjoyed robust economic growth. From 2000 to 2008, the CIS economies grew at an average rate of over 6% (excluding the Kyrgyz Republic) (Jenish 2013: 4). However, the source of these developments was rooted mainly outside the CIS; in 2000–2006, all CIS countries, except Belarus, the Kyrgyz Republic, and Moldova, had more export and import ties with non-CIS countries than within the CIS. For example,
in 2007, trade between the EU and the CIS countries was 87% higher than the volume of trade within the CIS (Kaschunas 2007). In order to promote commercial and economic interactions among the CIS member countries, the Free Trade Zone Agreement was signed on 18 October 2011 in Saint Petersburg. In general, it aimed to catalyze the development of the member economies and to upgrade the capacity of the CIS. Presently, nine CIS member states—Russian Federation, Belarus, Ukraine, Moldova, Tajikistan, Armenia, Kazakhstan, the Kyrgyz Republic, and Uzbekistan—have approved a free trade agreement for the unobstructed movement of goods within their territory. However, the ongoing dispute between the Russian Federation and Ukraine has caused a serious disruption of trade between the two sides (International Trade Administration 2019).

Three post-Soviet states—Belarus, Kazakhstan, and the Russian Federation—agreed to form a customs union in 1995, with the Kyrgyz Republic and Tajikistan joining a year later. The remarkable point here was the relations of member countries between themselves. They did not have any glaring conflict, which was a factor that increased the functionality of the union. However, it was clear that the Customs Union’s aims were unrealistic in the short term given the member states’ continuing economic decline, their different economic policies, and their substantial disagreements over trade policy with other countries (Kembayev 2013: 718). In October 2000, member states agreed to upgrade the union into the Eurasian Economic Community (EurAsEC). With the ratification process finalized in 2001, the members aimed to determine a mutual external tariff for non-CIS countries and adapt the nontariff barriers. The Russian Federation has stressed EurAsEC’s purely economic characteristics on the basis of compatible and still-interdependent economies. Moscow looked for the EU’s recognition of the customs union and called on Brussels to cooperate with the Eurasian Economic Commission, which is a regulatory authority on trade matters related to the Russian Federation. Some believe that the EurAsEC could have been an effective and decisive body (Shumylo-Tapiola 2012: 3). However, it failed to reach its intended aims (Tochitskaya 2010: 4), the major reason being the diversity in the member states’ economic structures and their unequal degree of economic progress, as well as a lack of instruments to remove such obstacles. As a result, there was a mismatch of purpose between protecting economic sectors and opening them to international competition. Moreover, the Kyrgyz Republic acceded to the World Trade Organization (WTO) in 1990, thus having to manage its trade policies in conformity with its obligations, not excepting the level of external tariffs. Additionally, states increasingly redirected their commercial preferences away from regional trade
agreements (Tochitskaya 2010: 4). The reluctance of member states to unify national tariff regimes prevented them from obtaining the desired results.

The region took a new step toward regional economic integration when Belarus, Kazakhstan, and the Russian Federation agreed to establish the Eurasian Economic Union (EAEU), signing an agreement on 29 May 2014, which came into force on 1 January 2015. The Kyrgyz Republic and Armenia joined in 2015. The EAEU is a combined market comprising 183.8 million people (2.4% of world population) and a gross domestic product (GDP) of $1.9 trillion (3.2% of world's GDP). Providing 14.5% of the global oil production, the EAEU leads the world in global oil production, providing 14.5%, and is second in the world in global gas production, providing 20.2% (EAEU 2019).

The creation of the EAEU was evaluated as a natural and logical desire of the Russian Federation to bring together historically related people and to slow down the stripping apart of the post-Soviet space by foreign powers (Bykov 2016: 290). However, for similar reasons, including conflicts between states, lack of economic interests, and desire to trade with developed economies, Azerbaijan, Georgia, Turkmenistan, Ukraine, and Uzbekistan kept away from the EAEU and cast a shadow on its future success. Considering the potential of these countries, any discussion about full integration in the post-Soviet era is difficult.

Another concrete initiative in the Caspian region toward integration is the Central Asia Cooperation Organization (CACO), initially called the Central Asian Economic Union (CAEU) when it was first established in 1994 under the leadership of Kazakhstan, the Kyrgyz Republic, and Uzbekistan. Tajikistan joined the union in 1998, which was subsequently renamed the Central Asian Economic Cooperation (CAEC) program. In early 2002, the CAEC was converted into the CACO. In 2004, the Russian Federation joined the CACO as a member. In 2005, Uzbekistan applied for EurAsEC membership. At the same time, the CACO members agreed to disband the institution and to mutual cooperate only under the EurAsEC. Alignment of the CACO with the EurAsEC was a pertinent choice as the two bodies were too similar in composition. Two countries were exceptions: Uzbekistan was a member of the CACO but not of the EurAsEC, and Belarus vice versa (Kembayev 2013: 719).

No attempt has been made for more comprehensive regional integration of the Caspian countries since the collapse of the Soviet Union. Rather, there are experiences of Eurasian economic integration under the leadership of the Russian Federation, with some of the Caspian basin countries, except Iran, participating in these initiatives. However, the size of the Caspian basin market is ample, covering more than 295 million people (Table 17.1).
Bilateral trade relations between the Caspian states, however, developed during the late 2010s (Table 17.2). Due to the sectoral diversification of the Russian economy, geographical proximity, well-developed trading channels, as well as trading culture and perceptions inherited from the Soviet Union, the Russian Federation is the biggest trade partner among the countries. A general assessment might conclude that all these countries are dependent on developed economies for heavy industry, machinery, and innovative technology. Thus, fast consumer goods, energy, transportation, tourism, education, and health are the main trade items between the Caspian states.

Table 17.2: Trade between Caspian Countries, 2015–2017
($ million)

<table>
<thead>
<tr>
<th>Country</th>
<th>Azerbaijan</th>
<th>Azerbaijan</th>
<th>Georgia</th>
<th>Georgia</th>
<th>Iran</th>
<th>Iran</th>
<th>Kazakhstan</th>
<th>Kazakhstan</th>
<th>Russian Federation</th>
<th>Russian Federation</th>
<th>Turkmenistan</th>
<th>Turkmenistan</th>
<th>Uzbekistan</th>
<th>Uzbekistan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Azerbaijan</td>
<td>1.594,203,2</td>
<td>-</td>
<td>1.594,203,2</td>
<td>-</td>
<td>602,991,1</td>
<td>440,100,0</td>
<td>383,374,6</td>
<td>168,308,5</td>
<td>6.047,766,5</td>
<td>2.571,386,9</td>
<td>5.172,128,5</td>
<td>43,821,600,0</td>
<td>368,845,6</td>
<td>242,800,00</td>
</tr>
<tr>
<td>Georgia</td>
<td>440,100,0</td>
<td>-</td>
<td>440,100,0</td>
<td>-</td>
<td>602,991,1</td>
<td>440,100,0</td>
<td>383,374,6</td>
<td>168,308,5</td>
<td>6.047,766,5</td>
<td>2.571,386,9</td>
<td>5.172,128,5</td>
<td>43,821,600,0</td>
<td>368,845,6</td>
<td>242,800,00</td>
</tr>
<tr>
<td>Iran</td>
<td>602,991,1</td>
<td>440,100,0</td>
<td>602,991,1</td>
<td>440,100,0</td>
<td>602,991,1</td>
<td>440,100,0</td>
<td>383,374,6</td>
<td>168,308,5</td>
<td>6.047,766,5</td>
<td>2.571,386,9</td>
<td>5.172,128,5</td>
<td>43,821,600,0</td>
<td>368,845,6</td>
<td>242,800,00</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>383,374,6</td>
<td>168,308,5</td>
<td>383,374,6</td>
<td>168,308,5</td>
<td>602,991,1</td>
<td>440,100,0</td>
<td>383,374,6</td>
<td>168,308,5</td>
<td>6.047,766,5</td>
<td>2.571,386,9</td>
<td>5.172,128,5</td>
<td>43,821,600,0</td>
<td>368,845,6</td>
<td>242,800,00</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>6.047,766,5</td>
<td>2.571,386,9</td>
<td>5.172,128,5</td>
<td>1.784,400,0</td>
<td>6.047,766,5</td>
<td>2.571,386,9</td>
<td>5.172,128,5</td>
<td>1.784,400,0</td>
<td>6.047,766,5</td>
<td>2.571,386,9</td>
<td>5.172,128,5</td>
<td>43,821,600,0</td>
<td>368,845,6</td>
<td>242,800,00</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>368,845,6</td>
<td>-</td>
<td>2.379,000,0</td>
<td>561,000,0</td>
<td>368,845,6</td>
<td>-</td>
<td>2.379,000,0</td>
<td>561,000,0</td>
<td>368,845,6</td>
<td>-</td>
<td>2.317,021,0</td>
<td>667,500,00</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>62,371,2</td>
<td>242,800,00</td>
<td>62,371,2</td>
<td>242,800,00</td>
<td>62,371,2</td>
<td>242,800,00</td>
<td>62,371,2</td>
<td>242,800,00</td>
<td>62,371,2</td>
<td>242,800,00</td>
<td>62,371,2</td>
<td>242,800,00</td>
<td>62,371,2</td>
<td>242,800,00</td>
</tr>
</tbody>
</table>

= data not available.

Source: Author’s own using national trade statistics of countries.
There was no initiative for integration involving Iran from either side. Instead, the Caspian countries negotiate with each other to increase bilateral trade volumes, frequently expressing their desire to do so during their high-level official meetings.

In addition, a nonpermanent deal on the formation of a free trade zone with Iran was signed on 17 May 2018. The deal determines the principal rules of trade between the EAEU and Iran. Most of the defined rules are similar to those of the WTO, of which Iran is not a member. This legal framework provides an environment for stimulating an increase of the trade volume and economic interactions between both sides according to liberal trading rules. The document sets out the responsibilities and obligations of the signatory parties, aiming to reduce or eliminate the tariffs and nontariff barriers for trading certain goods. The deal also specifies the advantageous customs duty rates applicable to these goods. Both parties agreed on mutual recognition of sanitary and phytosanitary procedures of the exporting state, regardless of differences with its own procedures or those implemented by third parties. The agreement includes the regulations to determine the origin of goods to be involved in the preferential tariff regime. The temporary deal covers half the total trade volume between the sides (Zanganeh 2019). Initially, Iran aims to export about 350 articles to the EAEU and import 180 articles (Azernews 2017). This agreement is expected to promote trade between Iran and the EAEU and demonstrates a positive step towards regional cooperation. Considering that Azerbaijan, Georgia, Turkmenistan, and Uzbekistan are not members of the EAEU, prospects of full regional economic integration seem impossible.

17.4 Delayed Caspian Integration: Obstacles and Possibilities

The period after the Cold War has seen the Caspian countries engage in several integration initiatives such as the regional blocs discussed above. Though Iran did not directly participate in these formations, the country developed close bilateral economic relations with the participating countries. With respect to the post-Soviet states, specifically those in the Caspian region (excluding Iran), the term “integration” refers to two possible variants: a reconstitution-type of integration of the Soviet space under Russian leadership according to its priorities and rules of engagement and the Euro-Atlantic integration orienting toward Western organizations (Pourchot and Stivachtis 2014: 68). In this context, the Caspian states can be grouped into three major categories. The first group, which includes Georgia, officially declared their interest
to join the EU and the North Atlantic Treaty Organization. The second group, which includes the Russian Federation, is interested in Moscow-centered integration. The third group, which may include Iran before the breakdown of the nuclear deal, prefers a more multivector approach that maintains balanced contacts with both Brussels and the Kremlin (Pourchot and Stivachtis 2014: 69).

Comparing the current state of the Caspian basin with the other three Eurasian basin regions—the Mediterranean, Black, and Baltic Seas—the Caspian region is characterized by a lack of depth of integration of social contact and communication, commerce, business, investment, environment, economy, politics, and security (Alieva 2012: 443–444). Considering the location of the Caspian states in the study, it is difficult to identify them as belonging to any particular region on the globe. They are part of different geographical regions at the same time: the South Caucasus, Central Asia, the Middle East, Eurasia (Alieva 2009: 43), and even the wider Black Sea. Especially the Russian Federation, the world’s largest country, extends from the Baltics to the Balkans and the Far East. Moreover, the Caspian basin is a decomposition point and a meeting point of two dominant civilizations: Christianity and Islam. It lies on the dividing and also the uniting line of two continents: Europe and Asia. The absence of a common “Caspian” identity leads to the conclusion that the Caspian Sea divides more than it unifies (Alieva 2009: 43).

The location of the Caspian states in such a large geographical area poses a handicap in terms of social and cultural identity as well as economics. It is impossible to discuss any regional integration of such a great territory given one of its purposes is reducing costs (production, transportation, distribution, etc.). Different economic structures based on different political systems across a wide geography prevent an EU-type of integration in the Caspian region. These differences make difficult to harmonize the rules (EU acquis) and their implementation as required by a regional economic integration, mainly removing technical barriers in trade, expanding trade in services, engaging in regional trade agreements, establishing special economic zones, and facilitating customs clearance and border crossings.

The size of the region allows the EU, Turkey, the PRC, and the United States to be the main external actors and to encourage multilateralism. They are among the top 10 foreign trade partners of the Caspian countries. The EU promotes its relations with the Caspian countries both on the union and member state levels in the context of soft power. On the union level, it uses concrete instruments such as Technical Assistance to the Commonwealth of Independent States, Interstate Oil and Gas Transport to Europe, Transport Corridor Europe Caucasus Asia, a partnership and cooperation agreement, a deep comprehensive free trade area, and an
association agreement, and creates several attractive platforms such as the European Neighbourhood Policy, the Eastern Partnership, and the Central Asia Strategy. Thus, the EU, and Western Europe generally, is attractive for the Caspian countries not only economically, but also in terms of the democratization of their societies. Conversely, some of the biggest Western companies, such as BP, Chevron, ExxonMobil, ENI, Total, and Statoil, are the main contracting parties of the important energy agreements of these countries. Particularly the newly emerged Caspian states prefer to cooperate with developed Western countries because they provide advanced technological opportunities for energy exploration and production and uninterrupted energy incomes. As all Caspian states are energy-producing countries, and their economies are mostly based on oil and natural gas production, they are pushed toward deals with energy-consuming countries. It is possible that in the post-Soviet years the Caspian countries did not have to struggle for rich energy resources, which are usually accepted as a source of instability, but they also could not agree on the legal status of the fossil-rich Caspian Sea for a long time, preventing regional cooperation. Besides, the countering attitudes of the traditional powers of the region—the Russian Federation and Iran—on energy transportation projects of new Caspian states have made Turkey an active player in this regard. As a result, there is a close trilateral Turkey–Georgia–Azerbaijan partnership in the region. Turkey has become an effective economic partner in the Caspian region, with a shift in its policies grounded on emotional links based on ethnic and historical ties to strategic cooperation based on mutual interests. The success of the trilateral cooperation has motivated Turkey to apply the same format in its relations with Kazakhstan and Turkmenistan. Moreover, Georgia was included in the initiative to link the Trans-Caspian pipeline to the EU-supported Southern Gas Corridor, which aims to deliver Turkmen natural gas to Europe.

One of the biggest beneficiaries of the integration gap between the countries in the Caspian region is the PRC. Both the PRC’s attractive trading conditions and the Russian Federation’s geopolitics-based integration have fostered bilateral cooperation between the PRC and the Caspian states. The launch of the Belt and Road Initiative, the PRC’s regional infrastructure project for Eurasia, aims to elevate the PRC’s bilateral relations with the Caspian states to a more comprehensive and multilateral level.

The Central Asia Regional Economic Cooperation (CAREC) program, developed by the Asian Development Bank, is another integration effort to encourage economic cooperation among countries in the Central Asian region. Some of the Caspian countries—Azerbaijan, Georgia, Kazakhstan, Turkmenistan, and Uzbekistan—are parties of the
intergovernmental body, which addresses how to stimulate the economic collaboration in the Central Asian region and along the Silk Road to generate and share beneficial knowledge. CAREC has defined five thematic priorities: economic and financial stability; trade, tourism, and economic corridors; infrastructure and economic connectivity; agriculture and water; and human development. The CAREC Institute acts as a knowledge linker to ensure harmony in planning and application of policies, programs, and projects to encourage regional economic interaction and integration.

The newly emerged Caspian states pose an alternative for Iran. However, Iran’s position in the international community, and its relations with the Western countries, also determine Iran’s distance from these countries. Both the Russian Federation and Iran react to other players in the region with care. Pro-Western energy and energy transportation policies of the Caspian countries, including Georgia’s position as a transit state, have faced rigid opposition by the Russian Federation and Iran on the determination of the legal status of the Caspian Sea. The controversial attitudes of the Russian Federation and Iran on regional conflicts are also an important obstacle to regional integration. The new Caspian states prefer a cautious approach with these two countries based on historical facts, “refusing to join the deeper form of post-Soviet regionalism” (Samokhvalov 2016: 83).

All of the abovementioned shows that the states discussed in this study could not integrate with one another economically in the post-Soviet era. Current global practices demonstrate that economic integration can be achieved as desired by the parties at any time. A “limited” or “core” integration between the Caspian countries is still possible, though not in the form of the EU or USMCA. This argument is based on ongoing political, economic, and financial developments. In particular, a trend in international relations in recent decades is that globalization deepens the intertwining of ties between states (Alimov 2018: 114). While James (1993: 275) argued that the interests of all states are far from common, considering that globalization currently limits states’ ability to solve their problems alone, especially developing states, a trend toward regional integration seems inevitable as it provides an opportunity to solve problems together. Regional integration positively affects the economic growth in countries and lightens the balance-of-payments problems. Further, the collapse of the Soviet Union has left behind an enormous potential for an integrated Eurasian region.

The aim of regional economic integration can be economic or political—both goals are even likely to coexist. However, in the case of integration among developing countries, political reasons remain secondary. Developing countries perceive integration established by developed countries as creating unfair competition for themselves.
Moreover, a large market reduces uncertainty compared to a small market. Resource allocation and low costs can provide more competitive opportunities in a big market (Balkir 2010: 421–422).

The formation of the EU, which is regarded as the best example of integration in the world, started after two devastating wars. The Customs Union between the Russian Federation, Belarus, and Kazakhstan also was established after the global financial crisis of 2008–2010, following a decade of rapid economic growth. Therefore, this situation conflicts with the argument about crises leading to a surge of protectionism, especially when the all cooperating parties are affected simultaneously (Vinokurov and Libman 2014: 341–342).

The 2008 financial crisis, which particularly affected the EU, caused an economic contraction in the member states and slowed trade with the Caspian states. Before the full negative effects of the crisis could be overcome, the decline in oil prices in the world markets stopped the economic growth of the former Soviet countries in the Caspian region. The sanctions imposed against the Russian Federation after the annexation of Crimea, the negative atmosphere created by the Syrian crisis worldwide, and the sanctions imposed against Iran, which already has unstable relations with Western countries, have forced the Caspian countries to enter into closer cooperative relations in the region, leading to various initiatives such as trade in national currencies, reducing the dependence on the United States dollar, and even Iran’s membership in the EAEU.

On the sidelines of the current suitable geopolitical and economic environment, establishing the technical infrastructure is also achievable. The post-Soviet Caspian states have left behind the difficulties of transitioning to a market economy. Their economic growth in the 2000s allowed them to improve their information technology (IT) capacities and resources. Modern IT enables them to complete technical harmonization in a short time. Moreover, including Iran, these countries benefit from several development programs by the EU, the World Bank, CAREC, and the Asian Development Bank, among others. These offer opportunities to take advantage of support projects for regional economic integration.

Considering that the private sectors in the Caspian countries are willing to deepen cooperation in order to minimize the negative effects of the existing international political economy, crisis-driven integration is possible.

In the framework discussed above, the Caspian states still have a good chance at economic integration. First, they can clearly define the areas of economic integration. In fact, the experience of bilateral cooperation between the Caspian states in the post-Soviet era gives
them an advantage in terms of defining their priorities. By matching up the prioritization of areas that can be integrated on the individual level in countries, their common priorities can be determined. The identified common priorities can be a sustainable start for economic integration in the Caspian basin that spreads continuously. The countries can consolidate their stakes. A new joint commission could be established to review the already existing bilateral, trilateral, and multilateral agreements between the countries of the region, and the overlapping areas can be determined for negotiating within a common framework. In this respect, it is possible to act jointly on issues such as trade in goods and services, energy, transportation, tourism, visa facilitation, border transits, customs duties, health, and education, which are already the most prominent cooperation fields on the individual level.

More specifically, a good reference is the European Commission’s White Paper of 1 March 2017, which sets out achievable alternative options for the continuity of the union. Faced with difficulties due to globalization, the effects of technological innovations on societies and employment, security issues, and increasing populism, five priority integration models for the EU to overcome the crisis as a union were published (European Commission 2017):

- Continuing by improving changes
- Focusing only on the Single Market
- Deepening integration only with willing member countries in particular areas
- Achieving less more efficiently in determined policy areas
- Achieving much more together in all policy areas.

These five scenarios offer a hint about how to initiate regional integration in the Caspian basin. In accordance with this five-speed economic integration scenario, the Caspian states can form an integration chain at the stage that suits their interests.

In order to draw a clearer framework for possible economic integration, a good example is the Baku–Tbilisi–Ceyhan (BTC) pipeline project. At the end of the 1990s, the Russian Federation and Iran were described as the main rivals to the development of any pipeline in the region. Turkmenistan also opposed the pipeline because of the disputes about unshareable oil and natural gas deposits. After the successful start of the pipeline operations at the end of the 2000s, Kazakhstan, the Russian Federation, and Turkmenistan began to use the BTC as an alternative for transportation of their oil. Tehran officials also declared their desire to explore the BTC export option for the Southern Caspian oil, though this did not come to fruition due to its commercial unprofitability (Bayramov 2019: 17). Actually, the mutual benefits for the
Caspian states promoted pragmatic cooperation on the BTC, in spite of serious opposition at the beginning.

Another example is the Convention on the Legal Status of the Caspian Sea that was signed at the Fifth Caspian Summit in Aktau, Kazakhstan, on 12 August 2018 by the presidents of Azerbaijan, Iran, Kazakhstan, the Russian Federation, and Turkmenistan. After a long negotiation process, the agreed document is the result mainly of extraregional geopolitical and economic factors that brought the Caspian states together.

Considering the limited economic abilities of the Caspian states, even the lowest level of economic integration will benefit these countries. Recent developments at the global level have helped increase the awareness of Caspian states on this issue. It will be important to implement the correct policy in order to achieve productive results.

17.5 Conclusion

To sum up, after the dissolution of the Soviet Union, the Caspian region seemed mostly to be a conflict arena of state interests and great powers. Ethnic problems, energy issues, and issues surrounding the legal status of the Caspian Sea led to a purely geopolitical perspective on the region, and economic cooperation between the Caspian countries has been shaped by this view. In fact, geopolitics do not create enough conditions for a region’s development or a solution to the economic problems in an increasingly complex contemporary world. The lack of a common Caspian identity based on the region’s geographical, historical, and cultural features demotivates the states toward division. The regional integration initiatives led by the Russian Federation did not achieve the desired results as limited resources for integration were insufficient to fulfill its leadership ambitions. Conversely, fear of Russian domination of the regional partners is one of the great handicaps for regional integration (Makarychev 2011:6). The Russian Federation and Iran’s approach to regional ethnic conflicts arouses suspicion by other small states in the region that are involved in the conflicts. The different political and economic systems of the Caspian states also still pose a serious obstacle for harmonization of common policy implementation. The Caspian states are energy-producing countries (except Georgia), and their economies are highly dependent on energy revenues. These states need energy-consuming countries with stable energy incomes more than each other. This is also a major dividing factor in the region.

However, the latest crises in the region have been followed by pro-integration trends between the Caspian states. It is obviously not realistic to expect an EU-type of integration due to the geographical, historical, political, economic, social, traditional, and cultural realities
of the Caspian basin. And it is also not easy to create a new integration structure in such a divided area, which exists between two economic powers—the EU, one of the best examples of integration in the world and economic giant, on the one hand, and the PRC, the world’s fastest growing and second biggest economy, on the other. The region does still have alternative options for evolving into a cohesive area. Economic relations between the Caspian states on an individual level are noteworthy. By identifying the primary areas in which the countries of the region want to cooperate, a gradual integration within a multispeed structure may be possible. In this context, it will be beneficial to start from the sectors where the Caspian states already cooperate. Cross-checking the ongoing bilateral, trilateral, and multilateral agreements and unifying them under a single structure is a potential first initiative. In this regard, the business communities of the countries in the region can conduct surveys to assess perceptions. By using modern technological facilities and the experiences of cooperation achieved up to today, implementation of technical infrastructure for easy access, customs operations, and standardization of relative trading documents can be harmonized quickly. In fact, the Caspian states are currently cooperating in several of these areas. The main question is how to collect these scattered cooperation areas and organize them under common integration institutions. Such an integration can motivate other states in the region. It can be particularly encouraging in the context of peaceful settlement of ethnic conflicts, one of the biggest problems in the region. It is known that ethnic problems do not benefit the countries of the region and have more destructive economic consequences than national interests.
References


18

Time to Look East: Lessons from Revisiting Asian Economic Integration

Upalat Korwatanasakul

18.1 Introduction

The concept of economic integration was introduced almost a century ago, but its progress has never risen as rapidly as in the last decades. On the one hand, the Association of Southeast Asian Nations (ASEAN) usually represents Asian economic integration due to the importance of its fast-growing economy; its central role in connecting powerful nations such as the People’s Republic of China (PRC), Japan, and the Republic of Korea; and its promising integration progress. However, ASEAN has been criticized heavily for its ineffectiveness in decision-making and problem-solving owing to its rule-by-consensus and noninterference principles. This has convinced many studies to conclude that ASEAN should follow the European Union (EU) model and abandon the ASEAN way. On the other hand, representing the most comprehensive economic integration, the EU has been regarded as the ultimate success in economic integration by many and used as a yardstick to compare with other regional economic or trade blocs. The EU model seemed well-functioning until the eruption of the European debt crisis in 2009 and, more recently, the withdrawal of the United Kingdom (UK), or Brexit, in 2016. These incidents have shaken the credibility of the EU model and called for the attention of other nations that are following the EU model, causing them to think twice.

Against this backdrop, it is more important than ever to revisit economic integration in Asia and Europe to understand the economic and political motivations and implications behind integration. Much research has been conducted on this topic, and what we know so far is that (i) the previous literature focuses only on the progress of East
Asian integration, or even a narrower economic bloc, ASEAN; and (ii) a comprehensive list of economic, political, and social factors leading to different stages of economic integration between Asia and Europe has been given.

As Park, Kim, and Park (2015) put it, “Literally, we could extend the list by adding anything that distinguishes Asia from Europe. As the list gets longer, however, economic integration in Europe increasingly seems as a sui generis phenomenon, without bearing any theoretical implications.” To fill the gap in the literature, this study tries to answer two research questions: What is the current progress of Asian economic integration? And what are the factors that contribute to integration? First, this study comprehensively, but not exhaustively, reviews the true progress of Asian economic integration, not just ASEAN+n. Thus, the scope of the review covers major Asian economic blocs and dialogues, including the Asia Cooperation Dialogue (ACD), ASEAN, the Economic Cooperation Organization (ECO), the Eurasian Economic Union (EAEU), the Gulf Cooperation Council (GCC), the Regional Comprehensive Economic Partnership (RCEP), and the South Asian Association for Regional Cooperation (SAARC), in comparison with the EU. Second, this study argues that the factors proposed in the previous literature—among others, pooled sovereignty; historical reconciliation; common institutions; and heterogeneity in economic, political, and social factors—are perhaps irrelevant in the context of Asian economic integration. Analysis in this area will aid in creating greater understanding of the mechanism and role of economic integration, and in predicting the future movement of regional enlargement in both Asia and Europe.

18.2 Literature Review

After the establishment of the European Economic Community (EEC), a customs union stage of the EU, in 1957, research on economic integration in Europe found its place in the international economics and trade literature (among others, Balassa 1975; Bacon, Godley, and McFarquhar 1978; Molle 1980; Owen 1983; Milward 1984). Nevertheless, it was not until the late 1990s and early 2000s that there was a surge of studies on ASEAN, the EU, and comparison of these two economic blocs. This was due largely to the 1997 Asian financial crisis that drove ASEAN countries to actively work together as an economic bloc, and the adoption of the euro as a common currency in 2002 by the EU. With these two historical events, the literature has primarily focused on identifying the impacts and benefits to each bloc, the differences between the blocs, and the lessons learned, mostly from the EU by ASEAN, and sometimes the other way around. This section offers a comprehensive literature review of
the factors contributing to the different stages of economic and regional integration between Asia and Europe, along with a list of the lessons from the development of the EU and ASEAN.

18.2.1 Factors Leading to the Success of the European Union and the Failure of Economic Integration in Asia

Economic, political, and social heterogeneity. Great heterogeneity and diversity among countries in ASEAN, or Asia in general, have been argued to be a significant factor hindering the process of their regional integration (e.g., Sakakibara and Yamakawa 2003; Blandy 2005; Fong 2005; Langhammer 2007; Zepter 2008; Murray 2010; Plummer 2010). Compared to Europe, Asia is such a complex entity with a lower level of collective regional identity. Different levels of economic development (e.g., Feng and Genna 2003); a variety of legal and political systems; and diverse cultures, religions, and customs (e.g., Moxon-Browne 2008; Mashodo 2015) can be observed throughout the region. This complexity comes with higher transaction and coordination costs, and therefore determines the nature of Asian regional integration (Mashodo 2015), which is starkly different from the European experience.

Pooled sovereignty, historical reconciliation, and common institutions. Baldwin (2011) contends that supranational institutions, usually achieved through sovereignty sharing and historical reconciliation (Cameron 2010; Mashodo 2015), are necessary for deep economic integration. Supranational institutions provide a clear policy framework and legal mechanism. Even though the historical reconciliation between France and Germany granted the success of the EU, Asian regional integration opts to remain shallow and less institutionally designed, but more bilateral and intergovernmental (Berkofsky 2005; Langhammer 2007; Börzel and Risse 2009; Murray 2010; Mashodo 2015). It shows no interest in pooled sovereignty, especially among countries in South Asia and Southeast Asia (Blandy 2005; Fong 2005; Venables, Winters, and Yueh 2007; Cameron 2010; Plummer 2010; Baldwin 2012). It seems that economic and regional integration in Asia is shaped by the political intentions of states mainly to conserve their national identities (Ravenhill 2009; Plummer 2010). Without genuine reconciliation among Asian countries, regional integration seems far-fetched.

Regional leader and power balance. Lack of regional leaders and economic and political power balance also delay the integration process (Baldwin 2007; Venables, Winters, and Yueh 2007; Cameron 2010; Urwin 2014; Mashodo 2015). The driving force behind integration in Europe came largely from France and Germany, which have acted as
the regional leaders since the inception of the EU. Along with the EU enlargement, Italy and the UK came to play a significant role in the power balance, especially in terms of economics. Baldwin (2007) argues that this scenario prevents the emergence of a hegemon and helps promote integration. This is unlikely to be the Asian case, however, where there have been no clear leaders in the region (Baldwin 2012).

**Consensus, tolerance, and internal support.** A consensus approach, together with solidarity and tolerance, is an important mechanism behind the success of the EU (Cameron 2010). This approach prompts all member states to support each other and move forward together without leaving anyone behind. For example, in the 1970s, the EU implemented structural and regional funds to address the problems of less developed economies such as Spain and Portugal. Moreover, in the time of financial crisis, the EU provided a bailout program and significant financial transfers to Cyprus, Greece, Ireland, and Portugal to allow those countries catch up with the norm. It seems obvious that economic reform through internal expenditure programs and balanced economies among the member states are prerequisites for the process of economic integration (Ren and Ma 2007; Das 2009; Mashodo 2015). Although Asian integration is based on a consensus approach, there is no mechanism to level economies among member states. Huge economic gaps and unbalanced economic growth are generally observed in Asia, where monetary and financial cooperation remain weak (Feng and Genna 2003; Kang 2009).

**The role of the United States toward integration and external support.** One factor contributing to the development of the EU was support from the United States (US) in the early stages of European integration (Beeson 2005; Eichengreen 2007; Cameron 2010; Murray 2010; Murray and Orcalli 2012). Apart from the economic benefits created by integration, the EU was a fruit of the exigencies of wartime reconstruction and the Cold War. Therefore, the US played a large role in shaping and supporting the EU. Unlike the experience of the EU, there has been no concrete support from the US in any Asian integration.

### 18.2.2 Reciprocal Lessons from the Development of the Association of Southeast Asian Nations and the European Union

The EU has been characterized as a supranational institution with shared regional sovereignty among its member states. It has clear frameworks and policies for all three pillars: economic, political, and social. Together with an enforceable legal system, this strong institution has delivered stability and prosperity for all three pillars. In terms
of the economic pillar, the EU’s main economic driving forces are its well-developed single market and monetary union that promote free movement of goods, services, capital, and people. These, in turn, help in encouraging competition among member countries and maximizing economic growth and welfare for citizens, while maintaining regional economic and financial stability. To further ensure market efficiency, the EU created regional structural and cohesion funds to support less developed members to close the economic gap among member countries thanks to its principles of solidarity and tolerance. As Asian integration is still in an early stage, it can perhaps benefit from these positive features of the EU model.

Nonetheless, there are shortcomings of the EU model that Asia should be aware of. Its well-established institution came with the cost of losing its flexibility. It has created complex and rigid rules and regulations in several areas, especially in the labor market (Plummer 2006). This has led to economic inefficiencies, as the market cannot quickly adapt to new investment trends and opportunities. Furthermore, additional inefficiencies can be observed in other aspects, including subsidy and expenditure programs such as the Common Agricultural Policy (CAP) that prevents competition in the agriculture sector, and the EU’s preference for regionalism over multilateralism (Capannelli and Filippini 2010). The preference for regionalism causes the EU to be overly protected and to narrow its possibilities for being more integrated into global value chains.

In contrast, the EU may be able to learn from the ASEAN integration model. ASEAN is based on the noninterference principle and a consensus decision-making approach. Compared to the EU, ASEAN, or Asia in general, is relatively flexible due to its light and liquid mechanisms (Pascha 2004). It can promptly respond to, and therefore benefit from, the world market. Moreover, economic integration in Asia is market-driven and largely shaped by the private sector. This is evidenced by the complex regional production networks and trade patterns (Capannelli and Filippini 2010). Therefore, intraregional movements of inputs, labor, investment, and technologies have risen significantly over time. These movements further induce less developed economies to catch up with more developed ones through the transmission of technology, industrial development, and economic growth. However, without clear rules and regulations, the progress of the integration can be hindered when member states do not follow agreed commitments and principles. Table 18.1 summarizes the reciprocal lessons from the development of ASEAN and the EU.
### Table 18.1: Reciprocal Lessons from the Development of ASEAN and the EU

<table>
<thead>
<tr>
<th>Areas</th>
<th>From Europe for ASEAN</th>
<th>From ASEAN for Europe</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic governance</td>
<td>Backbone of economic laws and good market governance (+)</td>
<td>Pragmatism, flexibility, and adaptability to changing global and regional economic environment (including labor market flexibility) (+)</td>
</tr>
<tr>
<td></td>
<td>Clear definition of powers among institutions (+)</td>
<td>No clear rules and legal system to control or punish member states (−)</td>
</tr>
<tr>
<td></td>
<td>Clear rules for budget proportional contributions (+)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Rigidity, especially in the labor market (slow change), and overly complex rules and regulations (−)</td>
<td></td>
</tr>
<tr>
<td>Economic policy</td>
<td>Regional structural and cohesion funds (+)</td>
<td>Transmission of industrial development and economic growth from advanced to developing economies (+)</td>
</tr>
<tr>
<td></td>
<td>Regional exchange rate mechanism and the introduction of the euro (+)</td>
<td>Market-driven economic dynamism and interdependence (open regionalism, focus on productivity and competitiveness) (+)</td>
</tr>
<tr>
<td></td>
<td>Subsidies (e.g., Common Agricultural Policy) which hinder competition (−)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Expenditure programs to buy off opponents of integration (−)</td>
<td></td>
</tr>
<tr>
<td>Organizational principles</td>
<td>Sharing regional sovereignty (+/−) Subsidiarity (+/−)</td>
<td>Light institutions (+/−)</td>
</tr>
<tr>
<td></td>
<td>Small-country and minority bias in decision-making and voting mechanisms (−)</td>
<td>Noninterference principle and consensus decision-making (ASEAN Way) (+/−)</td>
</tr>
<tr>
<td></td>
<td>Peer pressure to create healthy competition among members (+)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Preferring regionalism to multilateralism when the latter is possible (−)</td>
<td></td>
</tr>
</tbody>
</table>

ASEAN = Association of Southeast Asian Nations, EU = European Union.
Note: (+) indicates a good or positive lesson; (−) indicates a bad or negative lesson.
Source: Author’s compilation based on Blandy (2005), Plummer (2006), Capannelli and Filippini (2010), and Mashodo (2015).

In conclusion, what we know so far is the following.
(i) The previous literature has intensively studied the impacts and benefits of ASEAN and the EU, differences between these economic blocs, and the reciprocal lessons from the
development of ASEAN and the EU. However, studies of other Asian economic blocs and dialogues have been marginalized, and comprehensive studies of the overall Asian integration, not just ASEAN+n, are rarely found.

(ii) The reciprocal lessons from ASEAN and the EU suggest that the EU should be more flexible and market-driven, while ASEAN should be more institutionalized and law-based.

(iii) Factors including a) economic, political, and social heterogeneity; b) pooled sovereignty, historical reconciliation, and common institutions; c) regional leader and power balance; d) consensus, tolerance, and internal support; and e) the role of the US toward integration and external support contribute to the success of the EU and the failure of Asian integration.

Nevertheless, these proposed factors may not necessarily hold true under the current economic context, where the credibility of the EU has been shaken but the rise of Asia can be observed. Revisiting economic integration in Asia and Europe may offer different results, interpretations, and policy implications. This study therefore presents a comprehensive analysis of Asian economic integration covering major Asian economic blocs and dialogues, including the ACD, ASEAN, the ECO, the EAEU, the GCC, RCEP, and SAARC, and contrasting them with the EU experience in order to address the aforementioned gaps and limitations in the previous literature.

18.3 Brief Overview of Economic Integration in Asia and Europe

A phenomenon known as the “noodle bowl effect” is a good description of the characteristics of Asian economic integration. As no clear regional leaders and no common economic institutions have been observed in Asia, countries are likely to adopt pro-free trade agreement (FTA) policies and create multiple trade blocs within the region. This section gives a brief overview of the major trade blocs and dialogues in Asia, together with the EU. Table 18.2 shows the stages of economic integration of the EU and selected Asian economic blocs and dialogues. Some of the economic blocs in Asia, such as the GCC and the EAEU, are in the process of transition toward full economic and monetary union equivalent to the EU, while others—the ACD, ASEAN, the ECO, RCEP, and SAARC—are aiming for looser economic ties, such as FTAs and common or single markets.
Asia Cooperation Dialogue (ACD). The ACD was established in June 2002 with the organization of the first continent-wide forum in which 18 foreign ministers from the founding member states participated. In 2016, Nepal was the last country to join the ACD, making 34 member countries. The aims and purposes of the ACD are mainly concentrated on economic cooperation and facilitation. This continent-wide dialogue makes the ACD the largest economic dialogue in the world in terms of area (46 million square kilometers), population (4.4 billion), economic size ($29.3 trillion of gross domestic product [GDP]), and trade volume ($15.1 trillion). However, its regional cooperation remains rather informal and at a minimal level.

Association of Southeast Asian Nations (ASEAN). ASEAN was inaugurated in 1967, when the five founding countries—Indonesia, Malaysia, the Philippines, Singapore, and Thailand—got together to sign the ASEAN Declaration (Bangkok Declaration). Currently, ASEAN

Table 18.2: Stages of Economic Integration of the EU and Selected Asian Economic Blocs

<table>
<thead>
<tr>
<th>Stages of Economic Integration</th>
<th>Dialogue</th>
<th>Free Trade Agreement</th>
<th>Customs Union</th>
<th>Common/Single Market</th>
<th>Economic Union</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zero tariffs within trade bloc</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Common external tariff</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Free movement of capital and labor and some policy harmonization</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common economic policies and institutions</td>
<td>Yes</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Current economic integration  
ACD, ECO  SAARC, RCEP  ASEAN  EAEU, GCC, EU

ACD = Asia Cooperation Dialogue, ASEAN = Association of Southeast Asian Nations, EAEU = Eurasian Economic Union, ECO = Economic Cooperation Organization, EU = European Union, GCC = Gulf Cooperation Council, RCEP = Regional Comprehensive Economic Partnership, SAARC = South Asian Association for Regional Cooperation.

Notes:
  
a RCEP is expected to be concluded in 2019.
b ASEAN does not have the characteristics of a customs union and no common external tariff regime. It is expected to finalize its agreements on a single market by 2025.
c The EAEU and the GCC are in the process of transition toward full economic and monetary union.
d The EU is both an economic and a monetary union.

Source: Author’s compilation.
comprises 10 countries: the five founders, plus five newcomers—Brunei Darussalam, Cambodia, the Lao People’s Democratic Republic, Myanmar, and Viet Nam. ASEAN aims to consolidate the three principal pillars of economic, political, and social cooperation among the member states. ASEAN played a central role in economic integration in Asia, especially East Asia. ASEAN has featured major economic dialogues and FTAs, including ASEAN-PRC, ASEAN-Japan, ASEAN-Republic of Korea, ASEAN+3, ASEAN+6, and RCEP. The central role of ASEAN, coupled with its large market (a population of 647 million) and economy ($2.8 trillion of GDP), has attracted trade and investment attention from countries around the world. By 2025, ASEAN is aiming to launch its single market. This will promote its intraregional trade and attract more foreign direct investment (FDI).

Economic Cooperation Organization (ECO). The ECO is an intergovernmental organization to promote sustainable economic development of its member states and the region as a whole. It was formally established in 1985 with three founders—Iran, Pakistan, and Turkey—and currently includes 10 countries. The ECO focused mostly on bilateral agreements between member countries rather than a regional FTA. Its progress in economic and regional cooperation is quite slow, with a limited market and economy size. Nevertheless, recently the ECO has put more efforts on its regional FTA and aims to conclude it by 2025.

Eurasian Economic Union (EAEU). The EAEU was established as an international organization for regional economic integration in 1995 by five countries located in Central Asia, Western Asia, and Northern Asia. Even though the EAEU’s market size and economy are rather small compared with those of other Asian economic blocs, it is the most advanced economic integration in Asia. It created a single market in 2000 and is currently in transition to a full economic and monetary union.

Gulf Cooperation Council (GCC). The GCC was established with the signing of the GCC Charter in 1981. The GCC comprises six member states located on the Arabian Peninsula in Western Asia. The objective of the GCC is to strengthen regional cooperation in a wide range of perspectives, including economic and financial affairs; commerce, customs, and communications; and social and health affairs. Similar to the EAEU, a single market was achieved in 2008, while it aims to establish an economic union in the near future.

Regional Comprehensive Economic Partnership (RCEP). RCEP is the most recent FTA initiative in Asia and was proposed by ASEAN countries plus six other countries—Australia, India, Japan, the PRC, the Republic of Korea, and New Zealand. The negotiation has been ongoing
since 2012 and is expected to be concluded by the end of 2020. RCEP will become the world’s largest economic bloc, accounting for virtually half of the global economy ($25.6 trillion) with a market of 3.6 billion people, and total trade worth $12.5 trillion.

**South Asian Association for Regional Cooperation (SAARC).** SAARC was established in 1985 with the signing of the SAARC Charter by the seven founding members—Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka. Afghanistan joined in 2005, forming the eight member states of SAARC. As set out in the Charter, the aim of SAARC is to develop economic, political, and social cooperation among member states. The level of economic cooperation is kept to a minimum, comprising an FTA. Nevertheless, there is a large potential market within SAARC, as the region comprises a population of 1.8 billion.

**European Union (EU).** The EU was established as the European Coal and Steel Community (ECSC) in 1951 by Belgium, France, Germany, Italy, Luxembourg, and the Netherlands. It became a common market known as the EEC in 1957. The EU launched its single market in 1993 and reached the highest economic integration, economic and monetary union, in 2002. Currently, the EU comprises 28 member states. The EU’s economic integration is believed to have a positive impact on trade flows and economic development, and spillover effects among the member states (Mashodo 2015). The EU is important in terms of its market size (512 million people), covering 7% of the global population; its large economy ($17.3 trillion) accounting for 25% of global nominal GDP; and its high trade volume ($15.2 trillion).

Table 18.3 summarizes the basic statistics, historical background, and objectives of the economic blocs and dialogues discussed.

### 18.4 Evaluating Potential Economic and Trade Integration

This section first summarizes the overall economic trends among economic blocs in Asia compared with those of the EU. Figure 18.1 shows where the Asian economic blocs stand on the EU’s economic development path, measured by GDP per capita (in terms of purchasing power parity, or PPP) over time. Except for the GCC, all Asian blocs are far behind the EU and show large variation among blocs. In 2017, SAARC was the least developed bloc with $6,579 of GDP per capita. Its current economic development is roughly equivalent to that of the EU in 1952. In other words, SAARC’s economic development is approximately 65 years behind that of the EU. The other Asian economic blocs need at least 15–40 years to catch up with the EU.
Table 18.3: Comprehensive Summary of the Selected Economic Blocs and Dialogues in Asia and Europe

<table>
<thead>
<tr>
<th>Economic Bloc or Dialogue</th>
<th>Asia Cooperation Dialogue (ACD)</th>
<th>Association of Southeast Asian Nations (ASEAN)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year of establishment</td>
<td>2002</td>
<td>1967</td>
</tr>
<tr>
<td>Stage of development</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dialogue</td>
<td>2002</td>
<td>1967</td>
</tr>
<tr>
<td>Free trade agreement</td>
<td></td>
<td>1992</td>
</tr>
<tr>
<td>Customs union</td>
<td>–</td>
<td></td>
</tr>
<tr>
<td>Common market/Single market</td>
<td></td>
<td>2025</td>
</tr>
<tr>
<td>Economic union</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Member states</td>
<td>34</td>
<td>10</td>
</tr>
<tr>
<td>Afghanistan, Bahrain, Bangladesh, Bhutan, Brunei Darussalam, Cambodia, PRC, India, Indonesia, Iran, Japan, Kazakhstan, Republic of Korea, Kuwait, Kyrgyz Republic, Lao PDR, Malaysia, Mongolia, Myanmar, Nepal, Oman, Pakistan, Philippines, Qatar, Russian Federation, Saudi Arabia, Singapore, Sri Lanka, Tajikistan, Thailand, Turkey, United Arab Emirates, Uzbekistan, Viet Nam</td>
<td>Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, Viet Nam</td>
<td></td>
</tr>
<tr>
<td>Headquarters</td>
<td>Kuwait City, Kuwait</td>
<td>Jakarta, Indonesia</td>
</tr>
<tr>
<td>Area (km²)</td>
<td>46,944,946</td>
<td>4,489,194</td>
</tr>
<tr>
<td>Population (million, 2017)</td>
<td>4,430</td>
<td>647</td>
</tr>
<tr>
<td>GDP (PPP) ($ trillion, 2017)</td>
<td>62.3</td>
<td>7.9</td>
</tr>
<tr>
<td>GDP per capita (PPP) ($, 2017)</td>
<td>14,061</td>
<td>12,279</td>
</tr>
<tr>
<td>GDP (nominal) ($ trillion, 2017)</td>
<td>29.3</td>
<td>2.8</td>
</tr>
<tr>
<td>GDP (nominal) per capita ($, 2017)</td>
<td>6,621</td>
<td>4,271</td>
</tr>
<tr>
<td>Total trade ($ trillion, 2017)</td>
<td>15.1</td>
<td>3.2</td>
</tr>
<tr>
<td>Objectives</td>
<td>1. To promote interdependence among Asian countries in all areas of cooperation by identifying Asia’s common strengths and opportunities which will help reduce poverty and improve the quality of life for Asian people whilst developing a knowledge-based society within Asia and enhancing community and people empowerment.</td>
<td>1. To accelerate economic growth, social progress, and cultural development in the region through joint endeavors in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of Southeast Asian nations.</td>
</tr>
</tbody>
</table>

continued on next page
2. To expand the trade and financial market within Asia and increase the bargaining power of Asian countries in lieu of competition and, in turn, enhance Asia’s economic competitiveness in the global market.

3. To serve as the missing link in Asian cooperation by building upon Asia’s potential and strengths through supplementing and complementing existing cooperative frameworks so as to become a viable partner for other regions.

4. To ultimately transform the Asian continent into an Asian Community, capable of interacting with the rest of the world on a more equal footing and contributing more positively to mutual peace and prosperity.

2. To promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries of the region and adherence to the principles of the United Nations Charter.

3. To promote active collaboration and mutual assistance on matters of common interest in the economic, social, cultural, technical, scientific, and administrative fields.

4. To provide assistance to each other in the form of training and research facilities in the educational, professional, technical, and administrative spheres.

5. To collaborate more effectively for greater utilization of agriculture and industries; the expansion of trade, including the study of the problems of international commodity trade; the improvement of transportation and communications facilities; and raising the living standards of their peoples.

6. To promote Southeast Asian studies.

7. To maintain close and beneficial cooperation with existing international and regional organizations with similar aims and purposes, and explore all avenues for even closer cooperation among themselves.

<table>
<thead>
<tr>
<th>Economic Bloc or Dialogue</th>
<th>Asia Cooperation Dialogue (ACD)</th>
<th>Association of Southeast Asian Nations (ASEAN)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2. To expand the trade and financial market within Asia and increase the bargaining power of Asian countries in lieu of competition and, in turn, enhance Asia’s economic competitiveness in the global market.</td>
<td>2. To promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries of the region and adherence to the principles of the United Nations Charter.</td>
</tr>
<tr>
<td></td>
<td>3. To serve as the missing link in Asian cooperation by building upon Asia’s potential and strengths through supplementing and complementing existing cooperative frameworks so as to become a viable partner for other regions.</td>
<td>3. To promote active collaboration and mutual assistance on matters of common interest in the economic, social, cultural, technical, scientific, and administrative fields.</td>
</tr>
<tr>
<td></td>
<td>4. To ultimately transform the Asian continent into an Asian Community, capable of interacting with the rest of the world on a more equal footing and contributing more positively to mutual peace and prosperity.</td>
<td>4. To provide assistance to each other in the form of training and research facilities in the educational, professional, technical, and administrative spheres.</td>
</tr>
<tr>
<td></td>
<td>5. To collaborate more effectively for greater utilization of agriculture and industries; the expansion of trade, including the study of the problems of international commodity trade; the improvement of transportation and communications facilities; and raising the living standards of their peoples.</td>
<td>5. To collaborate more effectively for greater utilization of agriculture and industries; the expansion of trade, including the study of the problems of international commodity trade; the improvement of transportation and communications facilities; and raising the living standards of their peoples.</td>
</tr>
<tr>
<td></td>
<td>6. To promote Southeast Asian studies.</td>
<td>6. To promote Southeast Asian studies.</td>
</tr>
<tr>
<td></td>
<td>7. To maintain close and beneficial cooperation with existing international and regional organizations with similar aims and purposes, and explore all avenues for even closer cooperation among themselves.</td>
<td>7. To maintain close and beneficial cooperation with existing international and regional organizations with similar aims and purposes, and explore all avenues for even closer cooperation among themselves.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Economic Bloc or Dialogue</th>
<th>Eurasian Economic Union (EAEU)</th>
<th>Economic Cooperation Organization (ECO)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year of establishment</td>
<td>1995</td>
<td>1985</td>
</tr>
<tr>
<td>Stage of development</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dialogue</td>
<td>–</td>
<td>1985</td>
</tr>
<tr>
<td>Free trade agreement</td>
<td>–</td>
<td>2025</td>
</tr>
<tr>
<td>Customs union</td>
<td>1995/1999</td>
<td></td>
</tr>
<tr>
<td>Common market/Single market</td>
<td>2000</td>
<td></td>
</tr>
<tr>
<td>Economic union</td>
<td>2014</td>
<td></td>
</tr>
</tbody>
</table>

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Table 18.3  continued

<table>
<thead>
<tr>
<th>Economic Bloc or Dialogue</th>
<th>Eurasian Economic Union (EAEU)</th>
<th>Economic Cooperation Organization (ECO)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Member states</td>
<td>Armenia, Belarus, Kazakhstan,</td>
<td>Afghanistan, Azerbaijan, Iran,</td>
</tr>
<tr>
<td></td>
<td>Kyrgyz Republic, Russian Federation</td>
<td>Kazakhstan, Kyrgyz Republic, Pakistan, Tajikistan, Turkey, Turkmenistan, Uzbekistan</td>
</tr>
<tr>
<td>Headquarters</td>
<td>Moscow, Russian Federation</td>
<td>Tehran, Iran</td>
</tr>
<tr>
<td>Area (km²)</td>
<td>20,260,442</td>
<td>8,067,792</td>
</tr>
<tr>
<td>Population (million, 2017)</td>
<td>181</td>
<td>476</td>
</tr>
<tr>
<td>GDP (PPP) ($ trillion, 2017)</td>
<td>4.5</td>
<td>6.1</td>
</tr>
<tr>
<td>GDP per capita (PPP) ($)</td>
<td>24,795</td>
<td>12,922</td>
</tr>
<tr>
<td>GDP (nominal) ($ trillion, 2017)</td>
<td>1.8</td>
<td>1.9</td>
</tr>
<tr>
<td>GDP (nominal) per capita ($, 2017)</td>
<td>10,018</td>
<td>4,071</td>
</tr>
<tr>
<td>Total trade ($ trillion, 2017)</td>
<td>0.93</td>
<td>0.97</td>
</tr>
<tr>
<td>Objectives</td>
<td>1. To develop a full-scale customs union and common economic space.</td>
<td>To promote sustainable economic development of its member states and the region as a whole.</td>
</tr>
<tr>
<td></td>
<td>2. To collaborate their efforts to gain admission to the World Trade Organization.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3. To harmonize customs tariffs.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>4. To develop common guidelines on border security.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>European Union (EU)</th>
<th>Gulf Cooperation Council (GCC)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year of establishment</td>
<td>1950</td>
</tr>
<tr>
<td>Stage of development</td>
<td></td>
</tr>
<tr>
<td>Dialogue</td>
<td>1950</td>
</tr>
<tr>
<td>Free trade agreement</td>
<td>–</td>
</tr>
<tr>
<td>Customs union</td>
<td>1957</td>
</tr>
<tr>
<td>Economic union</td>
<td>2002</td>
</tr>
<tr>
<td>Member states</td>
<td>28</td>
</tr>
<tr>
<td></td>
<td>Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, United Kingdom</td>
</tr>
</tbody>
</table>

continued on next page
**Table 18.3 continued**

<table>
<thead>
<tr>
<th></th>
<th>European Union (EU)</th>
<th>Gulf Cooperation Council (GCC)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Headquarters</td>
<td>Brussels, Belgium</td>
<td>Riyadh, Saudi Arabia</td>
</tr>
<tr>
<td>Area (km²)</td>
<td>4,384,318</td>
<td>2,572,998</td>
</tr>
<tr>
<td>Population (million, 2017)</td>
<td>512</td>
<td>55</td>
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<tr>
<td>GDP (PPP) ($ trillion, 2017)</td>
<td>21.8</td>
<td>3.4</td>
</tr>
<tr>
<td>GDP per capita (PPP) ($)</td>
<td>42,517</td>
<td>61,033</td>
</tr>
<tr>
<td>GDP (nominal) ($ trillion, 2017)</td>
<td>17.3</td>
<td>1.5</td>
</tr>
<tr>
<td>GDP (nominal) per capita ($)</td>
<td>33,836</td>
<td>26,476</td>
</tr>
<tr>
<td>Total trade ($ trillion, 2017)</td>
<td>15.2</td>
<td>1.5</td>
</tr>
</tbody>
</table>

**Objectives**

1. To promote peace, its values, and the well-being of its citizens.
2. To offer freedom, security, and justice without internal borders.
3. To promote sustainable development based on balanced economic growth and price stability, a highly competitive market economy with full employment and social progress, and environmental protection.
4. To combat social exclusion and discrimination.
5. To promote scientific and technological progress.
6. To enhance economic, social, and territorial cohesion and solidarity among EU countries.
7. To respect its rich cultural and linguistic diversity.
8. To establish an economic and monetary union whose currency is the euro.

1. To effect coordination, integration, and interconnection between member states in all fields in order to achieve unity between them.
2. To deepen and strengthen relations, links, and areas of cooperation prevailing between their peoples in various fields.
3. To formulate similar regulations in various fields including the following:
   3A. Economic and financial affairs.
   3B. Commerce, customs, and communications.
   3C. Education and culture.
   3D. Social and health affairs.
   3E. Information and tourism.
   3F. Legislative and administrative affairs.
4. To stimulate scientific and technological progress in the fields of industry, mining, agriculture, water, and animal resources:
   - to establish scientific research:
   - to establish joint ventures and encourage cooperation by the private sector for the good of their peoples.

<table>
<thead>
<tr>
<th>Year of establishment</th>
<th>Regional Comprehensive Economic Partnership (RCEP)</th>
<th>South Asian Association for Regional Cooperation (SAARC)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2012</td>
<td>1985</td>
</tr>
<tr>
<td>Stage of development</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dialogue</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Free trade agreement</td>
<td>2019/2020</td>
<td>1985</td>
</tr>
<tr>
<td>Customs union</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common market/ Single market</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Economic union</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*continued on next page*
Table 18.3  continued

<table>
<thead>
<tr>
<th>Member states</th>
<th>Regional Comprehensive Economic Partnership (RCEP)</th>
<th>South Asian Association for Regional Cooperation (SAARC)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia, Brunei Darussalam, Cambodia, PRC, India, Indonesia, Japan, Republic of Korea, Lao PDR, Malaysia, Myanmar, New Zealand, Philippines, Singapore, Thailand, Viet Nam</td>
<td>Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka</td>
<td></td>
</tr>
<tr>
<td>Headquarters</td>
<td>N/A</td>
<td>Kathmandu, Nepal</td>
</tr>
<tr>
<td>Area (km²)</td>
<td>25,826,602</td>
<td>5,135,333</td>
</tr>
<tr>
<td>Population (million, 2017)</td>
<td>3,581</td>
<td>1,788</td>
</tr>
<tr>
<td>GDP (PPP) ($ trillion, 2017)</td>
<td>49.6</td>
<td>11.8</td>
</tr>
<tr>
<td>GDP per capita (PPP) ($, 2017)</td>
<td>13,863</td>
<td>6,579</td>
</tr>
<tr>
<td>GDP (nominal) ($) trillion, 2017</td>
<td>25.6</td>
<td>3.3</td>
</tr>
<tr>
<td>GDP (nominal) per capita ($) 2017</td>
<td>7,145</td>
<td>1,870</td>
</tr>
<tr>
<td>Total trade ($ trillion, 2017)</td>
<td>12.5</td>
<td>1.3</td>
</tr>
<tr>
<td>Objectives</td>
<td>To achieve a modern, comprehensive, high-quality, and mutually beneficial economic partnership agreement among the ASEAN member states and ASEAN’s FTA partners.</td>
<td>1. To promote the welfare of the peoples of South Asia and improve their quality of life.</td>
</tr>
<tr>
<td></td>
<td>2. To accelerate economic growth, social progress, and cultural development in the region by providing all individuals the opportunity to live in dignity and realize their full potential.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3. To promote and strengthen collective self-reliance among the countries of South Asia.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>4. To contribute to mutual trust, understanding, and appreciation of one another’s problems.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>5. To promote active collaboration and mutual assistance in the economic, social, cultural, technical, and scientific fields.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>6. To strengthen cooperation with other developing countries.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>7. To strengthen cooperation among themselves in international forums on matters of common interest.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>8. To cooperate with international and regional organizations with similar aims and purposes.</td>
<td></td>
</tr>
</tbody>
</table>

FTA = free trade agreement, Lao PDR = Lao People’s Democratic Republic, PPP = purchasing power parity, PRC = People’s Republic of China.

Source: Author’s compilation based on World Bank Open Data (https://data.worldbank.org/) and the official websites of each economic bloc and dialogue.
However, the integration time frame of each bloc differs considerably. While some blocs, such as the EU and ASEAN, have a much longer history, some—the ACD, the EAEU, among others—are relatively new. Table 18.4 displays the average GDP per capita (PPP) by different time periods constructed from each bloc’s year of establishment or year of major change. There are four time periods: 1957–1966, 1967–1985, 1986–1997, and 1998–2017. Depending on the economic bloc, these time periods correspond to different integration periods. For example, the first integration period (Period 1) of the EU corresponds to the time period 1967–1985, whereas Period 1 for the ACD corresponds to 1998–2017. Figure 18.2 presents the average GDP per capita (PPP) by integration period (Periods 1–4). The EAEU and the GCC showed greater performance than the EU in Period 1, while ASEAN, the ECO, SAARC, and the ACD lagged behind. In Period 2, economic development in the Asian blocs gradually converged toward

Figure 18.1: GDP per Capita (PPP) in 2017 of Asian Economic Blocs on the EU’s Economic Development Path, 1960–2017 ($)

ACD = Asia Cooperation Dialogue, ASEAN = Association of Southeast Asian Nations, EAEU = Eurasian Economic Union, ECO = Economic Cooperation Organization, EU = European Union, GCC = Gulf Cooperation Council, GDP = gross domestic product, PPP = purchasing power parity, RCEP = Regional Comprehensive Economic Partnership, SAARC = South Asian Association for Regional Cooperation.

Source: Author’s calculation and compilation based on Penn World Table 9.1 and World Bank Open Data (https://data.worldbank.org/).
Table 18.4: Average GDP per Capita (PPP) of the Selected Economic Blocs and Dialogues in Asia and Europe, 1957–2017 ($)

<table>
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<tr>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia Cooperation Dialogue (ACD)</td>
<td>8,163</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eurasian Economic Union (EAEU)</td>
<td></td>
<td>16,251</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Economic Cooperation Organization (ECO)</td>
<td>4,937</td>
<td>8,917</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gulf Cooperation Council (GCC)</td>
<td></td>
<td>24,370</td>
<td>43,602</td>
<td></td>
</tr>
<tr>
<td>South Asian Association for Regional Cooperation (SAARC)</td>
<td>1,514</td>
<td>3,582</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Association of Southeast Asian Nations (ASEAN)</td>
<td>2,478</td>
<td>3,619</td>
<td>6,734</td>
<td></td>
</tr>
<tr>
<td>European Union (EU)</td>
<td>9,699</td>
<td>16,937</td>
<td>23,336</td>
<td>31,368</td>
</tr>
</tbody>
</table>

GDP = gross domestic product, PPP = purchasing power parity.

Source: Author’s calculation and compilation based on Penn World Table 9.1.

Figure 18.2: Average GDP per Capita (PPP) by Economic Integration Period ($)

ACD = Asia Cooperation Dialogue; ASEAN = Association of Southeast Asian Nations; EAEU = Eurasian Economic Union; ECO = Economic Cooperation Organization; EU = European Union; GCC = Gulf Cooperation Council; GDP = gross domestic product, PPP = purchasing power parity; RCEP = Regional Comprehensive Economic Partnership; SAARC = South Asian Association for Regional Cooperation.

Note:
Period 4: 1998–2017 for the EU.

Source: Author’s calculation and compilation based on Penn World Table 9.1.
that in the EU. With a slow pace of economic development, it is difficult for ASEAN and the other blocs to follow the EU in the next period of their integration. ASEAN’s growth miracle has slowed down and the Asian financial crisis has shaken confidence not just in ASEAN, but also in the other Asian blocs. Currently, ASEAN is making its fullest efforts to realize its single market and RCEP, with the hope of boosting the regional economy through trade and financial intensification.

Figure 18.3 shows the total intraregional trade volume of economic blocs and dialogues in Asia and Europe. The overall intraregional trade volume has increased over time and reached its peak in 2008. The drop observed in the trade volume is systemic due to the global financial crisis in 2007. Nonetheless, it seems the EU was hit harder than other economic blocs, as a relatively large drop in the intraregional trade volume of the EU can be observed. Thanks to a well-developed intraregional production network, ASEAN has higher intraregional trade volume than the other blocs with a similar number of member countries.

Figure 18.3: Total Intraregional Trade Volume
($ trillion)

ACD = Asia Cooperation Dialogue, ASEAN = Association of Southeast Asian Nations, EAEU = Eurasian Economic Union, ECO = Economic Cooperation Organization, EU = European Union, GCC = Gulf Cooperation Council, RCEP = Regional Comprehensive Economic Partnership, SAARC = South Asian Association for Regional Cooperation.

Source: Author’s calculation and compilation based on International Monetary Fund, Direction of Trade Statistics.
Furthermore, to succinctly measure trade and market integration, three main indicators—namely intraregional trade openness (IT Openness), intraregional trade share (IT Share), and intraregional trade intensity (IT Intensity)—are presented in this section, along with a discussion of each indicator. IT Openness is an indicator of the relative importance of intraregional trade in the economy of an economic bloc. The IT Openness of region $i$ is defined as

$$IT\ Openness_i = \frac{(X_{ii} + M_{ii})}{(GDP_i)}$$  (1)

where $X_{ii}$ is intraregional exports of region $i$, $M_{ii}$ refers to intraregional imports of region $i$, and $GDP_i$ represents total gross domestic product (GDP) of region $i$.

As shown in Figure 18.4, overall IT Openness increased before the global financial crisis (before 2008). The IT Openness of ASEAN outperforms that of the ACD and RCEP, and is second only to the EU.
(on average, 8% lower). With the much larger EU, ACD, and RCEP blocs being around 39%, 22%, and 19% respectively, the IT Openness for ASEAN of 27% suggests a comparatively very high level of intraregional integration. In contrast, the IT Openness of the EAEU, the ECO, the GCC, and SAARC remains at a very low level over time, both before and after the crisis. After the crisis, ASEAN’s IT Openness dropped sharply and levelled off thereafter. However, its IT Openness remains at a high level relative to other blocs (approximately 25%).

IT Share is commonly used to measure regional interdependence. By comparing the relative importance of intraregional and external trade dependence, the IT Share comes with one caveat, that a higher IT share implies a lower extra-regional trade share (less global integration). This may not be a desirable property; therefore, the IT Share should be interpreted cautiously. The IT share of region $i$ is defined as

$$IT \ Share_i = \frac{(X_{ii} + M_{ii})}{(X_i + M_i)}$$ (2)

where $X_{ii}$ refers to intraregional exports of region $i$, while $M_{ii}$ refers to intraregional imports of region $i$. $X_i$ represents total exports of region $i$, whereas $M_i$ represents total imports of region $i$.

In general, the IT Share of several trade blocs remains constant over time (Figure 18.5). ASEAN and the World Bank (2013) explain that this stagnation in IT Share comes from the contrasting trends of imports, exports, and overall trade at the country and sectoral levels. The EAEU, the ECO, the GCC, and SAARC indicate a low level of intraregional interdependence, roughly only 10%. While ASEAN’s IT Share is moderate at 24%, the shares for the ACD and RCEP have gradually increased and account for almost half of the total trade of the regions. However, the shares are still lower than that of the EU by approximately 20%.

Figure 18.6 presents the long-term trend of IT Intensity. This index measures a degree of intraregional interdependence, given the region’s importance in world trade. Therefore, the index is less size-dependent and more internationally comparable than IT Share (ASEAN and World Bank 2013). The IT Intensity of region $i$ is defined as

$$IT \ Intensity_i = \frac{(X_{ii} + M_{ii})}{(X_i + M_i)} \frac{(X_i + M_i)}{(X_{ii} + M_{ii})} = \frac{IT \ Share_i}{IT \ Share_i}$$ (3)

where $X_i$ refers to total exports of region $i$ to the world, while $M_i$ refers to total imports of region $i$ from the world. $X_{ii}$ represents total world exports, whereas $M_{ii}$ represents total world imports.
ACD = Asia Cooperation Dialogue, ASEAN = Association of Southeast Asian Nations, EAEU = Eurasian Economic Union, ECO = Economic Cooperation Organization, EU = European Union, GCC = Gulf Cooperation Council, RCEP = Regional Comprehensive Economic Partnership, SAARC = South Asian Association for Regional Cooperation.

Source: Author’s calculation and compilation based on International Monetary Fund, Direction of Trade Statistics.
Regarding IT Intensity, there are mixed trends among different economic blocs. First, the IT Intensity of the ACD, the EU, and RCEP is constant at 2% over time. This indicates that intraregional trade and the region’s importance in world trade are well balanced, since the IT Share and the share in world trade increase proportionally. These blocs have not sacrificed their intraregional trade to increase their share in world trade, or vice versa. According to Kunimoto (1977), these blocs are close to geographical neutrality, or the absence of trading bias. The second trend is the declining IT Intensity of ASEAN and SAARC. However, the trend of ASEAN’s IT Intensity is different from that of SAARC. The IT Intensity in ASEAN had been rising until 2008. This can be explained by trade from the development of an intensive regional production network in ASEAN. Thus, its IT Share has outpaced the growth of its share of world markets. However, the growth in fragmented trade and production further induces ASEAN’s higher share of total world trade. This results in the declining trend of ASEAN’s IT Intensity after 2008. In contrast, the IT Share of SAARC is considerably low. The declining trend of SAARC’s IT Intensity was the result of higher dependency on world trade rather than intraregional trade. Since 2008, SAARC’s IT Share and IT Intensity have remained stable, which indicates that there is also no change in its share of world trade. In other words, there are no improvements in terms of intraregional and extra-regional trades. This trend is also observed in the ECO. Last, a rise in IT Intensity, with a moderate increase in IT Share, can be observed in the EAEU and the GCC. While their IT intensity is increasing, their share in world trade is diminishing. This implies that these economic blocs are trading off their share in world trade for larger intraregional trade.

In conclusion, three main findings can be drawn from the trend over the last decades in economic development and intraregional trade in the Asian economic blocs. First, in terms of economic development and living standards, most Asian economic blocs still lag behind the EU. However, a rapid convergence of economic development of the Asian blocs, especially ASEAN, toward that of the EU can be observed. Therefore, large economic and market potential is still emerging in Asia. Second, the high volume of intraregional trade of the ACD, ASEAN, and RCEP signals tight economic integration among Asian countries. Third, in contrast with the experience of the EU, all indicators show that the ACD, ASEAN, and RCEP maintain a good balance between intraregional and extra-regional trade. In other words, the Asian economic integration model (Asia model or East Asia model) is following a pattern of “open regionalism” (Capanelli, Lee, and Petri 2009)—that is, an economic bloc does not sacrifice extra-regional trade for intraregional, or vice versa. Nevertheless, the EAEU, the ECO, the GCC, and SAARC have not
fully developed or utilized their economic blocs, as their intraregional and overall trade remain low and constant over time. Interestingly, even though the stages of economic integration of the EAEU and the GCC are more advanced than those of the ACD, ASEAN, and RCEP, their intraregional trade has not intensified. This implies that the role of the private sector in expanding fragmented trade and production and building regional production networks is crucial.

### 18.5 Lessons from Revisiting Asian Economic Integration

Revisiting the economic integration in Asia has yielded important findings and policy implications. A comprehensive continent-wide economic integration in Asia is unlikely to happen soon. Asian economic integration is confined mainly to East and Southeast Asia, while other parts of Asia are much less integrated and globalized (Feng and Genna 2003). The ACD, ASEAN, and RCEP perform well in terms of trade and market integration and show high potential in leading other blocs in the region. Even though the EAEU and GCC have not efficiently and effectively utilized their economic blocs, they are in the process of transition toward a full economic and monetary union equivalent to the EU. Hence, their stage of economic integration is the most advanced among all economic blocs in Asia. The EAEU and the GCC are, to some extent, ready and have capabilities necessary to further integrate with other Asian blocs, such as ASEAN and RCEP. Gradual integration and expansion of an economic bloc would help intensify Asian integration through capacity building and technological development from more advanced economic blocs. This would also help the least developed blocs such as the ECO and SAARC to smoothly integrate with the rest. The Asian economic integration is analogous to the World Trade Organization experience. When multilateral trade agreements among a large pool of members, such as all Asian countries, cannot be realized, it is better to form smaller, parallel, regional trade agreements, such as ASEAN, the ECO, or the GCC. Through much trial and error, Asian countries would be able to develop their own integration model.

Central to the literature is that the EU is the most advanced form of integration, while other forms are usually regarded as inferior (Murray 2010). However, Ruffini (2006) contends that each economic bloc must develop its own model, since the scope, depth, and sequencing of the integration process vary across different economic blocs. This study argues that the EU should not be regarded as the sole model for economic and regional integration, and that Asian economic integration
is another integration model, which may take time to prove its success. It is also worth remembering that, unlike the EU, the intention behind the economic integration of several Asian blocs is to develop a single market, not an economic and monetary union. The ACD, ASEAN, the ECO, RCEP and SAARC are aiming for loose economic ties, while keeping their economic and political cooperation at a minimal level. Hence, it is unproductive to use the EU experience to critique Asia for lagging behind the EU (Pempel 2005; Langhammer 2007).

The success of ASEAN and RCEP would imply the success of the Asia model to some extent. Given that ASEAN became properly active after the 1997 financial crisis and aims to establish its single market by 2025, ASEAN may take only 28 years to realize its single market, while the EU took 43 years. Furthermore, RCEP, if on schedule (by 2020), would take only 8 years to establish the world’s largest FTA, whereas the EU took 7 years to conclude its FTA. These successes would be the obvious counterarguments to the factors that were claimed to contribute to the success of the EU but the failure of the Asian economic integration. First, although there is great heterogeneity and diversity among countries in ASEAN and RCEP, this does not seem to hinder the process of the integration. Second, in contrast with the EU experience, pooled sovereignty, historical reconciliation, and common institutions have not been observed among member countries that have deep historical conflicts, such as the PRC, India, Japan, and the Republic of Korea, among others. These countries have been working closely together in order to realize the RCEP by the end of 2020. Third, ASEAN has been well-functioning in many aspects. However, instead of a leader, ASEAN is often placed as the main facilitator in major economic dialogues and FTAs. Fourth, regarding consensus, tolerance, and internal support, these attributes seem partly to apply to ASEAN and RCEP. Even though ASEAN is based on the noninterference principle and a consensus decision-making approach, there is no concrete mechanism to level economies among member states. Huge economic gaps and unbalanced economic growth are generally observed among ASEAN and RCEP member countries. Fifth, unlike the experience of the EU, there has been no support from the US in facilitating ASEAN or RCEP. The US even showed little interest in the region, as the US decided to withdraw from the Trans-Pacific Partnership in 2017. Nonetheless, external support from Australia, the EU, the PRC, and Japan, among others, can be observed.

The proposed factors or attributes in the previous literature play a very limited role in determining the success of the Asia model, while the scope, depth, and sequencing of the integration process largely explains the success. This is mainly because the integration time frames of the
EU and Asia models differ considerably. As Asian integration emerged during the era of globalization with a proliferation of global value chains, fragmented trade and production, and regional production, the Asia model is heavily market-driven and private sector-oriented (Urata 2004). The government acts as a facilitator by providing support and policy cooperation; therefore, the absence of the institutional mechanisms used in the EU is relatively unimportant (Venables, Winters, and Yueh 2007).

### 18.6 Conclusion and Policy Recommendations

Covering major Asian economic blocs and dialogues, this study comprehensively reviews the true progress of Asian economic integration in comparison with the EU. The results show that comprehensive continent-wide economic integration in Asia is unlikely to happen soon, since the integration is confined mainly to East Asia and Southeast Asia, while other regions are much less integrated and globalized. ASEAN and RCEP perform well in terms of trade and market integration, and show a high potential to lead other economic blocs in the region. The results also suggest that gradual integration and expansion would help intensify Asian economic integration through capacity building and technological development from more advanced economic blocs. This would help the less developed blocs to integrate smoothly with the others. This study also argues that the factors or attributes proposed in the previous literature—among others, pooled sovereignty; historical reconciliation; common institutions; heterogeneity in economic, political, and social factors—are irrelevant in the context of Asian economic integration. Instead, the scope, depth, and sequencing of the integration process largely explain the success of the Asia model. Unlike the experience of the EU, the model is heavily market-driven and private sector-oriented due to the impact of globalization and changes in global trade patterns and production processes—e.g., fragmented trade and production, and regional production. The government and institutional mechanisms are relatively unimportant in the Asia model.

According to the findings, policy recommendations are proposed as follows:

(i) The Asian model should remain market-driven and flexible in order to respond promptly to changes in trade patterns and production processes due to rapidly changing technologies and demands from the private sector.

(ii) Unnecessary government interventions should remain minimal, while policy cooperation to promote the facilitation of trade should be emphasized. The government may develop
a comprehensive trade facilitation package or program that covers a wide range of issues and areas, such as infrastructure, business law and patents, trade in services, FDI regulations and promotions, research and development, and Industry 4.0. This package would help close the economic gaps among the member countries and further intensify both intraregional and extra-regional trade.

(iii) Mechanisms to support less developed economies in the region should be introduced in the Asian economic integration. This is to help less developed economic blocs such as the ECO and SAARC in terms of capacity building and technological development that can be transferred from the more advanced economic blocs. This, in turn, smooths the integration among economic blocs with different levels of economic development and economic and trade integration.

(iv) The Asian economic blocs may learn from the EU model by adopting features that are suitable in the context of Asia, while avoiding the same mistakes as the EU—among others, debt and financial crisis, or rigid and overly complicated institutions. It is therefore time for the EU to look East and learn from the Asia model as well.

The limitations of this study can pave the way for future research. For one, the main analysis focuses only on economic potential and trade integration. It does not cover other aspects of economic integration, such as FDI, financial integration, macroeconomic independence, people-to-people exchanges, and intraregional income gaps. Thus, it would be interesting to investigate those aspects in comparison with the EU, and to draw a more comprehensive list of policy recommendations and lessons from the Asian model.
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19

Europe and Northeast Asia: Different Responses to Financial Crises

Uwe Wissenbach

19.1 Introduction

The handling by the European Union (EU) of the sovereign debt crisis was seen by many analysts and policy makers as disastrous (Tooze 2018). It has probably made East Asian policy makers even more cautious about regional financial and monetary integration. This chapter will give a more nuanced and comparative view on how the EU and East Asia handled financial crises in the past and what the lessons could be. The two cases of Asia and the EU will show the staggering challenge for global and regional governance of the globalized financialized economy posed by the tensions between national sovereignty, the need for democratic accountability, and the hierarchical structure of global finance.

A number of mostly American economists have long argued that the design of Europe’s Economic and Monetary Union (EMU) was so flawed that it was bound to disintegrate. This argument was based on optimum currency area theory (Mundell 1961). But later iterations of this theory have relativized this criticism by including monetary and trade integration aspects (Rhodes 2011; Vollaard 2014, 1145; Krugman 2013). The question is less the creation of the EMU as such than how it should be governed—essentially the degree of centralism of institutions and the symmetry of decision-making (Priewe 2017, 8–10). EU policy makers knew about these theories and were aware of design flaws (Eichengreen 2012). The EMU was not the result of a stepwise functionalist integration logic (Balassa 1961), but a political project. The Maastricht Treaty enshrined an asymmetry: centralized monetary policy (with a limited scope) and decentralized but coordinated fiscal
policy (Buti and Krobath 2019, 3). It is important to remember here that the 27 member countries of the EU are still sovereign countries, even though in many policy areas they have pooled decision-making, including, for 19 of them, in monetary policy, by adopting a common currency. However, macroeconomic and fiscal policy and financial supervision have been far less integrated. The EMU was left without a central fiscal capacity, and thus, decision-making during the crisis was largely intergovernmental (Buti and Krobath 2019; Priewe 2017). At the beginning of the crisis the EU had 27 different regulatory systems and bank rescue measures in place. There was no common financial safety net, nor was the European Central Bank (ECB) conceived as a lender of last resort or as competent for microprudential supervision of European financial institutions. Macroprudential regulation and supervision were even more limited due to the fragmentation of national regimes. The criteria for EU countries to join the EMU laid out in the 1993 Treaty of Maastricht were believed to be sufficient for EMU stability (Draghi 2019).

As the financial crisis hit, the EU budget managed by the supranational institutions was about 1% of the EU’s total gross national income, whereas the overall share of member states’ public authorities was about 47%. EU funds were not designed for bailouts or fiscal stimulus. Instead, member states used their own budgets largely as they saw fit. Consequently, subsequent policy negotiations and coordination were largely intergovernmental. This aspect is crucial, as the intergovernmental decision-making process is very different from the “normal” EU community method (Buti and Krobath 2019, 1). Intergovernmental bargaining is the very thing that also makes Asian regional mechanisms stutter and perform below potential. The asymmetry in the eurozone slowly evolved during the crisis through the establishment of common mechanisms, for instance to regulate financial markets and banking supervision (Buti and Krobath 2019, 3; Kudrna 2016). In the EU, the tensions resulting from bargaining about bailouts for other countries and accompanying conditions (austerity) caused the emergence of nationalist and Euroskeptic political parties (Börzel and Risse 2018).

Nevertheless, the severe global financial crisis (GFC), which started in the United States (US) and mutated into a sovereign debt crisis, did not lead to disintegration of the EMU (Wissenbach 2020, 75–94). Instead, the EMU was further developed and became more integrated through a number of reforms of existing, and the creation of new, institutions (Kudrna 2016), which are well covered in other chapters of this book. This governance reform has made the EMU governance more polycentric (Wissenbach 2020, 82–3) but at the same time more
centrally regulated and supranational and probably better prepared for the next crisis than Northeast Asia (De Brouwer 2018; Rana 2017; Rhee, Sumulong, and Vallée 2013).

To examine the lessons for the current situation, a comparative look at how Europe and Asia (here Northeast Asia) have handled financial crises in their regions is important. In Asia, even intergovernmental coordination proved to be very limited in line with the traditional emphasis on national sovereignty, but as the Asian financial crisis (AFC) showed, this also proved challenging, especially when looked at through a global governance lens appropriate for the 21st century and the recent surge of nationalism and protectionism that are threatening global economic governance (Wissenbach 2020).

19.2 The Governance Challenges of Financial Crises

19.2.1 Challenge 1: National Sovereignty and Contagion—The Asian Financial Crisis

The Asian financial crisis as a catalyzer for nationalism cum globalization. The key lesson drawn by most Asian countries was to defend national sovereignty as much as possible from intrusive multilateral or foreign conditionality, while preserving the openness of the global economy for Asian trade (Tangkitvanich and Rattanakhamfu 2018, 203). This is in line with Northeast Asia’s “conflicted regionness” (Wissenbach 2020, 119–42). In East Asia, regional financial safety nets are viewed with skepticism, while any conditionality from the International Monetary Fund (IMF) is resented. Regional networks such as the Chiang Mai Initiative have not been used in any crisis, while the national policy responses seemed effective in the short run, but may turn out to be costly and challenging for regionalization in the long run. Self-insurance was more by default than by design (Rhee, Sumulong, and Vallée 2013). Japan was less vulnerable because its debt burden is largely domestic, while the People’s Republic of China (PRC) had effective capital controls and the means to borrow domestically for large stimulus measures (but its domestic debt is now huge; IMF 2019). Hence, large-scale fiscal stimulus has so far not been implemented in the coronavirus disease (COVID-19) crisis (Anderson 2020, 96, 100–1). The Republic of Korea was more vulnerable, but at least had reformed its banking sector after the AFC in 1997/98.

In Northeast Asia, after the AFC, countries pursued domestic reforms and regional cooperation as an integral part of each country’s
globalization agenda (Shu 2015, 104). The PRC reformed state-owned enterprises, and after it joined the World Trade Organization in 2001, it entered a period of super-high growth (Mühlhahn 2019, 549–59). Japan reformed its economic bureaucracy during a phase of stagnation, and the Republic of Korea reformed its chaebols and pursued free trade agreements with partners inside and outside its region (especially the US and the EU). During the global financial crisis, the PRC and the Republic of Korea were among the main advocates for preserving the open trading system against protectionist reflexes. After the GFC, however, the PRC, given the environmental and economic unsustainability of its high-growth economic model, structurally changed to a “new normal” of lower growth while the total debt in the Chinese economy quadrupled from $7 trillion to $28 trillion between 2007 and 2014 (Mühlhahn 2019, 562, 591–614; Green and Stern 2017, 426). That “new normal” of Chinese growth and its massively expanding financial sector will undoubtedly shape its COVID-19 response (Anderson 2020, 100–1) and have major long-term impacts on the Asia region. Even so, while intraregional trade increased slightly during the period 1995–2015 from 45% to 47.2%, nontariff measures between Association of Southeast Asian Nations (ASEAN) member states increased significantly during the same period (Tangkitvanich and Rattanakhamfu 2018, 186, 192). Most intraregional trade is not covered by trade agreements, especially Japan’s (Tangkitvanich and Rattanakhamfu 2018, 189). The trade and investment linkages between ASEAN and Northeast Asia are stronger than the intraregional linkages in each subregion. The Asian region maintains strong linkages with the outside world in a triangular trade structure (open regionalism). Financial and banking integration is even weaker and advances very slowly (Tangkitvanich and Rattanakhamfu 2018, 186, 198).

19.2.2 Challenge 2: Past Crises as Laboratories for Global Governance

The lessons from a past crisis tend to focus on past issues and may overlook new challenges and new disruptive complexities (Wissenbach 2020, 11–14). After the AFC, regional and global mechanisms were established that were further developed during the GFC. The G20 group of finance ministers and central bankers was created in 1999 to improve coordination of national economic policy making and in 2008 was elevated to the summit level. The Financial Stability Forum was also created as a reaction to the AFC, and the G20 upgraded it to the Financial Stability Board in 2009. In fact, international crisis management for the
AFC was undertaken to a large extent at the global level rather than at the regional level. This was due to the absence of effective regional mechanisms (Rhee, Sumulong, and Vallée 2013). But given the changes in doctrine and instruments the reformed IMF now has at its disposal after drawing (self-critical) lessons from its misdiagnosis during the AFC (Hill and Menon 2012, 3; Rana 2017 Rhee, Sumulong, and Vallée 2013; Wissenbach 2020, 143), and considering the inadequacy despite all these reforms of the IMF as a potential backstop (Truman 2018), it is not wise to vilify the IMF, nor is it wise to rely entirely on it. During the GFC, it was the US that “bailed out” directly or indirectly the rest of the world, but it is not very likely that they will do so again. Even during the GFC, there had been a lot of behind-the-scenes tensions within the US (Tooze 2018) and the tide would seem to have turned against action by the US to bail out foreigners. The prime role of the US in the GFC and its containment was even more obvious (Tooze 2018). That seems to suggest that crises are (costly) opportunities to strengthen multilateral cooperation (as the EU and other cases also show; Rhee, Sumulong, and Vallée 2013). But multilateralism has fragmented and become more unpredictable both because of the structurally chaotic dynamics of financial globalization and because of a rise in nationalism and protectionism. Moreover, the existing global financial safety nets have not been reformed sufficiently to keep pace with the global challenges. The US and the IMF remain the financial backstop for the region, but how reliable and capable are they now (Rhee, Sumulong, and Vallée 2013; Sussangkarn 2017; Truman 2018, 6)? The reactions to the COVID-19 pandemic—a disruptive health crisis with potentially disastrous economic consequences that will stress the global financial system—will tell, but at the time of writing (March 2020) the shutting down of borders and market reactions do not augur well (IMF 2020).

The idea of an Asian monetary fund was touted during the AFC, but it never materialized. Instead, a weak mechanism of bilateral currency swaps, the Chiang Mai Initiative, was set up and, during the GFC, was multilateralized and accompanied by a minuscule macroeconomic surveillance office (ASEAN+3 Macroeconomic Research Office, or AMRO), but no one seemed to believe that these institutions could in fact constitute an adequate regional financial safety net. Instead, the Republic of Korea, the most vulnerable country in Northeast Asia, proposed a new set of global financial safety nets during its G20 chair period in 2010, with limited success. Neither Asian nor global financial safety nets are ready for the next crisis in the region (Rana 2017; Truman 2018, 5). Regional cooperation is not a priority, although it is clear from the financial network structure that without regional cooperation Asia
depends on US (and IMF) support in critical times (Oatley et al. 2013). This lack of cooperation in a world characterized by disruption and complexity is risky:

The world – and the Asia Pacific region maybe more than other regions – is vulnerable to spillovers from events like trade and currency wars, military conflicts, and security posturing getting out of hand.

(De Brouwer 2018, 13)

By contrast, in 2017, the EU embarked on setting up a European monetary fund (see section 19.4.2). The underlying reasons for a lack of regionalization in Asia are the rivalries between Northeast Asian countries due to nationalism and ensuing moralization gaps in their past (Wissenbach 2020). Those, from an international relations perspective, will need to be addressed. In this sense, this chapter complements economic analysis on regionalization in Asia.

19.2.3 Challenge 3: Complexity—The Network Structure of Global Finance

Financial crises follow the hierarchical network structure of transnational finance (Oatley et al. 2013). The AFC was a peripheral crisis that hardly affected the network center (the US and European financial institutions). The GFC, by contrast, was a crisis in the center with immediate and disastrous repercussions around the globe. Global coordination led by the US was necessary because of the hierarchical structure of the global financial networks centralized on the US and a strong transatlantic link that lacked a regional system in Asia (Oatley et al. 2013). Therefore financial crises cannot be addressed on the basis of national interest and sovereignty alone, but neither can it be expected that the center will always intervene to bail out the periphery—except now in the EU with an *incipient* but still weak central fiscal capacity and the ECB for centralized monetary policy and polycentric prudential supervision.

Nationalism and an excessive emphasis on sovereignty impose an important limit on governance of critical collective goods such as financial safety nets. Conversely, many states have disempowered themselves in the past by abandoning political responsibility for financial and banking regulation to the market players themselves. Meanwhile, multilateral institutions, designed in another age for other purposes, proved inadequate:
The IMF financed trade deficits and handled public debt crises. It was not in the business of filling gigantic private sector funding gaps. Its programs were denominated in tens of billions of dollars. It was not conceived for an age of trillion-dollar transnational banking.

(Tooze 2018, 206)

That—and the relative success of Asian development states in avoiding the worst in the GFC after 2008—is not an argument to reject multilateral regional and global regulation. The COVID-19-induced economic and financial crisis is an unprecedented complex external shock with enormous global ramifications. It affected the centers of the network structure (and Asia has become more central than it was in 1997). In the recovery, the impact of nationalism on global governance will likely be exposed (Rogoff 2020).

19.3 Comparing the Incomparable? Financial Crises in the European Union and in Asia

Comparison between the EU and Asian crisis management is not straightforward as the two regions are very differently constituted, but there are important similarities nevertheless in the causes of the AFC and the GFC:

In each case the fundamental problem was one of perverse incentives and tendencies toward herding by financial-market participants that resulted in excessive risk taking and overinvestment in particular areas.

(Willett 2009, 118)

The EU was badly hit by a prolonged sovereign debt crisis whereas the Asian countries managed the impact of the global crisis through national stimulus measures and US liquidity provision (Tooze 2018). Importantly, Northeast Asian countries did not have to rescue a common currency, an integrated financial market, or an integration project like the EU had to. They “only” needed to protect their national banking and corporate sectors and to some extent those of their main trading partners (such as ASEAN, hence the regional ASEAN+3 upgrades). They achieved that through national stimulus programs and with the help of the global liquidity provision by the Fed (Rhee, Sumulong, and Vallée 2013; Tooze 2018). Besides national measures, Asia reinforced its very weak regional
safety nets built up after the AFC out of concern about contagion from the eurozone sovereign debt crisis and global instability. However, they were not used. Northeast Asia has avoided (for now) a sovereign debt crisis, although in all countries public debt (notably regional and municipal) has risen sharply due to massive—and in the PRC’s case, gigantic—stimulus programs launched in 2008 (IMF 2019; Tooze 2018, 243–51). Therefore, one cannot speak of effective regional economic and political governance in Asia. Accumulated debt (from the GFC stimuli) has reduced the fiscal firepower in another liquidity crisis such as the one prompted by the COVID-19 global health emergency (Anderson 2020).

Despite obvious differences between the European and Asian cases, several economists have compared the two and concluded that the Asian financial safety nets are unlikely to be used in the next crisis. Based on the EU experience, Asian experts have called for a more structured and institutionalized cooperation in Asia (Rana 2017; Rhee, Sumulong, and Vallée 2013).

The EU was affected by the GFC in both similar and different ways to Asia. The European integration process, notably the eurozone, was deeply challenged, but was itself also a cause of the mutation of the global financial and banking crisis to the European sovereign debt crisis. Regional multilateralism, much deeper than Asia’s, was subjected to a severe and costly stress test. But the multilateral fabric and the EU’s multilateral development path did not unravel and revert to nationalistic ones, unlike, for instance, during the Eurosclerosis in the wake of the economic crisis in the 1970s after the Nixon and Organization of the Petroleum Exporting Countries shocks. Instead, integration was reinforced despite the more intergovernmental tendency of the EU as a whole since the Lisbon Treaty (2010).

The EMU has revealed at least five deep flaws and weaknesses (Buti 2020; Priewe 2017):

1. divergence of inflation and real interest rates among EMU members (the most fundamental and most difficult to tackle);
2. too little, too late reactions of the ECB before 2012 and its enduring lack of competence to act as a lender of last resort;
3. excessive austerity at the wrong time coinciding with excessive debt;
4. a lack of centralized fiscal policy capacity; and
5. insufficient (and before the crisis decentralized) banking supervision.

Asia does not have a currency union, but a lack of coordinated banking supervision and a lack of regional fiscal policy capacity (regional financial safety net) are also issues for the region.
Northeast Asia’s multilateral mechanisms played more of a symbolic role than a real one during the crisis. In both the AFC and the GFC, the Republic of Korea was more affected than the PRC and Japan due to its openness and integration with the global financial markets (Tooze 2018, 256–61). Interestingly, the Korean case resembles the Greek one in one aspect: In both cases, the joining of an international institution (for the Republic of Korea, the OECD; and for Greece, the EMU) led to an uncritical lowering of risk category by banks and subsequently excessive inflows of capital (Wissenbach 2020, 146). The financial crisis revealed the real underlying risks and weaknesses of each country.

Asia’s reaction to the financial crisis is comparable in some technical aspects to the EU’s because there were efforts to expand and improve global and regional safety nets and macroeconomic surveillance (Rhee, Sumulong, and Vallée 2013). These regional mechanisms, such as the Chiang Mai Initiative, were created in the larger context of ASEAN+3. The “+3” (the PRC, Japan, the Republic of Korea) are the creditor nations and potential backstops (like Germany, the Netherlands, Finland, and others in the eurozone), but they are not full members of ASEAN where all three Northeast Asian countries have major trade and investment interests. Regional measures were only token lines of defense after national currency reserves and bilateral swap agreements, which are faster to activate and nationally controlled. They were not actually used in either the Asian financial crisis or during the GFC due to major shortcomings in design (Hill and Menon 2012; Rana 2017; Willett 2009). In the midst of political rivalry, there was little political will to conceive of regional institutions (Park 2013). Moreover, Asia did not have the type of institutional foundation of a regional single market like the EU or a currency union. Safety nets and financial assistance require financial solidarity and trust (Rhee, Sumulong, and Vallée 2013). Instead, national programs and bilateral assistance were preferred mechanisms, while the IMF played a central, but ultimately problematic, role notably in the Republic of Korea and Indonesia during the AFC with deep social consequences. As a result, the IMF has become associated with stigma, and at least in the Republic of Korea and Indonesia it had a major impact on democratic processes. This leaves the question of what would happen in the next crisis with no coordinated strategy and every country scrambling for itself. The situation for the EU is more predictable given that the EU has created preventive and defensive measures and monitoring and surveillance mechanisms both at macroeconomic and macroprudential levels as well as more integrated microprudential institutions. In Asia, where such measures are largely symbolic, the question is how long national financial policy can withstand both the integration and the potential disruption dynamics.
19.4 Lessons from Financial Crises

19.4.1 East Asia

The first proposal for a regional financial safety net came from Japan just before the AFC in 1996 (Rhee, Sumulong, and Vallée 2013). Japan proposed an Asian monetary fund to limit the IMF’s role and boost Japan’s influence in the region (Park 2013, 95; Shu 2015, 98; Sussangkarn 2017). Japan underestimated the resistance by Washington and failed to enlist the PRC and this project failed.

After the AFC, Japan proposed that ASEAN extend the ASEAN Swap Arrangement to include Japan, the PRC, and the Republic of Korea (ASEAN’s three partners since 1999). This financial safety net relying on the currency reserves of the “+3” was called the Chiang Mai Initiative (CMI). The CMI was linked to the IMF at the PRC’s insistence to counterbalance Japan’s endeavor to use it to internationalize the yen (Park 2013, 100; Shu 2015, 98–9; Rhee, Sumulong, and Vallée 2013). The competition between the PRC and Japan impeded a truly regional multilateral solution (Park 2013, 87). Moreover, the CMI bilateral swaps were agreed in 2002 between ASEAN and the “+3” countries. However, both arrangements were strictly national in character and did not create a central institution where funds would be managed jointly or could be drawn upon quickly in an emergency. Furthermore, and as in Europe before the European Stability Mechanism (ESM) was created, the pledged funding was inadequate.

When the GFC hit Asia with a short-term liquidity crisis (capital outflows), the CMI failed the test, as the countries in need of liquidity support instead used bilateral swaps with the US, the PRC, Japan, Australia, and multilateral development banks (Hill and Menon 2012, 2; Rhee, Sumulong, and Vallée 2013). Therefore, the CMI was multilateralized in 2009 (CMIM) by repackaging the set of bilateral swaps into one self-managed reserve pooling arrangement. In 2012, during the eurozone crisis, CMIM participants doubled its scope to $240 billion (the share that could be mobilized without an IMF program was elevated to 30%). In 2011, the ASEAN+3 Macroeconomic Research Office (AMRO) was set up to enhance surveillance. It took until 2012 for a joint ASEAN+3 meeting of finance ministers and central bank governors to take place (Hill and Menon 2012, 6). The new group launched preventive and precautionary credit lines similar to those created earlier by the IMF under the impulse of the G20 (Hill and Menon 2012, 6). The three Northeast Asian countries, in parallel to supporting the CMIM, set up bilateral currency swaps and bond-buying programs among themselves, but because of political tensions, the Republic of Korea, for instance, did not prolong its swap arrangements with Japan.
The rationale for the CMIM was for the Northeast Asian countries to provide a financial safety net to their weaker ASEAN neighbors in which they have all invested for industrial production (Hill and Menon 2012, 4). But it is not an Asian mutual assistance pool in the way that the EU has embarked upon.

AMRO complements the CMIM with independent monitoring and analysis for due diligence to minimize moral hazard in the borrowing process (Watanabe 2018). So while these later financial safety mechanisms look more multilateral than those created after the AFC and have similar objectives to those of the EU, their structures are far weaker (Rhee, Sumulong, and Vallée 2013). The CMIM in its present shape is unlikely to be used or to be effective in a future crisis. It cannot be seen as a complement or an alternative to the IMF, even though that had been the ambition for its creation (Hill and Menon 2012, 7–13; Rhee, Sumulong, and Vallée 2013; Sussangkarn 2017). The ASEAN+3 arrangements mostly require a link to an IMF program, and the process is slow as decisions have to be taken in each capital without empowering coordinating institutions, which have correspondingly very limited personnel and resources and no institutional autonomy (Hill and Menon 2012, 4–5; Rana 2017). Not surprisingly, during the GFC, the Republic of Korea, when it chaired the G20 in 2010, promoted the idea of global financial safety nets rather than a series of regional ones (Rhee, Sumulong, and Vallée 2013).

The weakness of the Asian regional financial safety net is that it is still essentially an accessory to national currency reserves, programs and controls, and bilateral swaps, in particular with the US Fed. Functionally and technically, it may be similar to the EU’s, but because of these limitations, the Asian financial safety nets cannot be characterized as a truly multilateral or regional institution. For Northeast Asia, this is even more so, because the CMIM and AMRO are focused on potential borrowers, with the “+3” in the role as potential lenders for ASEAN countries. For the “+3” countries, the IMF link provides decidedly more assurance against moral hazard than AMRO. This is very different from the EMU, in which after the GFC the supranational institutions (European Commission and ECB) were empowered to perform surveillance and supervision tasks for the creditor countries based on legally binding treaty provisions (Rhee, Sumulong, and Vallée 2013). Before the reforms during the GFC, the IMF was involved—after some controversy—in the large bailout programs launched at the beginning of the sovereign debt crisis. In the future, this may no longer be necessary (Buti 2020).

Asia’s response to the financial crisis was intrinsically different from the EU response, relying on national development state approaches to solving international banking and debt crises. While successful, these
self-help solutions only produced a weakly institutionalized regional or multilateral financial safety network, which looks almost designed not to be used (CMIM, AMRO). This situation leaves Asia’s indebted countries vulnerable to another crisis.

19.4.2 European Union

What started as a financial and banking crisis in the US (also affecting EU countries as banking crises) mutated into a sovereign debt crisis in Europe. The EU—after providing balance-of-payment assistance to Latvia in 2008—soon focused on a different problem to that of Northeast Asia. The focus on the Greek sovereign debt crisis and the dominance of its creditor countries in crisis management made the EU focus excessively through a fiscal lens (Buti 2020, 6). The reform of the EMU during the crisis was an incremental, long, drawn-out, and complex process. While institutional integration, multilateral policy cooperation, and coordination were enhanced, this was not a “crowning development” of stepwise integration (Balassa 1961). The advance in integration achieved during the crisis was more muddling through than design—not unlike in previous integration phases (Schimmelfennig 2018, 974). Critical analysts bemoan the inefficient and costly muddling through (Tooze 2018) or warn that there is “no exit from the Euro-Rescuing Trap” (Scharpf 2014). The trilemma between EU integration in some areas, national policy making, and democratic accountability continues to haunt the EU amidst persistent high unemployment and tepid growth (Bellamy 2019; Crum 2013; Macaes 2013; Dauderstädt 2014).

During the crisis, decision-makers in the EU had to manage overwhelming market pressures. However, they are ultimately accountable to national electorates, not to financial markets. Crisis management affected major concerns of their citizens such as jobs, pensions, savings, and education, and how to finance all this (taxes, debt). In this respect, the EU differs from the IMF, which faced no such democratic accountability constraints toward the citizens of Asian countries during the AFC and imposed much more bitter conditionality (Wissenbach 2020, 161–2). Yet, the effect of national instead of collective democratic accountability on the intergovernmental crisis management led to suboptimal measures at the expense of more structural reform (Buti 2020, 4) and to the imposition of austerity due to the bargaining power of the creditors. However, as in other areas of EU policy making—such as single market legislation—the community method ensures an EU-level democratic accountability through co-decision by qualified majority voting among member states in the Council and citizen representatives in the European Parliament (Buti and Krobath 2019, 5).
EMU reforms have to contend with better and more transparent democratic accountability involving the European and national parliaments. It is actually the tension between different national interests and accountability deficits for collective EMU decisions that have led to a crisis of citizen confidence in the EU (reflected in surveys and a surge of votes for Euroskeptic or anti-establishment parties and movements; Börzel and Risse 2018). Such tensions do not arise as much in other policy areas where the community method ensures fairer compromises. However, support for the EU and the euro remains high as the 2019 European Parliament elections showed.

All EU crisis measures were taken through complex negotiations at different levels: There were different players, games, perceptions, and cultures involved (Schimmelfennig 2018, 977–8). Markets in particular were unpredictable and amorphous “negotiation partners” with their own games (Buti 2020). The EU was confronted with an overwhelming complexity of the political and economic context and the plurality of an imperfect multilateral polity. Multilateralism as such was thus a weakness compared to the crisis management by the US or Northeast Asian countries. Decision-making was by definition slower and less efficient than in a national system, especially in the intergovernmental mode. The EU performs better when decisions can be taken through majority voting in the European Council and the European Parliament, but consensus has been the rule for a long time (Bickerton, Hodson, and Puettter 2015). Powerful member states often determine the intergovernmental bargaining (Degner 2019). This difficulty of balancing multilateralism with national interests, market expectations, and accountability to citizens is also an important lesson for global governance.

The intrinsic problem of multilateral crisis management combined with a populist backlash have shown that taking decisions at the European level on financial, fiscal, and economic policies requires strong accountability mechanisms to legitimize the decisions taken in common. US decisions with major implications for other countries are taken without consulting them—the G20 activation during the GFC was an exception to that national economic management. The EU (unlike the IMF and arguably to some extent national polities in Northeast Asia) has to organize democratic accountability and political participation commensurate with the far-reaching impact that EU decisions have on the everyday lives of EU citizens. This political crisis cannot be solved by harmonizing fiscal policy or creating a political union as the fundamental citizen consent for such a move is nonexistent (Bellamy 2019). This political challenge of legitimacy for risk sharing and collective decisions is thus a constant part of the context of managing the EMU and the
reason for the much-criticized muddling through. The more critical popular scrutiny for European integration is a key factor that needs to be addressed in any reform endeavor after the intergovernmental decision-making has empowered nationalists (Wissenbach 2020, 75–94).

The EU overhauled the European regulatory framework that supervises banks, insurance, and security firms, creating a European System of Financial Supervision, building on European-level coordination committees of national supervisors that had been set up just before the crisis. The Single Rulebook for supervision was followed by the Single Resolution Mechanism (the Single Resolution Board started operations on 1 January 2016). The new bail-in rules of the Bank Recovery and Resolution Directive provide for the orderly resolution of banks and a burden sharing between shareholders and creditors, reducing the negative feedback loop between bank and sovereign debt further. The banking union has progressed, but still “European banks are European in life, but national in death” (Macaes 2013, 7). This quip describes the contradiction between a single currency and a single market for financial products and services and separate, national bank regulators (Eichengreen 2012, 129). The EU put a polycentric system in place that involves private actors (banks contributing to the fund), national governments and regulators (backstop in line with EU state aid rules), and the European financial safety net (ESM). The Single Supervisory Mechanism is managed by the ECB while the European System of Financial Supervision is managed by the European Banking Authority (Kudrna 2016, 79). There is as yet no European fund for deposit guarantees, but EU rules on levels of protection exist. This shows the difficult limits of financial solidarity between countries (“transfer union”) due to moral hazard. The banking union is polycentric because of its transnational (banks’ funding), transgovernmental (network of regulators), and supranational (ECB) elements. The EU’s posture is far from perfect and has not addressed all the deep flaws of the EMU. Nevertheless, it has proven resilient and the eurozone seems in a better shape to face future crises.

Besides these regulatory reforms, the EU enhanced budgetary and macroeconomic surveillance. It created new or reformed existing institutions. All these decisions were made under pressure from the markets, the US and other countries, and the IMF (Tooze 2018). There were a number of constraints: the need for unanimous intergovernmental decisions on fiscal measures and reforms and the limited mandate of the ECB, the fragmented legal framework for financial regulation, and prudential supervision. Complex multilevel negotiation games, notably between creditor and debtor countries, made reform slow and inefficient, often at the expense of citizens in debtor countries, notably Greece
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(Tooze 2018). There was no time to change the EU Treaty to overcome these constraints. Moreover, that would have had to be decided by unanimity and validated through referendums in some countries. Such a course would also have reinforced the fundamental national differences, not solved them. They were partly papered over, partly addressed in substance instead of pursuing a new grand institutional bargain (Moravcsik 1993 on that integration technique). Therefore, the EU reaction was suboptimal, but this was an international and multilateral political process, not a centralized national one as in the US or the PRC. The slow, intergovernmentally negotiated fiscal response was facilitated by the ECB’s creative monetary policy: The ECB (slowly and against notably German resistance) moved beyond a narrow definition of its mandate and adopted “unconventional” and more complex monetary policy measures (Draghi 2015; Priewe 2017). A similar “division of labor” is emerging at the beginning of the EU’s economic response to the COVID-19 pandemic.

After the crisis, the European Commission proposed pragmatic measures to complete the EMU in December 2017 rather than politically unrealistic fundamental reforms. European integration has long been about the politically feasible not the theoretically desirable optimum (Bickerton, Hodson, and Puetter 2015). Even proposals that sound “revolutionary” such as creating a European monetary fund and an EU minister of economy and finance are in reality incremental steps to consolidate the haphazard legacy of crisis management decisions. The legislative proposals by the European Commission are basically aimed at avoiding parallel structures through incorporating the intergovernmental elements into the normal institutional framework (including accountability to the European Parliament and judicial review by the European Court of Justice). The European Monetary Fund is simply but importantly (Rana 2017) anchoring the ESM in the EU’s legal framework without changing the distribution key for member states’ contributions and its governance structure. The intergovernmental treaty (“fiscal compact”) of 2012 is to be incorporated into the EU framework while the “finance minister” would just combine the existing remits of the Vice-President of the Commission and the Chair of the Eurogroup (the finance ministers of the 19 members of the eurozone).

The fundamental asymmetry between a centralized monetary policy and the lack of a centralized fiscal policy has perhaps somewhat narrowed, but still persists (Draghi 2019; Buti 2020, 7–8). This has been exposed again in the management of the economic impact of the COVID-19 pandemic. However, based on the lessons from the sovereign debt crisis a decade earlier, the ECB did not wait long to do “whatever it takes” to save the euro and announced a €750 billion Pandemic
Emergency Purchase Programme with almost “no limits” on 18 March 2020 (Lagarde 2020). This gave more time to EU member states to discuss various proposals for a fiscal response, which included hotly contested debt mutualization (“Coronabonds” or “Eurobonds”), the use of the ESM, and a strengthened central fiscal capacity for the EU in the guise of a European recovery program (Grund, Guttenberg, and Odendahl 2020).

19.5 Conclusions and Policy Recommendations

The two cases of Asia and the EU demonstrate the staggering challenge for global and regional governance of the globalized financialized economy. The tensions between national sovereignty, the need for democratic accountability, and the hierarchical structure of global finance and the interdependence associated with it make efforts to pursue international coordination in what is by necessity a polycentric governance endeavor very challenging. With all its limitations, the G20 coordination was more a step toward multilateral accountability than unilateral decisions—notably US monetary policy in the hierarchical network of global finance.

(1) Regional integration or regionalization is essentially a political project requiring citizen support, more obviously so in the case of the EU. Asian regionalization in the past mainly happened through the formation of global value chains, low tariffs, and business networks (“open regionalism”). Nation state-led economic regionalism has been a conscious policy choice of individual East Asian states in response to the domestic transformations of government–business relationships to embrace globalization as the main objective (Shu 2015, 88). Society involvement, democratic accountability, and political integration were largely absent in this strategy. The crises in 1997/98 and 2008/09 showed that this nationalist model of the development state has been resilient, but costly (Kalinowski 2008). Asia as a whole, and Northeast Asia in particular, has chosen not to pursue a multilateralist development path despite the creation of some incipient regional mechanisms and institutions by ASEAN and its Northeast Asian partner countries. This is a major difference to the EU. ASEAN countries see each other “as rivals in their pursuit of exporting to the global market or attracting FDI” (Tangkitvanich and Rattanakhamfu 2018, 200). The EU and its member states see themselves as a team playing in the global arena. Asian countries are not inclined to go beyond hands-off
regionalization and to address issues that require compromises on exclusive concepts of national sovereignty. This insistence on national sovereignty and cultivation of political rivalry between economically increasingly interdependent neighbors may at some stage have to change (Cheong 2020, 118). The comparison of the EU and Northeast Asia shows that the shape and efficacy of regional cooperation does not follow a particular theory but depends a lot more on deeper political structures and ideas such as nationalism and multilateralism, not just on trade and flows of goods and services (Wissenbach 2020). Multilateralism has found its most institutionalized expression in the EU. This is not to say that the EU is the only template for such regionalization, but it has the merit of having proven its value as a polity that—notwithstanding the “disastrous” management of the sovereign debt crisis—has successfully managed to create mechanisms owned by the member states to deal with global challenges and common public goods with a minimum of democratic accountability and solidarity. The EU is a laboratory for regional and global governance in its own right.

(2) Both regions face the challenge of regional cooperation in a globally networked financialized economy (see Oatley et al. 2013 for an analysis of that structure) and their respective policy instruments have proven inadequate in times of past crises, albeit for different reasons, since their instruments and institutions differ. Hence, these instruments have to be constantly retooled. This is not so much a question of economic theory (such as in optimum currency areas, trade creation and trade diversion, and global value chains) but an issue of political will to determine how national sovereignty should be conceived of and to what extent it should be shared in an age of globalization and chaotic complexity (Wissenbach 2020, 11–27).

(3) Both regions, in their respective ways, need to manage polycentric governance to synchronize fiscal and monetary policy (IMF 2020, 6) beyond the state (but also beyond multinational corporations and banks with their vested and parochial interests), something that is perhaps more challenging for nation state-oriented development states than the EU, which already has a polycentric polity that includes parliaments and other channels of accountability.

(4) Both multilateral (EU) and national (Asia) crisis responses had merits and shortcomings, both worked more or less,
and both focused on similar issues: banking supervision, macroprudential reforms, enhanced surveillance and monitoring of fiscal policies, and financial safety nets for different lines of defense, to name just a few. Due to their different constitution, the form of these measures naturally differs between the EU and Asia. But after a crisis is always before a crisis. Preparing for the next crisis requires strategic reforms at multiple levels: domestic reforms (Nakamura 2018), global multilateral coordination and regulation (G20; Basel III), and reforms in regional cooperation (EU, ASEAN+3).

(5) In a new period of disruption and unpredictability and “America first,” we can no longer assume that what worked during the GFC (Drezner 2012; Tooze 2018) will work again, as all the decisions were highly politicized and the outlook of the main player—the US—on the international order has dramatically changed. During the GFC one of the main (structural) reasons for Washington’s support was that the crisis affected the US itself as the center of global financial networks, whereas crises on the periphery (such as the AFC) have limited global repercussions (Oatley et al. 2013). In a new crisis, Asians or Europeans would probably have to rely more on themselves (and perhaps each other). And here, clearly the EU has enhanced its “economic sovereignty”—a main driver of European integration since its beginnings, by reforming the governance of the EMU. In Asia, because of de facto economic interdependence (and despite the insistence on national sovereignty), many countries are dependent on decisions made elsewhere, notably in Washington (and New York) and by their bigger neighbors, but they do not multilaterally coordinate fiscal and monetary decisions—for instance, as the COVID-19 pandemic hits the economy, the Republic of Korea may need bilateral currency swaps with the US and Japan that may be politically difficult to agree (Cheong 2020, 118). While in Europe some of the reforms, notably the banking union, are still construction sites, in Asia even the foundations are not yet in place. In both regions, banking regulation seems essential to avoid the negative feedback loop between private and public debt wreaking havoc the way it did during the AFC, the GFC, and the eurozone crisis. This is all the more important as central banks in an era of near zero interest rates have little leeway to support stimulus measures through loose monetary policy, and because most countries in Europe, but especially in Northeast Asia, have accumulated very high levels of debt.
Thus, there are important political and economic arguments for strengthening regional governance (and financial safety nets) in both regions to deal with the specificities in each region and for joining forces to improve global governance and global regulation of the global financial flows, which ultimately are more important than the trade flows (Tooze 2018, 206).

The COVID-19 pandemic is an economic crisis (external shock) with an impact on the financial system (the other way around to the GFC), but its consequences (sharp deep downturn, liquidity problems, market volatility, lack of trust) have prompted similar monetary and fiscal measures in Asia and in Europe, albeit in an environment of ultra-low interest rates and cheap credit. In Asia, the decisions have been strictly national. In Europe, tensions emerged again through the asymmetry between a Europe-wide monetary policy to provide liquidity and trust, with the ECB doing “whatever it takes” “without limits” to preserve the EMU, and the initially national fiscal measures (with the use of emergency flexibility clauses to avoid the stability and growth pact fiscal constraints) to stabilize national health systems, labor markets, and companies (Lagarde 2020). The EU still has no meaningful budget for its own fiscal measures, and thus intergovernmental negotiations on using the ESM were necessary.
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Regional Institutions in Europe and Southeast Asia: Lessons for Economic Integration in South Asia

Falendra Kumar Sudan

20.1 Introduction

Regional power is defined as the state’s capability to shape foreign policy relative to other states (Gardini 2016) for development of the regions (Fawn 2009). Here, regions are defined as the state’s form of economic institutions, which are developed by multiple actors at multiple levels of aggregation (Wunderlich 2007), whereas regionalism is defined as the “structures, processes and arrangements that are working towards greater coherence within a specific international region in terms of economic, political, security, socio-cultural and other kinds of linkages” (Dent 2016, p. 8). Regionalism places emphasis on opening regional markets to realize economies of scale and inter-regional trade negotiations. In the 1970s and 1980s, the “old regionalism” was based on an import substitution strategy (Baer 1972), whereas the “new regionalism” of the 1990s was based on an export-oriented strategy, which made developing countries more attractive locations for production and stronger actors in trade negotiations. Comparative regionalism focuses on common trends and differences between types of regionalism around the globe. Meanwhile, regional architecture is defined as “a reasonably coherent network of regional organizations, institutions, bilateral and multilateral arrangements, dialogue forums, and other relevant mechanisms that work collectively for regional prosperity, peace and stability” (Hu 2009, p. 4). Regional organizations embody regional communities, which share certain core norms and values.
Regional integration is defined as a process that gradually abolishes discrimination between economies (Balassa 1961), which increases welfare and reduces development gaps by increasing competition. This enables economies of scale and develops regional production networks (Ginsberg 2007) to reduce poverty through trade, investment, and cooperation (Kweka and Mboya 2004). It reduces the barriers to trade, improves economies of scale, and attracts investment, and led to more economic benefits from trade and welfare gains (Sapir 2011) via higher trade liberalization and multilateralism and noneconomic benefits from increased national income and poverty reduction (Calvo-Pardo et al. 2011). The ability of states to cooperate or integrate requires the regional powers to pursue benevolent, leading, and integrating strategies. Furthermore, economic cooperation among developing countries builds solidarity and helps them to address common development challenges. Regional integration improves trade–investment links and provides a basis for regional trade cooperation in Asia, which is one of the biggest markets. In addition, more than half of Asia’s trade is intraregional, which makes a strong case for regional economic integration. The existing economic synergies in Asian economies could be effectively used through regional economic integration.

Over the past few decades, the European Union (EU) has emerged as a prime mover of regionalization in the global economy. EU member states have subscribed to liberal human rights, peaceful dispute settlement, and multilateralism (Schimmelfennig 2005). In contrast, the Association of Southeast Asian Nations (ASEAN) is based on the principle of market liberalism as a provider of growth and social stability (Nesadurai 2006). The ASEAN Regional Forum was seen to be a way to socialize ASEAN’s neighbors into the norms of the ASEAN Way of regional cooperation (Acharya 2001), while Europeanization is based on the use of conditionality in the EU’s enlargement and association processes (O’Brennan 2016). Since the 1990s, there has been a steady surge in regional integration initiatives globally. The process of economic integration in ASEAN has been market led, while the EU’s integration has been accompanied by a commensurate institution building. However, the EU and ASEAN have followed different integration paths. While the EU is formed of sovereign like-minded nation-states with a robust institutional framework and growing supranationalism, ASEAN seeks to unite culturally very heterogeneous nations.

The regional integration initiatives in South Asia are even weaker than those in Southeast Asia. South Asia has an abysmal performance in intraregional trade, and bilateral trade is throttled between India and Pakistan. The South Asian Free Trade Area (SAFTA) members have
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roughly similar trade structures and relatively high tariffs, which limits the welfare benefits of the trade liberalization. Therefore, strengthening regional cooperation and integration in South Asia offers great potential to eliminate poverty, and achieve inclusive and sustainable development. However, we need to harness the potential of regional cooperation through learning from the experiences of Southeast Asia to address the challenges in South Asia.

Given this context, the main objective of this chapter is to assess the challenges and obstacles of economic integration in Southeast Asia, and to compare it with the EU, which is a well-connected and integrated region, to provide some practical policy recommendations for South Asia. This chapter also intends to review the institutional evolution of the EU and ASEAN, to evaluate the economic achievements of regional economic integration within ASEAN, to analyze the process and status of regional economic integration within ASEAN in comparison with EU, to find political and economic impediments and potential benefits of economic integration in South Asia, and to draw lessons for increasing economic integration in South Asia from the EU’s and ASEAN’s integration processes. Secondary data and information have been collected from various national and international publications, including multiple data sources, using data triangulation and a deductive content analysis to evaluate the data more comprehensively and scientifically.

20.2 Review of the Institutional Evolution of the European Union and the Association of Southeast Asian Nations

In 1957, six European countries decided to establish economic and trade links and formed the European Economic Community, referred to as the European Community, which developed from the functional integration and institutional integration in the EU. In 1992, the Common Market project was initiated, which combined the EU with a monetary union. Several attempts were made to build regional clubs, including the Comecon group of Central and Eastern European communist countries, the European Free Trade Association (EFTA) of independent, smaller European countries, and the European Economic Area of smaller EFTA countries with the EU. Southeast Asia is an important regional actor, and ASEAN was an early mover in Asian regional innovation. When ASEAN was established in 1967, it faced a highly uncertain regional and global environment including conflict in Viet Nam, the Lao People’s Democratic Republic (Lao PDR), and Cambodia, the dispute over Sabah in Malaysia and the Philippines, and leftist insurgencies in all but
Singapore. Therefore, ASEAN focused primarily on establishing regional harmony, and explicitly emphasized socioeconomic cooperation and development. Trade liberalization and various cooperation activities have included commerce and industry, agriculture, tourism, transport, and telecommunications.

The second phase of ASEAN’s evolution started in early 1976 with the beginning of a formal set of regional cooperation measures, including ASEAN Preferential Trading Agreement (APTA), ASEAN Industrial Projects (AIPs), ASEAN Industrial Complementation (AIC), and ASEAN Industrial Joint Ventures (AIJVs). APTA was aimed at intra-ASEAN trade through institutional integration and regional trade preferences, while AIPs aimed to establish large-scale intergovernmental projects in ASEAN member nations, and AIC and AIJVs were designed to promote specialized complementary products and resource pooling. However, these economic cooperation programs have had only a minimal impact on regional economic relations. For instance, APTA had little impact on intraregional trade due to low tariff cuts, and the failure to consult and involve the business community. AIP, AIC, and AIJVs have also had limited success.

The next phase of ASEAN’s evolution started in 1992 with the announcement of ASEAN Free Trade Area (AFTA), which emphasized stronger economic cooperation and reduction in the common effective preferential tariff rates, due to increased self-confidence in the region, sweeping policy reforms, attracting large foreign direct investment (FDI) inflows, and increased competitiveness and other changes in the regional and global commercial architecture. ASEAN countries have reinforced their outward orientation and built confidence in reform initiatives to learn from their more advanced neighbors. Over this period, the majority of products have been included in the respective Inclusion Lists, with tariffs of 0%–5%. In the mid-1990s, ASEAN started to develop the trade in services and it promoted investment. For instance, the Framework Agreement on the ASEAN Investment Area was signed in late 1998 and expanded into the ASEAN Comprehensive Investment Agreement in early 2009. In 2008 to 2009, the global financial crisis lowered the growth trajectories in ASEAN member states and Southeast Asia region lost some of its commercial attractiveness, due to which ASEAN was termed as an ineffective and feeble institution.

The creation of distinctly Asian institutional forms can be traced to the creation of ASEAN, the East Asian Economic Community, the idea of the Asian Monetary Fund, the development of the Chiang Mai Initiative, the formalization of the ASEAN Economic Community (AEC), routine East Asia Summit processes, and the initiatives around the Regional Comprehensive Economic Partnership (RCEP). In 2007, the AEC
Blueprint was established, and was eventually realized by 2015. It is due to be replaced by the Blueprint 2025 (ASEAN 2015a). The new phase of AEC 2025 focuses on the creation of a deeply integrated and cohesive ASEAN to achieve inclusive growth. Besides trade and investment, the new blueprint emphasizes science and technology, human resource development, good governance, and connectivity.

Southeast Asia took a long time to develop market-led integration under ASEAN, which attempted an institutional integration, functional integration, and AFTA, the Pacific Basin Economic Council, and the Asia-Pacific Economic Cooperation (APEC). In contrast, the EU’s integration is based on binding and built-in legal enforcement mechanisms, which differs from ASEAN’s norms and values, and mutual respect for national sovereignty (Katsumata 2003). ASEAN is based on the principle of noninterference and recognition of sovereignty, in contrast to the EU’s promotion of supranational institutions in a system of binding decisions. ASEAN’s noninterference creates the space to evade unfavorable arrangements, and, in such situations, member states tend to pursue self-interest and not collective interest. For example, the ASEAN member states are relatively reluctant to abolish the nontariff barriers (NTBs), which act as major trade barriers (Pelkmans 2016), increase the transaction costs, and hamper trade flow and free factor mobility. ASEAN’s consensus-building approach in inking agreement and decision-making is slow, but it has led to its success.

The current phase of ASEAN’s evolution is dominated by the return to growth and meeting the challenges of a rapidly changing regional and global environment, which includes the spread of preferential trade agreements, post-crisis macroeconomic coordination, intraregional trade liberalization, and rise of fragmentation trade. ASEAN’s focus is the theme of building resilient and innovative regional economies through deepening regional connectivity for seamless economic activity and growing opportunities, especially in e-commerce and the digital economy. The new initiatives include the ASEAN Single Window (ASW), which will connect and integrate the national single windows, wherein preferential tariff duty can be granted on the basis of electronic data through the ASW gateway; the ASEAN Framework Agreement on Services, which will promote services integration to the next level; the ASEAN Agreement on Electronic Commerce, which will promote cross-border e-commerce; the ASEAN Joint Declaration on Cruise Tourism, which will transform the region into a vibrant cruise destination; multilateral electricity trade to promote energy cooperation and multilateral electricity trade in the ASEAN Power Grid; the ASEAN–Hong Kong, China Free Trade Agreement (FTA); and the ASEAN–Hong Kong, China Investment Agreement for external
economic relations, highest priority on the negotiations for RCEP, a future ASEAN–EU FTA and a potential ASEAN-Canada FTA, and ASEAN and the Eurasian Economic Commission for closer economic cooperation among members (ASEAN 2018). The ASEAN region is highly diverse in levels of economic development but strongly united in vision. Meanwhile, Southeast Asia is acquiring new economic prowess, which has tremendous potential to shape the future global economy.

Countries in Southeast Asia are culturally more heterogeneous than in Europe. In contrast to the internal focus of the EU, ASEAN has an external orientation. The EU’s economic integration has been policy-oriented, in contrast to the market-oriented integration of ASEAN. The EU’s focus has been on exclusiveness, in contrast to ASEAN’s focus on inclusiveness. ASEAN has successfully integrated diversity compared to the EU. In Southeast Asia, economic cooperation has occurred without preferential regional agreements, in contrast to the EU. The financial crisis of 1997 had a considerable impact on the ASEAN economies (Chia 2013), which led to intensification of regional integration efforts and plans to create a single market by ensuring free factor mobility (MacGillivray and Carpenter 2013). The Belt and Road Initiative by the People’s Republic of China (PRC) is likely to improve the trade links between the ASEAN countries and Europe. RCEP presents a huge opportunity for Southeast Asia, with potential to integrate the entire Asia and the Pacific region. ASEAN has been able to integrate diversity, while the EU has not. However, ASEAN has to learn from the EU’s loss of the United Kingdom, along with the strength of its diversity. In summary, ASEAN has become a high-performing trading region. It is now a highly attractive investment destination, which succeeded by transforming the region through cooperation and economic integration brilliantly, and can be termed as a second EU in the making.

20.3 Economic Achievements of Regional Economic Integration within the Association of Southeast Asian Nations

Until the early 1990s, ASEAN economies had not shown impressive economic achievements thanks to the neglect of economic cooperation between ASEAN members until 1976. Even after 1976, doubts remained about the benefits of economic cooperation. Consequently, ASEAN countries followed widely differing development strategies, including free trade in Singapore, export promotion strategies in Thailand and Malaysia, and import substitution in Indonesia and the Philippines. In the mid-1980s, the economic policy priorities between ASEAN
countries were sufficiently converged, which paved the way for economic cooperation. The Southeast Asian economy grew at 5.3% in 2017, and was projected to surge at a slightly lower rate of 5.2% in 2019 and 2020 due to a structural slowdown in the PRC, rising geopolitical tensions, tightening of global financing conditions, and increased global protectionism (IMF 2018), whereas the combined gross domestic product (GDP) of Southeast Asia is expected to surge fivefold to reach $10 trillion by 2030 (ADB 2018). In 2017, Europe’s growth rate stood at 1.7%, which is expected to decline to 1.5% in 2022 (IMF 2017). ASEAN’s share of global GDP rose markedly from 0.8% in 1970 to 1.5% in 1990 and 2.6% by 2015. The ASEAN region has been transformed from a relatively poor region in the 1960s into a robustly growing region of middle-income to high-income countries. The per capita income in Southeast Asia has increased 33 times from $122 in 1967 to $4,021 in 2016. ASEAN’s global GDP share rose to almost the same as the South Asian Association for Regional Cooperation (SAARC) region by 1980 till 2000, and thereafter SAARC’s share in global GDP increased during 2000–2018 (ADB 2018).

ASEAN’s share in world total trade has increased rapidly since the 1980s, from 4% in 1980 to 7% in 2016, compared to growth of intraregional trade. This reflects de facto achievements in integrating regional markets and liberalizing intraregional trade. During the same period, RCEP’s share in world trade increased from 16% to 31%. In 2016, the EU share stood at 33% of global trade, compared to over 40% of global trade in 1993 (World Bank 2018). ASEAN’s extraregional trade in goods increased from 55% in the 1980s to more than 90% in the 2000s, followed by a sharp decline to below 80% in the late 2000s and afterward. This reflects the fast integration of the ASEAN region into a global economy and its deep interdependency with the world economy, which is a double-edged sword to the region. Intra-ASEAN trade has increased significantly from 18.6% in 1980s and 20% in the early 1990s, to 25% of total trade of ASEAN countries in 2018. Intra-ASEAN merchandise trade is significantly more than intra-SAARC trade but significantly lower than the EU. However, the lower intraregional trade share in ASEAN compared to the EU does not indicate failure of regional integration in ASEAN. The region also has a robust trade with non-ASEAN countries, including the PRC, Japan, the Republic of Korea, and India, which reflects open regionalism and growth of regional production networks in East Asia. Multilateral trade liberalization, implementation of AFTA, and the AEC Blueprint have dramatically reduced the average tariff rate within ASEAN and the average preferential tariff rate on intra-ASEAN trade declined from more than 20% in 1990 to 0.64% in 2015 (IMF 2018).

ASEAN’s dynamism is also attributed to its success in attracting FDI inflows, which increased by more than six times in 2000 to 2014, and
stood at $136.2 billion in 2014 but declined to $120.8 billion in 2015. In 2015, ASEAN’s FDI was at 6% of the world’s total FDI flows. Nearly 25% of FDI inflows into RCEP during 2010–2015 and over 17% of inward FDI to ASEAN were intraregional compared to nearly 20% of intraregional FDI to the North American Free Trade Agreement (NAFTA), 30% to RCEP and over 50% to the EU. Outward FDI from ASEAN countries significantly increased and stood at about 4% of world FDI. There has been a marked rise in intra-ASEAN FDI in the 2000s. The share of intra-ASEAN FDI in ASEAN’s total FDI inflows increased from 8.9% in 2004 to 18.4% in 2015, which reflects the growing regionalization of ASEAN-based firms. The share of intraregional investment in total FDI inflow to ASEAN increased from 15% in 2010 to 19.4% in 2017. About 20% of ASEAN FDI was intraregional during 2010–2017. The share of RCEP countries to ASEAN’s total inward FDI stood at 44%, and the EU and the United States contributed about 15%–20% regional FDI during the same period. The East and North-east Asian (ENEA) subregion is one of the most dynamic parts of the world. ENEA countries account for 26% of world GDP, 23.6% of global population, and 20.3% of world trade, and more than $5 trillion foreign reserves. However, intra-subregional trade in ENEA stood at 21.3%. Intraregional FDI among ENEA economies is low and 7% of inflows and outflows were within the subregion in 2008–2014 (ASEAN 2018). Over the period, ASEAN’s global share in FDI inflows increased significantly, which reflects a surge of FDI inflows into ASEAN since crisis years in the late 1990s and ASEAN significantly outperformed SAARC in global shares of FDI inflows in recent years.

Total FDI inflows to ASEAN have remained lower and trade was higher in 2017 compared to 2016, which reveals a faster global trade recovery compared to investment. At the same time, intraregional trade and FDI linkages have surged robustly in Southeast Asia in 2017 and are likely to double the intra-ASEAN trade by 2025 (ADB 2018). Intraregional trade in the EU stood at 63.8% in 2017, which was lowered by 0.1% from 2016. In Southeast Asia, intra-subregional trade stood at 22.4% in 2017 (World Bank 2018) and inter-subregional trade has increased in 2017 due to robust trade with regional trading partners. However, the region faces the tough challenges of sustaining economic growth and strengthening regional economic integration in view of strong undercurrents in the world trading system. Southeast Asia’s market-driven integration has been derived by trade and investment, resulting in welfare gains to ASEAN countries. The increase in share of intraregional trade to total regional trade is an indicator of market integration. Since the 1980s, the intraregional trade has increased in Southeast Asia and the fastest increase in intraregional trade occurred in the early 1990s until the 1998 financial crisis (IMF 2018).
In the early 1990s, the increase in Southeast Asia’s intraregional trade was due to strong growth of their economies, whereas in the early 2000s, the surge in intraregional export trade has been less than the increase in intraregional import trade. Market integration in Southeast Asia has been attributed to liberalization of trade and investment regimes and outward investments from Japan on account of the yen revaluation in the mid-1980s. This led to a surge in trade and export-oriented investments due to the emergence of regional production networks and supply chains by multinational corporations (Kawai 2005), contributing to the strong increase in machinery and electronics products in intraregional trade and emergence of international production networks in Southeast Asia.

There is only 25% of trade within ASEAN countries, which might not sufficiently increase GDP per capita of the members and has created the possibility of trade diversion. In 2016, ASEAN GDP stood at $2.549 trillion, which is equivalent to 2% of global GDP compared to 22% share of the EU in global GDP. The average applied tariff rates of ASEAN countries have declined from 8.92% in 2000 to 4.52% in 2015, while the number of nontariff measures have increased from 1634 to 5975 during the same period (IMF 2018). ASEAN’s share of total intra-ASEAN exports and imports in ASEAN total trade stood, respectively, at 24.5% and 23.5% in 2015 (ASEAN 2016). In contrast, the EU’s share of intraregional trade stood at 67% of total trade (European Commission 2017). Over this period, Southeast Asia has emerged as an important source of FDI and cumulative investments have been substantial (Kawai 2005). This has played an unintentional role of integrating Southeast Asia. The intra-ASEAN FDI has the largest share of FDI flows in ASEAN, which increased from 17% in 2014 to 18.5% in 2015 (UNCTAD 2018).

Economic and structural reforms are the driving force in the promotion of free trade and regional integration. ASEAN integration has become a platform for competitive liberalization because regional economic integration is very difficult to resist. In recent years, ASEAN has made vital commercial policy commitments, such as ASEAN+3 and ASEAN+6. ASEAN’s regional economic integration efforts aim to establish an AEC, for which the AEC Blueprint was adopted. ASEAN also participates in numerous regional and multilateral initiatives, including APEC and WTO-based negotiations. ASEAN is moving cautiously toward formulating an economic group, and it has significant achievements to its credit, including an effective functioning entity, freedom from major conflict, rapid economic development, rising living standards, and effectively playing a form of balance-of-power politics. However, despite these achievements, ASEAN has not succeeded in deeper economic integration, affecting factor markets and a common
macroeconomic policy regime, and it has been unable to develop a set of emergency support mechanisms.

The recent phase of ASEAN integration has faced numerous problems including the commitment for necessary domestic reforms, financial miscalculation, distinct regional characteristics, and congregation of national interests. However, institutional change, governance, and corruption have remained big challenges, which need to be addressed through democratic and decentralized governance. Therefore, learning lessons from overcoming the limitations of European integration can be highly valuable to ASEAN countries facing similar situations (Capannelli and Filippini 2010). There has also been reluctance on the part of ASEAN member countries to delegate enforcement mechanisms to subinstitutions. The transition to a full community in 2025 is just a few years away (Chia 2013), which calls for the hindrances to accelerate development to be addressed (MacGillivray and Carpenter 2013).

The scope for intraregional specialization and commerce is significant because of the greater diversity in economic structure in ASEAN countries. Institutional and commercial policy environments are also diverse in ASEAN economies. For example, Singapore is one of the most open economies in the world compared to Malaysia, Viet Nam, Thailand, and Cambodia. Like tariffs, NTBs are declining in ASEAN economies but have remained significant in some cases (World Bank 2019). The current levels of intraregional trade and investment indicate further deepening of economic integration processes in ASEAN countries.

The removal of trade barriers and adoption of nondiscriminatory treatment seems to be insufficient to induce deeper economic integration and the creation of a single market. The regulatory heterogeneity in Southeast Asia might also hinder deeper integration because of the higher costs for cross-border activities, specifically with the increase in a regional production network. The high interdependence of ASEAN countries generates regional and international externalities, which calls for greater regional regulatory harmonization and coordination to pursue deeper integration (Obashi and Kimura 2016). Since its establishment, ASEAN has emerged as one of the most successful regional collaborative initiatives based on the principles of openness and gradualism (Jusoh, Ramli, and Damuri 2019). In ASEAN countries, the complementarities bring greater benefits from regional integration, whereas heterogeneity could generate more gains from its comparative advantage compared to the EU.

The integration among ASEAN economies must be significantly strengthened to achieve a single market through identifying and reducing NTBs, and strengthening the institutions. The current ASEAN agenda is highly ambitious given its limited resources, which calls for
a sharper focus to accelerate its liberalization process and tangible outcomes. There is also need to focus more on reducing barriers to trade and facilitating cross-border trade and factor mobility. In particular, ASEAN should focus on significantly reducing its NTBs and switch from its current positive list approach to a negative list approach in negotiating its service liberalization (Dee 2015). It should also synchronize service liberalization to achieve a single market and single production base (Fukunaga and Ishido 2015). Finally, ASEAN should take the necessary steps toward a customs union for deeper economic integration (Basu, Sen, and Srivastava 2015). Robust institutions and organizations are essential for deeper ASEAN integration. However, there is incompatibility between full national sovereignty and economic integration. In the EU, trade integration is based on pooled sovereignty. Therefore, unless ASEAN countries are willing to increasingly pool their sovereignty, economic integration will not be strong. Southeast Asia’s deeper regional integration calls for binding commitments, which may be difficult for a number of countries in the region. The European experience reveals that it is better to begin with a small number of countries; on the basis of initial success, reluctant partners will be motivated to sign up to stronger and binding commitments. Both ASEAN and the EU need to work together and learn from each other because the shared global challenges require cooperation and coordination between ASEAN and EU. The economic slowdown, along with recent challenges posed by climate change, disease, demographic changes, and migration, need a collective response.

20.4 Status of Regional Economic Integration within the Association of Southeast Asian Nations in Comparison to the European Union

The EU and ASEAN launched their single market projects at different times. The European project, i.e., the Treaty of Rome, called for the creation of a common market. Likewise, ASEAN’s Bangkok Declaration called for similar ends. The EU fosters supranational authority through its institutions for economic integration, while ASEAN strictly maintains intergovernmental institutions and conscientiously pursues a policy of noninterference in the affairs of its members. Therefore, both the EU and ASEAN have divergent institutional structures and roles in regional integration. In the EU, there exists an interactive relationship between institutions and actors, which shapes EU policy and governance. EU institutions remained adaptable and play a significant role in EU
integration (McNamara 2006). The European Commission enforces regulations to prevent national governments from giving private aid that distorts markets. ASEAN’s institutions have led to de facto market-driven integration, which needs stronger regional political institutions to implement a top–down approach.

The EU presents the most outstanding example of a regional economic integration, and it serves as a benchmark to analyze regional integration across the world. However, there are significant political, economic, cultural, and historical differences between Europe and Asia. In particular, Asian regionalism is qualitatively different European regionalism. ASEAN’s regional and international project activities include a wide range of initiatives, and the region is highly diverse in economic, political, cultural, and linguistic characteristics compared to the EU. ASEAN is different from an EU-type organization, and it is highly unlikely to adopt a common external trade regime and to develop formal mechanisms for a common currency or central bank. Therefore, ASEAN is institutionally unable to establish a stronger variant of economic cooperation.

Southeast Asia has a much less ambitious integration agenda when compared to the EU, at least in terms of functionalism and institutionalization. Unlike the European case, the Southeast Asian experience seems to be more in tune with time and the sentiments of ASEAN countries. More economic integration is better because it is far more difficult to reach an appropriate level of integration in both political and economic terms. The EU has recently experienced skepticism as regards its continued path toward regional integration. However, EU policy makers have prioritized their political project and have consequently not found an appropriate level of economic integration that is in line with both the political and economic realities of the member states. Although the EU is a more advanced regional integration compared to ASEAN, it is a closed form of regional integration and not comparable. Meanwhile, the EU’s institutional and multilevel governance makes it a reference point for regional integration elsewhere in the world. The EU is considered as central to regional integration analysis and also an exception to it, and there remains confusion about how far the EU can be used for comparative regional integration or if it remains an exception.

Since the mid-1980s, several forces have contributed to strengthening economic integration in the Asian region, which includes liberalization of trade and investment regime of many Southeast Asian countries, increasing Japanese FDI into Southeast Asia, strengthening regional economic involvement of Asian newly industrialized economies, and the emergence of the PRC as a new industrial location for many firms
originating from the region. Consequently, Southeast Asian economic integration, although not institutionalized, has been progressing and has now reached a relatively high level. In regional integration, there is seldom a situation of one-category-fits-all. ASEAN had initiated efforts to promote deeper regional integration before the late 1980s, but with limited success due to the lack of trust and divergent economic interests of member countries. However, until 1992, ASEAN’s goal of a common market was not addressed. ASEAN Vision 2020 was aimed at a stable, prosperous, and highly competitive ASEAN Economic Region for the free flow of goods, services, and investments, including equitable economic development and reduced poverty. AFTA was established in 1992, which was considered the most significant step toward regional integration. Later, the AEC was initiated for further regional trade liberalization and integration.

Numerous regional forums—including APEC, the Trans-Pacific Partnership, the Comprehensive Economic Partnership for East Asia, and the Trans-Pacific Strategic Economic Partnership Agreement—offer alternatives to integration through ASEAN, while the EU is the only viable regional organization for economic integration in Europe. The EU has extensive intraregional trade, which stood at more than half of all the EU’s trade. A similar trend has been noticed in the EU’s FDI. This has led to EU market integration.

Intra-ASEAN trade is much lower than those observed in the EU, which leaves ASEAN with less incentive to pursue deeper integration. Furthermore, regional trade dynamics differ in the EU and ASEAN. For instance, trade agreements are structured between the EU as a bloc and negotiating party due to which all new free trade agreements affect trade for the whole bloc equally and all members share the benefits. However, individual bilateral trade agreements are common, both inside and outside of ASEAN, and they have not fostered increased regional trade or economic integration in Southeast Asia. Despite alternative paths for addressing trade issues and economic integration, member states have continued to pursue deeper integration exclusively through ASEAN and the regional trade environment faced by ASEAN is significantly different from the environment fostering deeper integration in Europe.

The Asia-Pacific Regional Cooperation and Integration Index has been developed to gauge the degree of regional cooperation and integration (ADB 2017) and to identify different drivers of regional integration (Park and Claveria 2018a), which reveals modest growth of regional integration in Asia over 2006 to 2016. Southeast Asia had the highest degree of integration among Asian subregions followed by East Asia; South Asia and Central Asia have lower degree of integration (Park and Claveria 2018b).
However, ASEAN still suffers from significant institutional weaknesses for effective regional integration because of the lack of binding mechanisms for compliance and dispute resolution. The legal instruments of ASEAN have been incompatible with the aim of creating a single market. ASEAN has significantly influenced the APEC negotiations, which remained a loose institution and a more appropriate model due to the different levels of economic development in ASEAN states. Similar to APEC, the ASEAN Regional Forum has a weak institutional framework based on the norms and principles of ASEAN. The Asian institutions need to move beyond the ASEAN Way of informal and strictly consensus-driven cooperation and should adopt greater institutionalization and legalization. There is a need to increase the integration of ASEAN economies by internal liberalization to reduce barriers in intraregional trade of goods and services, to enhance investment environment, and to better integrate the finance sector. Greater regional integration is essential to reap the benefits of global value chains, high demand competitiveness, better realization of economies of scale, collective efficiency, and organic formation of regional innovation systems (ASEAN 2015b). In brief, the emergent challenge for the EU will be to use effective strategies for engagement with Asia, besides tackling its own economic and social challenges. Asia also faces challenges of human rights and democracy, and environmental degradation and climate change. Both the EU and ASEAN need to focus on practical aspects of economic cooperation with the EU’s stronger engagement in Southeast Asia.

20.5 Political and Economic Impediments to Economic Integration in South Asia

Following the success of NAFTA, the EU, and ASEAN, SAARC was initiated in 1985, followed by the Committee on Economic Cooperation in 1991, the SAARC Preferential Trading Arrangement in 1995, the South Asian Growth Quadrangle in 1997, the South Asian Subregional Economic Cooperation in 2001, SAFTA in 2004, and the SAARC Agreement on Trade in Services and the SAARC Development Fund in 2010. Despite these initiatives, regional integration in the SAARC countries has remained very weak and much slower compared to ASEAN countries. Even today, South Asia is facing numerous hurdles in effective cooperation compared to rich experiences in regional cooperation by Southeast Asia. Power asymmetry and diversity are huge in South Asian countries, which are different from those in Southeast Asia and act as a strong barrier in mutual cooperation and
regional integration. There are significant economic gaps among South Asian nations compared to Southeast Asian countries. In addition, the fear psychosis in smaller South Asian countries (including Pakistan) poses a significant constraint in economic cooperation. In addition, political willingness has a minimal role in enhancing economic cooperation between Pakistan and India because the Pakistan–India bilateral relationship dominates SAARC, and the political adversarial relationship is a key hurdle.

Substantial intraregional trade complementarities exist within the South Asian subregion, which provide immense potential to be realized. However, South Asia has an abysmal record on intraregional trade. In SAARC countries, more than half of export potential has remained underutilized, which is proportionally very high in Maldives and Bangladesh. SAFTA has huge potential for trade creation, which can result in stronger growth and improved welfare for all member countries, more so in relatively poorer countries, including Bangladesh, Nepal, Bhutan, and Maldives. SAFTA provides strong opportunities for vertical specialization, reaping economies of scale, increased FDI inflows, improved production networks, and high competitiveness. Besides producers and industry, consumers will also benefit from regional economic integration. In South Asia, the strongest FTA is between India and Sri Lanka, which is also very weak in promoting bilateral trade. The SAARC Preferential Trading Arrangement has limited product coverage, and SAFTA is restricted to trade in goods only. The status of NTBs is also worse. The bilateral trade between India and Pakistan is minuscule despite a long, shared border. Most SAARC member countries have similar trade structures and competing low-value products. Therefore, FTA liberalization has limited welfare effects. SAFTA member countries have relatively high tariffs, and NTBs and FDI restrictions, which results in higher trade diversion. Intraregional trade liberalization is also not conducive for South Asian countries.

The exiting structural barriers—including high transport costs, tariff, and NTBs—are responsible for lower intraregional trade compared to the potential in South Asia. In addition, unreported informal trade has led to low intraregional trade, which is more or less similar to formal trade flows. Most informal trade occurs between India and neighboring countries, which has been estimated multiple times as higher than formal trade. Stronger regional integration is essential for formalizing informal trade flows in South Asia. The trade costs of intra-SAARC imports are very high compared with far distant markets such as the EU and the United States, whereas trade costs for exports have declined to different regions but not for intra-SAARC trade. Thus, intra-SAARC
trade has failed to exploit its locational benefit and has incurred higher costs compared to distant locations. Therefore, physical connectivity and trade facilitation need to be improved to lower trade costs. The geopolitical tensions between Pakistan and India are also blocking effective regional integration and have always barred them from active participation in the process of regionalization of South Asia. However, bilateral economic cooperation between Pakistan and India is essential to attain normalcy between them.

SAFTA has a lengthy implementation schedule, and it has long lists of sensitive or negative products, which hampers trade liberalization and industrial restructuring. Therefore, SAARC countries should compress implementation schedules, implement tariff liberalization, and reduce large sensitive lists of products. Compared to the EU and ASEAN, SAARC has failed to emerge as a regional economic power, mainly due to the India–Pakistan adversarial relationship. The recent economic policies of South Asian countries have a strong element of protectionism. In spite of a common culture and rich heritage, conflict and rivalry are intense among countries in the region. The liberalized trade and investment policies are not complementary, and their trade and investment rely more on countries outside the region compared to countries within the region. Many SAARC countries have failed to initiate significant liberalization and reforms to facilitate regional services integration (Chanda 2015). In addition, illegal cross-border migration is a serious issue in South Asian countries (Wickramasekara 2011), which needs to be addressed as a priority (Srivastava and Pandey 2017). The tourism and health sector potential of South Asian countries has remained untapped, due to the lack of coherent policies. In addition, telecom and information technology-related activities need to be strengthened in SAARC countries to reap its comparative advantage. In this context, the political willingness to proceed in the right direction and wider role of private sectors is not overemphasized. In brief, South Asia’s integration with the world economy is low and integration within the region is even more limited because of the poor business environments across borders. Consequently, South Asia has been unable to reap the benefit of a surge in demand in the United States and Europe. Stronger regional and global integration is essential to increase productivity and growth, generate more jobs, and reduce poverty in South Asia. Therefore, a long-term strategy is called for to increase sustainable intergovernmental institutional initiatives to carry forward the agenda of regional cooperation and integration in South Asia in a well-defined timeline that covers mobility, trade, investment, finance, and infrastructure by robust reforms in all sectors.
20.6 Potential Benefits of Economic Integration in South Asia

South Asia has experienced a surge in manufactured exports and FDI inflows since the 1970s, but they are very low compared with Southeast Asia. Intraregional trade as a share of region’s total trade has stood at 3%–5% since the early 1990s, which is just over 1% of regional GDP and 7% in Southeast Asia, which is attributed to high intraregional trade- and-FDI barriers. South Asia’s trade with extraregional markets is high compared to countries within the region. For example, South Asia’s share in world trade stood at 1.4% compared to less than 5% of Asia’s trade in 2005 (OECD 2018). South Asia has failed to integrate into global manufacturing supply chains compared to Southeast Asia, with the exception of the garments industry in Sri Lanka and Bangladesh. South Asia’s share in global processing trade and information and communication technology supply chains is negligible. Therefore, South Asia lacks global integration, as well as trade-and-FDI links within the region and with Southeast Asia. In the 2000s, South Asia’s intraregional trade stood at 5% of total trade compared to 50% in Southeast Asia. The gaps between current and potential trade in South Asia are huge. In 2016, South Asia’s average tariff stood at 13.6% compared to 6.3% of the world average. Intraregional investment stood at less than 1% of total investment (WTO 2018).

Since the 1990s, the contribution of service sector to GDP growth has increased considerably compared to the 1970s and 1980s. During the 2000s, all countries in the region except Afghanistan recorded above 50% contribution of the service sector in their GDP (World Bank 2016). India’s service sector increased at a compound annual growth rate (CAGR) of 9% compared to 10.9% in the PRC from 2001 to 2012 (Government of India 2015). The increase in trade in goods and surge in trade in services has a substantial potential for intraregional trade and regional integration in South Asia (Chanda 2015). Trade in commercial services was strong in the world economy in 2018 (WTO 2018), which offers considerable opportunities for intraregional trade in services in South Asia, dominated by India, but remained restricted due to policy, regulatory, infrastructural, institutional, and cultural constraints.

In South Asia, regional integration and economic cooperation would help to reduce economic dependence on the developed countries. The potential for intraregional trade within South Asia is immense, which could be tapped by reducing the transaction costs and enabling faster transportation. Intraregional trade could improve regional collective self-reliance through horizontal and vertical economic integration,
increase trade, and facilitate economic growth in the SAARC region.

The complete elimination of tariffs under SAFTA may increase intra-SAFTA trade by reducing structural rigidities due to adverse political relationships. However, restrictive policies in the South Asian countries result in a low level of intraregional trade. SAARC countries would benefit not only from regional cooperation in intraregional trade but also in other areas. Regional trade could be improved through regional cooperation, and regional economic integration is essential to improve trade within South Asian countries. Trade creation and trade diversion will cause overall welfare gains in the regional economies of South Asia. The larger economies of India and Pakistan would particularly gain from preferential arrangements with a bigger block such as NAFTA and the EU, while the smaller economies of Bangladesh and Nepal would benefit more from regional integration. South Asia would gain much from regional integration and trade facilitation measures, such as improving road density, rail lines, and mobile tele-density per capita, transport and communications, and regulatory regimes. With robust economic growth, high domestic consumption, huge public investments, and a large population, the South Asian region has immense market potential but has remained one of the least integrated regions of the world due to mistrust, cross-border conflicts, and security concerns.

In South Asia, services capabilities have been more balanced and complementary. India has immense capabilities in computer and information services, while other countries in the region have more capabilities in travel and transport. Therefore, the existing potential of trade in services should be fully utilized for mutual benefits. Industrial restructuring and productive capacities in less developed SAARC countries have remained underutilized, which presents a substantial potential for these economies in liberalizing investment in joint venture projects to facilitate industrial restructuring.

In this context, robust banking and financial linkages are essential for facilitating trade and investments between SAARC countries, but the existing reciprocal banking links are very poor. Therefore, there is need to expedite the liberalization of banking and financial linkages in the South Asian region on a reciprocal basis. In addition, the local capital markets are shallow in South Asia. Only a few, large well-known Indian enterprises have been able to raise capital from international capital markets. The more developed capital markets in India, Pakistan, and Sri Lanka offer immense opportunities for enterprises in less developed SAARC countries to list and raise capital through subregional stock exchanges. The SAARC Development Fund can also be a potential source for development financing in the subregion. In addition, a SAARC development bank could meet the financial needs of bigger projects to
strengthen regional connectivity and development needs through a cofinancing arrangement with the Asian Development Bank and other financing institutions. In South Asia, the trade and transit facilitation have substantial opportunities for developing extended transport corridors to facilitate intraregional trade and to make the region a hub of East-West trade in the Eurasian region.

South Asia is highly optimistic about the future prospects for regional integration, due to its immense potential to facilitate investment and industrial restructuring and to exploit the subregional complementarities in merchandise and service trade for improved trade balances and productive capacity of the less developed SAARC countries. The political barriers need to be addressed as a priority to sustain regional cooperation. There are huge opportunities for South Asia to take center stage in global trade and investment, given the prospect of increasing costs in the global factory of Southeast Asia, and to regain its lost place as a link between the East and the West.

In recent years, economic growth has remained strong in South Asia, dominated by India, but the surge in growth has failed to create enough jobs for millions of young people. Therefore, South Asia needs to generate huge job opportunities to sustain its growth and unlock the untapped economic potential of its young demographic. Manufacturing and related logistics and services have underperformed in South Asia compared to East Asia and Southeast Asia. These services need to be revitalized by promoting economic corridors consisting of industrial economic clusters along transport corridors to strengthen the manufacturing sector and generate jobs and facilitate economic integration within SAARC countries, and between South and Southeast Asia.

### 20.7 Lessons for South Asia from Integration within the Association of Southeast Asian Nations

The EU’s institution-led integration and ASEAN’s market-led integration are among the most important examples of regional cooperation across the world. In contrast, South Asia’s regional integration has been slow following the establishment of SAARC due to the slow reform process in the member countries. The success of the European and Asian types, specifically Southeast Asian integration, presents many important lessons to accelerate regional integration in South Asia. In spite of huge diversity and differences between Southeast Asia and South Asia, some modifications can be made in the process in regional integration in
South Asia based on the broader experiences in certain policy areas of Southeast Asia. In Southeast Asia, the cooperation among the countries is strong, despite the hostility and conflict among South Asian countries. In the recent past, SAARC countries have initiated economic reforms, including trade and investment reforms and liberalization measures, but they have failed to encourage trade liberalization to a level that could accelerate intraregional trade and investment compared to Southeast Asian economies. This is also evident from the fact that South Asian countries are more introverted and less open compared to higher degrees of trade openness and sustained investment in Southeast Asian countries. Protectionism is highly prevalent in South Asian countries, while Southeast Asian economies have preferred accelerated trade and investment reforms even after the Asian crisis.

Southeast Asia’s intraregional trade has been remarkable, whereas South Asia is the least integrated region in the world. This needs to be improved through bilateral FTAs for the fuller benefits of integration with ASEAN and political commitments from the governments. ASEAN needs to be more competitive, and it should diversify its export markets to utilize the full potential of regional integration with South Asia. In South Asia, regional cooperation and integration have occurred mostly at the bilateral and subregional levels rather than at the region level. Europe and the United States have been the main markets for South Asian exports, and they remained the major sources of FDI. There should be stronger FDI integration within ASEAN and SAARC countries by increasing intra-SAARC FDI flows and cross-border investments in telecommunications, construction, roadways, and financial services. In Southeast Asia, market-led integration has been facilitated by strong regional production networks and the international supply chains. However, South Asian economies, with the exception of India, have failed to participate in the production networks. South Asia and Southeast Asia production network and value chain production activities need to be integrated. In addition, an Asian common market should be established to facilitate the free mobility of goods, services, labor, knowledge, and capital within ASEAN and South Asian countries by removing border barriers.

Regional economic cooperation and integration has resulted in robust change in Southeast Asia through economic growth, trade, investment, and competitiveness. It has strengthened the ability of the policy makers to address the domestic challenges in the respective economies. Regional economic cooperation and integration also has a huge potential to eliminate poverty and achieve inclusive and sustainable development in South Asia. Therefore, it is essential to harness the potential of regional economic cooperation and integration
to address immense development challenges facing in the region specifically in the context of meeting the 2030 Agenda and its Sustainable Development Goals. The economic integration of South Asia could deliver large benefits to the poor population of the region. The potential areas of subregional links in South Asia should include high market integration, better transport, improved energy, wider information and communication technology and people-to-people connectivity, more investment in infrastructure development, and reduced common vulnerabilities and risks. Stronger market integration should be given top priority to increase trade in the region. Post the global financial crisis, the Asian countries, specifically Southeast Asian countries, have emerged as new engines of global growth. Therefore, wider regional and subregional economic integration is a highly desirable policy option to sustain economic dynamism and generating necessary resources for achieving the Sustainable Development Goals in South Asia.

20.8 Conclusion and Policy Recommendations

The ASEAN economies have performed significantly well in the recent past, which has been associated with a long-standing export-oriented development strategy. However, the global financial crisis slowed growth in ASEAN, which was followed by a pronounced rebound with recovery in international trade. Regional trade within ASEAN, along with a large and vibrant domestic market and a growing middle class, is a potential source of resilience to global demand shocks. Intra-ASEAN trade has surged rapidly with regional trade liberalization, which needs to be sustained. Intra-ASEAN trade stood at about 25% of total ASEAN trade compared to more than half of intraregional trade in the EU, which is attributed to nontariff measures in ASEAN. Therefore, the gradual removal of the nontariff measures could facilitate the creation of a single ASEAN market.

The AEC represents a significant step toward ASEAN economic integration. ASEAN 2030 needs to further deepen regional integration by creating a truly borderless economic community. To realize ASEAN 2030 growth aspirations of tripling per capita income and raising the quality of life, appropriate national and regional policies are needed. ASEAN countries need robust domestic structural reforms and deep regional integration to eliminate any remaining barriers to the free flow of goods, services, and factors of production. ASEAN economies also need to increase resilience to macroeconomic shocks by reorienting policies to ensure flexibility in adjusting to shocks and financial crises, manage risks and volatilities to short-term capital flows, upgrade technical regulatory and supervisory capacity, and pursue fiscal and
monetary discipline. Robust institutional reforms should focus on shifting powers from national to regional institutions. However, ASEAN should not transform itself into a highly bureaucratic organization, or a structure similar to the EU. ASEAN has managed to break through the barriers hindering cooperation and has become a unique model for socioeconomic integration.

ASEAN has robust track records in regional cooperation, economic integration, and growth, and is able to deal with its great regional diversity. Although ASEAN’s open regionalism has succeeded, there remain significant challenges and opportunities for deeper economic integration within ASEAN and other subregions and the rest of the world. ASEAN has a combined market of over 2.5 billion people on its borders, which offers opportunities to serve the PRC and India. In the future, ASEAN’s economic opportunities will be enormous due to economies of scale and huge potential for increasing trade to meet new domestic and regional demand. A nearly 5% gain in ASEAN’s aggregate income is likely to be realized once the AEC is in place, for which ASEAN members should implement strong domestic structural reforms to boost productivity and strengthen initiatives for regional cooperation, failing which ASEAN economies would not be able to achieve their growth potential. There exists a huge potential for closer economic integration and cooperation between South Asia and Southeast Asia, which requires the market for goods and services to be expanded to increase economies of scale and competition, enhance regional competitiveness through specialization in regionally competitive industries, extend the movement of production networks from Southeast Asia and South Asia to take better advantage of wage differentials, lower import prices to the region and improve its terms of trade, and increase export-oriented FDI to connect firms with regional production networks and supply chains. Large and comprehensive FTAs would reduce the trade costs for the spread of production networks.

Despite their achievements, the performance of South Asian countries in economic integration is not strong under the institutional arrangements of SAARC. Over the period, South Asia has emerged as one of the fastest-growing regions in the world. The average rate of growth has been estimated at above 7%, which is expected to reduce poverty and unemployment. However, SAARC has not been able to leverage the drivers for economic growth in the member countries through regional cooperation, which is evident from the fact that the South Asian countries are better integrated with countries outside the region compared to their own neighbors. Therefore, robust regional integration calls for more integration within the countries of the South Asia. Like Southeast Asia, comprehensive approaches are needed to
enhance competitiveness and create attractive markets in the South Asian region for an enabling the economic environment to increase industrial cooperation and strengthen production networks, sustain the synergies between liberalized trade and investment across countries, strengthen the financial system to enterprise development, remove infrastructure bottlenecks to gain from conducive policies, improve energy efficiency and cooperation, and collaborate for research and development through improved quality of human capital.

In summary, South Asia should firmly promote SAARC as a truly regional organization focusing on deeper economic integration focusing on promotion of regional trade and economic issues. The SAARC Secretariat should be built into a powerful and knowledgeable body in trade, economics, and nontraditional security threats. SAARC should focus on a common vision for future trade and economic integration. South Asia should implement a SAARC-wide FTA for all members by 2022. The region should collaborate to speed up the construction of new physical infrastructure and settle all border disputes among member nations. Finally, the core issues related to economic liberalization, regional integration, and nontraditional security threats should be given high priority.
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21

Belts, Roads, and Regions: The Dynamics of Infrastructure Connectivity Initiatives in the People’s Republic of China and Japan and Europe’s Responses

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21.1 Introduction

Infrastructure matters; connectivity matters. The field is quickly developing into one of the major international and multilateral policy fields, next to international trade and foreign direct investment. Infrastructure encompasses around 14% of the global gross domestic product, and it is likely to gain in importance over many years to come (McKinsey Global Institute 2017). The Organisation for Economic Co-operation and Development (OECD) noted, focusing on transport: “Transport infrastructure is crucial to connect developing countries and help them to boost trade, growth and regional integration” (OECD 2018, Caption). Beyond economics, as the People’s Republic of China (PRC) tries to invigorate its posture in the regional and multilateral order and reshape some of its features, it has chosen connectivity, through its Belt and Road Initiative (BRI) and new mechanisms like the Asian Infrastructure and Investment Bank (AIIB), as a major route to pursue this ambition.

This chapter analyzes the dynamics of infrastructure connectivity, which initiatives from East Asia, namely the PRC and Japan, considerably shape. The second aim of the chapter is to study and evaluate how Europe, and the European Union (EU) in particular, react to these developments. The public choice view of international political economy
Frey (1984) informs our approach. The idea is to apply the basic premises of neoclassically inspired economics to issues of international relations. For instance, we can understand the introduction of an infrastructure initiative as creating a public good, as will be shown.

21.2 The Growing Importance of Infrastructure Connectivity

Infrastructure and connectivity have received a considerable amount of attention in recent years, both for economic and political reasons. The literature has treated infrastructure and connectivity as closely related concepts, the former rather focusing on the input side and the latter on the output side. Connectivity (as well as infrastructure) involves different types of networks, ranging from the physical domain, like transport—roads, railways, sea, and air—or energy, to digital and other information flows, and financial and people-to-people networks (GICA 2018). First, connectivity, particularly transport infrastructure, is a crucial factor for international trade and economic growth but also for other concerns, like regional integration and the Sustainable Development Goals (OECD 2018, 15). On the level of cross-country comparison, a positive correlation between infrastructure and gross domestic product growth is undeniable, although the direction of causation is more difficult to establish (ADB 2017, 37). On the basis of country case studies, infrastructure development played a significant role in the fast economic development of East Asia, including the PRC, Japan, and the Republic of Korea.

Important beneficiaries share the basically positive view of the role of extended infrastructure, and the Association of Southeast Asian Nations (ASEAN) group of economies is a case in point. Vision 2020 and the ASEAN Economic Community of 2015 already contained important ideas to develop a competitive economic region, including infrastructure. The Master Plan on ASEAN Connectivity 2025 focuses on five key areas: sustainable infrastructure, digital innovation, seamless logistics, regulatory excellence, and people mobility. It formulates the following as a vision: “To achieve a seamlessly and comprehensively connected and integrated ASEAN that will promote competitiveness, inclusiveness, and a greater sense of Community” (ASEAN 2016).

Second, the spread of global supply chains has made connectivity even more important and attractive for the benefit of more efficient networks of production. To make full use of declining transport and communication costs, it is necessary to create appropriate transport networks and other linkages on the basis of substantial infrastructure investment.
An important study conducted by the Asian Development Bank (ADB) and the ADB Institute (ADBI) in 2009 estimated the infrastructure needs of the Asian region to be around $8 trillion by 2020. The 2009 study’s policy conclusions almost sound like a blueprint for the PRC’s One Belt One Road agenda of 2013: “This study’s long-term vision is the creation of a seamless Asia: an integrated region connected by world-class environment-friendly infrastructure networks that link national markets with distinct strengths, promote strong and sustainable economic growth, provide for people’s basic needs, and thus help reduce poverty” (ADB and ADBI 2009, 26).

A 2017 update of the ADB study confirmed the trend of the vast needs in the region (ADB 2017). The new estimate for the infrastructure investment that the region requires is $22.5 trillion until 2030. According to McKinsey Global Institute (2017), there is a global need for some $3.7 trillion per year up to 2035 with a gap of a total of $5.5 trillion. The needs are particularly strong in Asia, while the gaps vary widely between countries. For instance, there is an expectation that the PRC will record a domestic surplus over the years.

Third, the financing gaps have become particularly noticeable since the global financial crisis of 2008–2009. Private investment finance declined significantly after the crisis (Bhattacharya and Romani 2013): in terms of long-term syndicated bank lending, infrastructure lending reached a peak of more than $50 billion in 2007 and fell to $30 billion and below in the years to 2012. If the role of national government budgets and national development banks of less economically developed countries is limited, multilateral development banks (MDBs), such as the World Bank, or regional development banks could offer relief. However, during those years, MDBs and official development assistance (ODA) only contributed a minor part of less than 10% to the annual global spending on infrastructure, amounting to around $0.8 trillion to $0.9 trillion. Moreover, while MDB lending for infrastructure peaked at around $70 billion for 2009 and 2010, it decreased in the following years (Bhattacharya and Romani 2013).

Fourth, another concern in the years following the global financial crisis was (and still is) the engines for global economic growth. For many years, there has been strong growth of trade originating from economic globalization. In recent years, however, global trade has been stagnating at best. Already in 2010, the Harvard Business Review published an essay on a possible “Peak Globalization” (Nussbaum 2010). The reasons for such concerns are manifold. Among them, it has been difficult to create and sustain further trade liberalization and facilitation, as is clear from the stalling World Trade Organization negotiations and the rising protectionism in many countries, including the United States (US) under
the Trump administration. In comparison, infrastructure expenditures are still likely to grow significantly. Infrastructure makes up about 14% of the global economy (McKinsey Global Institute 2017). From that perspective, it is possible to interpret a multilateral effort to invest in infrastructure as a highly welcome growth initiative. Indeed, the Seoul summit of the G20 in 2010 discussed utilizing global savings surpluses to meet pressing infrastructure needs in this spirit (Kohli 2015). Finding appropriate financing mechanisms is essential for using the resources effectively (Yoshino, Helble, and Abidhadjaev 2018).

If the arguments listed are compelling, it is necessary to ask why it has been so difficult in the past to finance and set up appropriate connectivity investments. The basic reason is the public good properties of infrastructure investment. According to basic economics, there are few incentives for potential beneficiaries of public goods to finance such products, if non-excludability and non-rivalry hold. While infrastructure is not a perfect public good, its public good properties are powerful enough to create the mentioned problem: there is strong de facto non-excludability due to exorbitant costs of exclusion for several goods like roads. Moreover, there is non-rivalry at least for the transaction cost benefits of establishing infrastructure ecosystems. There are also significant positive externalities, which can hardly exclude non-contributors. The meritocratic properties of access and opportunities are also frequent claims. Moreover, it is notable that transnational infrastructure creates additional public good issues of global vs. regional or bilateral provision (Sandler 2013).

What is necessary for a country to take the lead in providing an infrastructure initiative as a public good? In the case of multilateral public goods, the standard answer is that a “benevolent hegemon” (originally Kindleberger 1973) is necessary. Compared with the usual economic benefits and costs, which are not enough for a country to provide a public good, the potential advantages for the hegemon also include political benefits, like prestige, agenda-setting power, and influence. Such political benefits can become particularly relevant in a leadership contest.

An important consideration in this context is the changing political and economic weights in the region. While the importance of the PRC has significantly increased in recent years and it is actively seeking a more prominent role, Japan’s position has relatively weakened, while the US has set other priorities. Whereas the “Pivot to Asia” strategy of the Obama administration did have a trade and investment component, the focus of the initiative was rather strategic and military.

For the PRC, this situation provided compelling reasons to start a major infrastructure initiative. Compared with the usual cost-benefit
analysis of incumbent or aspiring leaders, the PRC, in the years after the global financial crisis, could realize a number of peculiar advantages: the economic cost of starting such an initiative and providing significant funds as an early mover faced lower fiscal and economic burdens than usual due to the existence of ample foreign exchange reserves. The economic benefits also promised to be especially high: because of relatively low wages and ample construction industry capacity, even over-capacity, the PRC could expect to win a significant number of international contracts. If one includes distributional concerns in the economic benefits, support for the backward western regions of the PRC through improved connectivity with Eurasia via Central Asia was a valuable additional plus factor. Finally and most importantly, such an initiative promised significant political benefits for an aspiring international leader in terms of influence, agenda setting, and increased reputation. The delay of the 2010 reform of the International Monetary Fund and the World Bank to change the voting shares in favor of poorer and upcoming countries contributed to the PRC’s search for ways to establish itself as an international leader by providing an alternative approach to installing public goods. An infrastructure investment initiative could therefore appear as an ideal instrument in the light of the circumstances of the years around 2010.

The following section will trace the PRC’s approach and Japan’s reaction in some detail, arguing that the initiatives that have emerged in East Asia during recent years have very much shaped the recent dynamics, to which the EU also relates, as the study will show.

21.3 The PRC’s Infrastructure Initiative and Japan’s “Partnership For Quality Infrastructure”

21.3.1 PRC Infrastructure Initiatives: Belt and Road and Beyond

The Archimedean point from which to interpret recent infrastructure initiatives is the PRC’s Belt and Road Initiative (BRI), which President Xi Jinping announced in 2013; it was originally referred to as One Belt One Road (OBOR). It is hard to overstate its importance as a game changer in multilateral cooperation: searching Google Scholar in May 2019, one could already find some 14,000 entries for OBOR plus the PRC and even 68,000 for BRI plus the PRC. Here, it may suffice to list some fundamentals and rather focus on the dynamics since 2013 (for the early
years, see for example Li and Schmerer, 2017; for a recent overview, see Fang and Nolan 2019). The proposal, which President Xi announced in two speeches during 2013, focused on connectivity across Eurasia, a “belt” with three routes and a maritime “road” with two southern routes. Initially, the proposal identified 58 countries as potential partners. Cooperation would be based on bilateral memorandums of understanding (MOUs) between the PRC and individual countries. It defined specific roles for PRC regions, particularly inland regions. While it emphasized the connectivity aspect, the proposal encompassed five links: policies, infrastructure, trade, finance, and people. Various financial mechanisms would become involved, quite a few of which were newly created: the Silk Road Fund, established in late 2014 with $40 billion from foreign exchange resources, the PRC’s sovereign wealth funds, including the China Investment Corporation, major national policy banks, like the China Development Bank and the China Ex-Im Bank, the newly created AIIB, and the New Development Bank BRICS, plus other mechanisms, for instance the Shanghai Cooperation Organization Interbank Consortium, the China–Central and Eastern Europe Investment Cooperation Fund, and the China–Eurasian Economic Cooperation Fund (see, for instance, Delman 2019).

Among these mechanisms, the AIIB is the most widely discussed one, as it seems to challenge the established MDBs, like the World Bank or the regional Asian Development Bank, and thus it is possible to interpret it as a vanguard for how the PRC would try to influence the framework of global and regional multilateral relations. President Xi announced the new MDB in 2013, and it started business in December 2015 with 57 founding members, including Australia, the Republic of Korea, the United Kingdom, and Germany but not the skeptical US and Japan. The bank was endowed with capital stock of $100 billion, of which $20 billion was paid-in capital. In terms of governance, the regional members account for not less than 75% of the votes, of which the PRC holds 26%; major institutional decisions require a super majority of 75%, so the PRC has a very strong position. The AIIB, which is located in Beijing, has nonresident Boards of Governors and Directors, and the first president is from the PRC; among the five vice presidents, there is a British and a German national.

From the beginning, critical voices have questioned the prudence of the new MDB. For instance, they have pointed out that nonresident directors could weaken the role of voice in monitoring senior management. The organization has intentionally installed a number of self-binding mechanisms, however: extensive stipulations of environmental and social standards, a strong role of cofinancing with established mechanisms like ADB and the European Bank for
Reconstruction and Development, and vice presidents, plus a chief risk officer from Western countries. So far, the AIIB has acted more prudently than the critics expected. It seems that projects that meet the stringent standards are not easy to identify, so the bank has usually been the junior partner in cofinanced projects so far. This also explains why progress in terms of AIIB lending is slower than people expected: while the goal is disbursements of $10 billion–$15 billion per year, between 2016 and September 2018, the amount was only around $6.4 billion. As a percentage of outstanding BRI-related loans, Deloitte (2018) estimated that the AIIB so far accounts for no more than 1%.

If one tries to characterize the whole BRI project from the perspective of 6 years after its foundation, we suggest that four features are prominent. First, the BRI is deeply embedded in the political and economic strategic positioning of the PRC. In addition to using a temporal “window of opportunity” cannily to create leadership in infrastructure investment with the associated political and economic benefits, as discussed above, the BRI provides an answer to the longstanding domestic debate on how to support the laggard economic regions in the western PRC. Moreover, it fits the regional shift of foreign policy from “responsive diplomacy,” which includes “keeping a low profile” under Deng Xiaoping and his successors, to a “proactive policy” under Xi Jinping, the latter also including an aspiration for “discourse power” (Kohlenberg and Godehardt 2018; Delman 2019).

Second, the concept is an evolving one, and adaptation involves learning. The PRC authorities themselves see it as a “vision” or an “initiative” that can adapt. For example, the PRC made the key document of the BRI public only in 2015, 2 years after President Xi’s announcement of the BRI (National Development and Reform Commission 2015). As another example, the lead of the PRC has modified the use of bilateral agreements to allow for more equal multilateral arrangements.

Third, there is considerable opacity about the project (Öztürk 2019). There are no headquarters, and the National Development and Reform Commission, the Ministry of Finance, and the Ministry of Commerce share the responsibilities and, to some extent, compete for influence. There is no unified budget or detailed regular reports. Decisions about membership are not rule based, and the willingness to sign an MOU seems to be more important than the priority of creating connectivity. There is also no autonomous multilateral conflict resolution mechanism, only a PRC-led arbitration court, to mention but a few examples.

Fourth, the PRC’s leadership claims win–win situations. President Xi reiterated this in his keynote to the Second Belt and Road Forum in 2019: “We need to promote a global partnership of connectivity to achieve common development and prosperity. I am confident that
as we work closely together, we will transcend geographical distance and embark on a path of win–win cooperation” (Xi 2019). While this is a sharable hope, it is by no means clear, given the opacity that we discussed earlier, that it is possible to meet this claim fully. It is rather symbol politics to gain support at home and abroad.

21.3.2 Japan’s “Partnership for Quality Infrastructure” in the Context of Other Initiatives of Japan and the PRC

The second major player in East Asia is Japan. Researchers have frequently argued that Japan became active only as a reaction to the PRC’s BRI strategy. However, Japan has been active in infrastructure initiatives for a long time. Japan has always emphasized infrastructure-related projects in its ODA policy, based on its own development experience but also on its business interests (Rix 1980)—even during times when the global OECD Development Assistance Committee community did not particularly support this (Kato 2016). Still, the PRC’s approach clearly influences the style of its more recent post-2013 initiatives. The study will therefore compare specific features of Japan’s policies with those of the PRC, which will clarify Japan’s position much better than by simply outlining it without such cross-references.

Southeast Asia has traditionally been the focus of Japan’s aid, but the country has also developed initiatives elsewhere. The Hashimoto Government (1996–1998) set up a so-called “Eurasian diplomacy” in the context of the democratization and transformation of East European and Central Asian economies. It focused on political goals like dialogue and the support of democracy, just as much as on economic cooperation and cooperation for natural resource development. A somewhat more specific “Central Asia Plus Japan” followed in 2004 as part of the government that Prime Minister Junichiro Koizumi led. It included a policy dialogue, intraregional cooperation, business promotion, intellectual dialogue, and cultural as well as people-to-people exchanges. The government had other priorities, however, and Koizumi visited the region only late during his term as prime minister. It propagated the short-lived “Arc of Freedom and Prosperity” in 2007 as a “value-oriented diplomacy” (Yuasa 2008). Shinzo Abe introduced cooperation in the Indo-Pacific region among Australia, India, Japan, and the US as an option during his first turn as prime minister in 2006–2007. In his “Confluence of Two Seas” speech to the Indian Parliament in August 2007, he noted: “By Japan and India coming together in this way, this ‘broader Asia’ will evolve into an immense network spanning
the entirety of the Pacific Ocean, incorporating the United States of America and Australia. Open and transparent, this network will allow people, goods, capital, and knowledge to flow freely. ... In addition, as maritime states, both India and Japan have vital interests in the security of sea lanes” (Abe 2007). About a month later, Abe stepped down as prime minister, and it took about 10 years for this line of reasoning to reappear in the context of the “Free and Open Indo-Pacific” (FOIP) idea, which the Trump-led US administration supported.

The latter observation already points to some of the major reasons why these early initiatives bore rather little fruit. One context is the domestic political instability in Japan, with several short-lived cabinets, which precluded a coherent and sustained policy approach. The second point is that objectives were somewhat blurred and poorly linked, oscillating between Western values and conventional economic development (Yoshimatsu 2017, 503). Third, domestic (economic) interests did not highlight the forceful mobilization of resources in those years; related to the observation noted above, the economic case for a “window of opportunity” to install a major infrastructure initiative had not yet arrived before around 2010.

Activities did continue, however. In 2010, the Economic Research Institute for ASEAN and East Asia, an institution that Japan and ASEAN founded in 2006, presented the Comprehensive Asia Development Plan (CADP) to the East Asia Summit. The CADP’s conception was “as a grand spatial design for infrastructure development in East Asia. The conceptual framework ... demonstrates how the region can pursue deepening economic integration as well as narrowing development gaps” (ERIA 2012), including a list of potential projects.

Efforts also continued on the government level. The Abe administration, after winning the December 2012 general election, installed a Ministerial Meeting on Strategy Relating Infrastructure Export and Economic Cooperation in 2013. Prime Minister Abe gave it a clear mandate: “Supporting the overseas business of Japanese companies and pushing forward the export of the most advanced infrastructure system are an important pillar for the growth strategy ... Japan must aim for achieving growth and prosperity together with the world, through these kinds of cooperation” (Abe 2013). The Infrastructure Export Strategy became part of the third “arrow” of economic reforms of the Japan Revitalization Strategy, endowed with ¥30 trillion until 2020.

The principal Japanese initiative in recent years has been the Partnership for Quality Infrastructure (PQI) of 2015. With an amount of $110 billion, people usually understand it as a reaction to the PRC’s BRI, while the above shows that there is a legacy from earlier Japanese endeavors. The four pillars of the PQI are (1) expansion and
acceleration of assistance through the Japan International Cooperation Agency, the country’s principle technical ODA-distributing agency; (2) collaboration with ADB; (3) measures to increase the supply of funding through the Japan Bank for International Cooperation and others; and finally (4) promotion of relevant international standards (Government of Japan, Ministry of Foreign Affairs et al. 2015). Some features of the PQI corroborate the impression that the intention is for the PQI to respond to the BRI one way or another: the claim of “quality” tries to differentiate Japan’s proposal from the arguably cheaper and less sophisticated offers from elsewhere. In addition, projects will be based on each country’s development plan, an alternative to the original bilateral and asymmetrical approach of the BRI, thus making it attractive for countries like India. Moreover, stressing cooperation with established mechanisms like ADB underlines the “quality” claim and is different from the PRC’s support of novel organs like the AIIB. In 2016, Japan extended the PQI from $110 billion to $200 billion, introducing a global reach for all parts of the program, not only standard setting, and widening it to projects beyond infrastructure, thus also involving other organizations in the field of energy, raw materials, and beyond.

In addition to the aspects mentioned, other features differ somewhat from the BRI scheme. One such feature is the role of private business in Japan’s proposal, which is much stronger than in the BRI case, in which state-owned enterprises in the PRC play an important role (Deloitte 2018). On the Japanese side, in 2014, the country formed the Japan Overseas Infrastructure Investment Corporation for Transport & Urban Development (JOIN) to support and facilitate Japanese corporations’ participation in the global infrastructure market. While the state holds a majority in JOIN, the Japan Infrastructure Initiative, which it established in 2017, basically runs through private enterprises such as the Hitachi Capital Corporation, Mitsubishi UFJ Lease & Finance Co., Ltd, and MUFG Bank, Ltd. The goal is to help close the funding gap for global energy, transport, information and communication technology, or water infrastructure, and thus support Japanese manufacturers, engineering companies, and others.

One important difference between the PQI and the BRI is the expected size of the whole initiative. It should be noted that, strictly speaking, there is no logical connection between the two initiatives, but both are lighthouse government infrastructure projects, and, through comparison, one can thus carve out their peculiar features, as we argued previously. Popular estimates for the BRI range from $1 trillion to $8 trillion (Hillman 2018), while the PQI’s announced level is $200 billion. From that perspective, the BRI seems to be significantly more substantial and deserves greater public awareness. However, a ratio of
5:1 or even 40:1 may exaggerate the actual differences. The derivation of the different numbers is not entirely clear. This is to some extent a result of the opaqueness of the BRI, but also, in the Japanese case, it is not entirely clear whether “regular” already foreseen spending on ODA or other spending is part of the $200 billion mark. With the involvement of Japan’s resourceful private business sector, the “multiplier effect” of any fiscal expenses may be somewhat higher in Japan, however. Moreover, it is noticeable that people cannot always take the alleged bountifulness of the PRC’s foreign exchange resources for granted either. The PRC’s direct investment flows into BRI countries actually declined between 2015 and 2017, which may be due either to more stringent profitability and risk awareness or to a limitation of funds (Deloitte 2018). More recently, with the PRC’s current account surplus declining rapidly in 2019 due to US–PRC trade friction, foreign exchange resources seem harder for overseas projects to obtain.

Another noteworthy feature of Japanese activities is their engagement with multilateral mechanisms to set standards for “quality infrastructure.” The 2016 G7 Ise-Shima Summit, which Japan organized and chaired, had already passed the Principles for Promoting Quality Infrastructure Investment (Table 21.1).

| Principle 1 | Ensuring effective governance, reliable operation, and economic efficiency in view of life cycle costs as well as safety and resilience against natural disaster, terrorism, and cyber-attack risks |
| Principle 2 | Ensuring job creation, capacity building, and transfer of expertise and know-how for local communities |
| Principle 3 | Addressing social and environmental impacts |
| Principle 4 | Ensuring alignment with economic and development strategies, including aspects of climate change and environment, at the national and regional levels |
| Principle 5 | Enhancing effective resource mobilization including through PPP (i.e., public–private partnerships) |


In 2018, the Asia-Pacific Economic Cooperation (APEC) forum passed a revised guidebook, which the Ministry of Economy, Trade and Industry authored, in line with Japan’s views (APEC 2018). The
The Government of Japan, as host of the 2019 G20 Summit in Osaka, made good use of this occasion: it successfully passed an elaborate list of “G20 Principles for Quality Infrastructure Investment,” with six pages of text and rather concrete specifications of “quality” (G20 2019).

The final aspect of Japan’s engagement that we need to appreciate is its involvement in the “Free and Open Indo-Pacific” strategy, which the US has supported under President Donald Trump since 2017, when he proposed cooperation toward a “peaceful, prosperous, and free Indo-Pacific” (Trump 2017). While economic cooperation, also in terms of infrastructure, is one aspect of the cooperation of the “Quad” countries—Australia, India, Japan, and the US—it is still not clear what its role will be vis-à-vis the security agenda concerning the PRC. From Japan’s perspective, Shinzo Abe already reiterated his interest in what he calls the four-country “Diamond” in a Project Syndicate article on 27 December 2012, shortly after being elected to his second term as prime minister (Abe 2012). Compared with 2007, he put more emphasis on security, explicitly mentioning the PRC as a concern, and he “invited” the United Kingdom and France, both possessing sizable navies, as European countries. He placed additional emphasis on “economic growth” and “Africa” during a 2016 speech in Kenya. Generally speaking, the FOIP is still an aspiration with little substance. The four Quad countries are diverse and do not constitute a naturally stable alliance. Japan’s foreign policy seems to view the FOIP in a “political” context and the PQI in an “economic” one. The PQI is not per se adversarial toward the PRC, although it will be difficult for the FOIP to shake off that image (see also Miller 2019).

Are the approaches of the PRC and Japan complementary, cooperative, competitive, or even confrontational? Some patterns may be discernible by interpreting the international infrastructure arena as a market (Pascha 2020). Based on such an understanding, complex idiosyncratic products (finance, local real estate, etc.) involving high risk characterize the international infrastructure market, requiring an appropriate ecosystem and often involving various public and private actors. Complexity will rise further because of sustainability issues, the creation of megaprojects, data-driven project development, and novel efficiency potentials (KPMG International 2019). One aspect of the complexity is that products often do not have clear definitions but require identification through search and discovery processes first, leading to issues of market creation. State actors become involved for economic reasons, to absorb some risks and to realize positive economic externalities but also to capture political externalities, like reputation and influence, as discussed earlier. Infrastructure markets can also be attractive for governments when it is possible to shift rents to the
domestic economy, which is not too unlikely, similar to the strategic trade policy argument (Krugman 2017). In terms of the supply side, because of such properties, there are usually few suppliers competing for a contract, often involving (national) state actors. On the demand side, there is often a natural monopoly, because, for infrastructure goods like roads or railway lines, only one investment will be able to make economic sense. Compared with the standard textbook case of a supply-side oligopoly, the instrumental variables are more complex as well, involving at least the price, contract conditions, and (uncertain) quality. A further complication is that infrastructure typically has the character of an experience good, which leads to issues of trust and reputation. In conjunction with the intransparent complexities of the infrastructure products involved, the market can be prone to rent seeking.

As in oligopolistic markets in general, there is an expectation that the strategies of the limited number of suppliers will very much drive the evolution of such markets, here the PRC and Japan. Given the frequent involvement of potential natural monopolies, clashes of interest are likely and have indeed already materialized. A famous example is the collision of Sino-Japanese interests in the Jakarta–Bandung High-Speed Rail case (Hong 2018). In 2011–2013, Japan conducted a feasibility study and estimated the total cost at $6.4 billion, with the expectation of a contribution from the Indonesian government. A competing PRC proposal with $5.5 billion emerged later, based on a 40-year soft loan from the PRC for 40% at a 2% interest rate, and no Indonesian government funds were apparently necessary. Surprisingly for Japan, the PRC won the contract in 2015, although Japan had improved its bid. The rail line is due to open in 2021. Japan, to improve its situation in future cases, reacted with faster government-related procedures by making yen loans available to subsovereign entities and by propagating “quality.” It is noteworthy that it has adjusted the strategy, in this case, in two ways: on the one hand, through the idea of offering a better “quality” to convince the demand side; on the other, by making more problematic changes. While faster procedures may be welcome at first sight, they could also signal an expectation of the dominance of political will over a careful planning and consideration stage.

Is conflict unavoidable? The PRC’s major competitive advantage is funds, recent current account issues notwithstanding, while Japan’s is know-how and the involvement of experienced private firms. This creates options for cooperation schemes like joint ventures. Indeed, the PRC and Japan have recently agreed on infrastructure cooperation during their October 2018 Summit, mentioning some 50 projects. Different goals and strengths may sometimes be compatible. Another consideration is that the exclusion of the other is often a first
There is a danger that competition between two suppliers, who want to enter into business because of underlying political motives, will lead to a lowering of standards and to phenomena associated with ruinous competition. Over the longer term, there is an expectation that the demand side will react to poor quality and contract conditions and take such negative experiences into consideration for future deals, so different paths of market development are conceivable.

An illustrative example is the case of Hambantota port in southern Sri Lanka. Its planning took place under the BRI scheme, but, because of financing problems of the Sri Lankan government, it had to hand over the port to the PRC in 2017 under a 99-year lease. This proved to be a public relations disaster for the PRC, as it seemed to confirm concerns regarding potential debt traps for weaker partner countries as a result of unsustainable and intransparent contracts. The symbolism of a long-term port lease—disturbingly similar to what the PRC had suffered with respect to Hong Kong, China under colonial rule—seemed like a powerful signal supporting those observers who had been critical of the whole concept of the BRI. Nevertheless, the Hambantota port case is merely one step in the longer-term development of infrastructure initiatives. As for Sri Lanka, the PRC has since offered other projects, in particular a $3.9 billion oil refinery close to the PRC-controlled port. In addition, India and Japan seem to be close to signing a major contract to develop a new commercially viable terminal in the port of the capital city of Colombo (Herskovitz and Marlow 2019). Competition in this case possibly leads to better offers for the demand side, raising its consumer rents. This would not be uncommon for similar markets: a case in point could be the development of railways in the US in the 19th century, which provided enormous rents for the users and localities close to the rail lines while jeopardizing the profitability for the railway companies (Wolmar 2012). On a wider scale, concerns about the prudence of the BRI vis-à-vis weaker partner countries and arguably the claim of a quality-oriented alternative that Japan produced have led the PRC to rethink and refine its strategy: during his keynote speech to the Second Belt and Road Forum in April 2019, Xi Jinping mentioned quality aspects as one of three priorities: “We need to pursue high standard cooperation to improve people’s lives and promote sustainable development. We will adopt widely accepted rules and standards and encourage participating companies to follow general international rules and standards in project development, operation, procurement and tendering and bidding” (Xi 2019).
Summing up, during the past years, the PRC and Japan have developed significant initiatives for infrastructure provision in Eurasia and elsewhere. Beyond the significant business, economic, and political implications of concrete projects on the ground level in various countries, these initiatives also have a meaning on the multilateral level in terms of shaping standards of interaction but also in terms of modifying the global and regional frameworks of governance. It should therefore be obvious that European players, including those at the EU level, should react to and be part of these developments. It is both encouraging and challenging to realize that the initiatives of the PRC and Japan, including players in the wider context, like the US or the Quad scheme, for instance, are still evolving and changing rapidly, giving the EU both a large stake and a significant opportunity to influence the developments.

21.4 The EU’s Role in the New Dynamics of Infrastructure Connectivity Initiatives

This chapter will discuss how the EU participates in the new dynamics of infrastructure connectivity initiatives by looking at existing organs, initiatives, and their relationship to the major East Asian initiatives. For a long period, infrastructure and connectivity have not been a core policy of the EU and of its predecessors. However, during the past 30 years, quite a few institutional mechanisms and initiatives have come into existence that create a basis for the strategic reorientation in this field.

In 1958, the European Economic Community created the European Investment Bank (EIB) as a policy bank. Over the years, infrastructure has become a “top priority,” with investments in the transport sector of more than €153 billion between 2005 and 2015 alone (EIB 2016). While the EIB focuses on intra-EU projects, engagement with partner countries under the umbrella of various initiatives also plays a role.

It is also necessary to mention the European Bank for Reconstruction and Development in this context. While it is not an EU institution like the EIB, a considerable initiative from the EU and major EU member countries established it in 1991 to support the post-Cold War system change in Central and Eastern Europe. The activities of the European Bank for Reconstruction and Development include Central Asia and are committed to involving the private sector in fostering change toward market economies. Infrastructure is one of its competencies, with a focus on urban and environmental infrastructure.

As for EU initiatives, four approaches in particular are notable (see a more detailed contextualization in EC-HR 2018):

- The first is the Trans-European Transport Network (TEN-T) policy of the European Commission. It is based on the 1991
Treaty of Maastricht and is concerned with the development of a Europe-wide transport network. For that purpose, it allocated funds to the various budget periods, with additional Cohesion Fund and European Regional Development Fund contributions.

- The second policy line is the European Neighbourhood Policy of the EU, as it relates to its eastern neighbors. The basic idea is to foster deeper relations with those countries nearby that do not have a short-term perspective to join the EU but in which the EU has a significant interest in prosperity, security, and stability. The cooperation has a value-driven component, but it is also concerned with the economic logic of infrastructure networks, which a 2011 Commission Communication entitled “The EU and Its Neighbouring Regions: A Renewed Approach to Transport Cooperation” (EC 2011) explicitly covered, connecting the Neighbourhood Policy to the TEN-T.

- The third relevant context is the EU’s ODA activities. Compared with several other OECD donors, the EU policy has a reputation of being rather value driven. According to the European Consensus on Development, renewed in 2017, principles and values like democracy, human rights, and rule of law are (again) a priority. The European Commission proposed to combine ODA and the Neighbourhood Policy in a single instrument during the period 2021–2027.

- Fourth and finally, the general external relations context requires consideration. The Global Strategy of 2016 set the framework, referring to “strategic autonomy” for the EU and signaling a strong value-driven agenda: “Our interests and values go hand in hand. We have an interest in promoting our values in the world” (EU 2016, 13). While the Global Strategy contains only a few remarks on particular regions, it does include a short passage on “Connected Asia” (EU 2016, 37–38), stressing that engagement with the PRC should occur on a level playing field and, with respect to Japan, mentioning the intention of a free trade agreement (which in the meantime it has already realized).

Different Directorates General of the European Commission plus the External Action Service run the policy fields mentioned above, complicating policy making and coordination. Individual EU member countries also follow their own policies, confusing matters further. In terms of general foreign and security policies, the mandate of the EU-level authorities is particularly weak. Consequently, while European authorities have developed the ingredients for a European-level strategy
in the past, as shown above, it comes as little surprise, and has received repeated criticism (e.g., Cameron 2017), that it has been very hard for the EU to formulate a stringent and coherent set of policies toward the region of Asia and its major players.

To some extent, given recent developments, it is necessary to reevaluate this problematic impression, because, in the last 2 years, the EU has made three important statements in particular that are relevant to the context of Asia-driven infrastructure initiatives: first, the conclusion of the EU–Japan Strategic Partnership Agreement in July 2018; second, the announcement of a new “EU–China Strategic Outlook” in March 2019 (EC-HR 2019); and finally, most importantly here, the Joint Communication “Connecting Europe and Asia: Building Blocks for an EU Strategy” of September 2018 (EC-HR 2018), in the following abbreviated as EACS (Euro Asia Connectivity Strategy).

The evaluation should take place in the light of the challenges that the EU faces in responding to the dynamism of infrastructure initiatives in recent years, as explained above. The major challenges, condensing them significantly, are the following:

1. Many features of the international infrastructure marketplace show properties of an oligopolistic market structure with strong externalities, beyond economics in the field of extra political benefits (influence, etc.), and the possibility of rent shifting. This constitutes a valid case for public involvement, also on a level beyond the national engagement of individual EU member states, making use of the potentially superior market power of the combined EU. The fact that other major players, like the PRC and Japan, are already trying to utilize these opportunities proactively strengthens the case for EU involvement.

2. The EU has to consider other major players as well, although they did not feature prominently in the analysis above. Foremost, it must consider the US. The US, Japan, and Australia signed an infrastructure agreement in July 2018, with an MOU in November, possibly involving as much as $1 trillion. However, the small amount of $113 million that the US has actually promised so far seems to support the argument that countries cannot currently regard the US administration as a serious and reliable actor and partner in this field. ASEAN and the Republic of Korea are other important actors in the East Asian context, with which the EU enjoys good strategic relations. Finally, the Russian Federation is yet another important player, which, due to its geographical position in Eurasia and its links in the region, is hard to avoid in Euro-Asia connectivity schemes. The current sanctions, imposed since 2014, imply considerable opportunity
costs for the creation of meaningful connectivity cooperation across Eurasia.

- More generally, there is the demanding challenge of making the value-driven agenda of the EU—in terms of democratic and sustainability norms in particular—conform to the more self-interested, but legitimate, economic, business, and political concerns that it has to pursue for the benefit of its members.
- To achieve a noticeable impact in the Euro-Asia connectivity and infrastructure field, a sizable contribution to overcoming the identified financial gaps is necessary.
- Finally, connectivity and East Asian infrastructure initiative issues concern not only faraway places but the area of the EU itself and of potential new EU members. The PRC has developed closer connections with 16 Central and Eastern European countries since 2012, and with Greece since 2019, making it a 17+1 scheme, encompassing 12 members of the EU plus five states in the Western Balkans. The cooperation has achieved noteworthy results in terms of trade expansion and increased direct investment for at least some of the 17 countries. The PRC has set up a PRC–Central and Eastern European investment fund and endowed it with €10 billion. There are concerns (for a summary, see Stanzel 2016) about whether such a cooperation might lead to projects not conforming with or even undermining EU guidelines and standards and whether EU members could become too lenient when other members feel that they should criticize the PRC for political reasons. It is notable that the group of 17 is not very cohesive, with the members competing against each other for the PRC’s attention. However, most of the concerns mentioned previously do not depend on the cohesion of the group but work on the level of individual states. In 2019, Italy, as a core EU member, signed an MOU with the PRC’s BRI, raising similar reservations. It is indeed noteworthy that the weaker states of the EU and the Western Balkans seek this kind of cooperation, while they are the ones that are the most vulnerable to problematic incentives. Finally, Japan’s Prime Minister Abe announced a Western Balkan Initiative during a 6-day visit in 2018 (Mlloja 2018), clearly reacting to the PRC’s activities.

To what extent do the three major statements and policy decisions mentioned above, on Eurasian connectivity, on the PRC, and on Japan, relate to these challenges? The EACS set out to explain and praise a “European way” of “sustainable, comprehensive and rules-based
connectivity” (EC-HR 2018, 2–3), which it recommended for the engagement with Asian partners, together with the mobilization of additional (financial) resources. Whether there is truly a “European way of connectivity” seems to be rather unlikely. However, enlisting various mechanisms for mobilizing financial resources, particularly in the context of a “new external investment architecture,” is meaningful, although details about concrete allocations or quantitative goals are missing. The EACS continued by listing specific issues and key actions in transport, digital connectivity, energy connectivity, and people-to-people connectivity, the latter including education exchange.

The proposals include sensible endeavors, like connecting the TEN-T framework with networks in Asia. Some of these actions are already underway, however. For instance, there was a previous agreement to extend the TEN-T to six Eastern European and Central Asian countries, namely Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine. In that respect, the EACS rather seems like a summary of policies of various parts of the European Commission and of the External Action Service, without constituting a forceful and consistent reorientation. It lists various fields and the various EU initiatives in those fields under the headlines of air, sea, and land transport, digital connectivity, energy connectivity, and people-to-people connectivity. The lofty claim of a “European way” does not substitute a strategic vision. Another feature, which fits this characterization, is that it largely leaves out controversial topics and thus remains indeterminate. For instance, the short paragraph on energy connectivity does not even touch on the grave problems of how to position the EU with respect to receiving gas from across Eurasia and through various (potential) routes, how to handle problematic actors like the Russian Federation in this context, and how to balance economic–strategic interests and European values. In this context, research has established well that the EU’s self-interest, namely its energy needs and the perceived energy security threat, mainly drive its strategic interest in Central Asia (e.g., Proedrou 2012).

The PRC and Japan appear rather prominently in the chapter on bilateral cooperation. In both cases, it mentions aspects of cooperation and coordination in an engaging way. In the case of the PRC, however, it records the potentially controversial issues of market access and a level playing field as important European positions. The March 2019 EU–China Strategic Outlook pointed out the position of the PRC as a partner but also as a competitor and even as a systemic rival even more clearly. For connectivity, this means that, on the one hand, people see the PRC as a valuable partner in finding fruitful configurations for connectivity across Eurasia. The EU–China Connectivity Platform, set up in 2015, serves this purpose. On the other hand, noting issues in the 16+1 (now
Belts, Roads, and Regions: The Dynamics of Infrastructure Connectivity Initiatives in the People’s Republic of China and Japan and Europe’s Responses

17+1) framework, the Western Balkans, and elsewhere, the EU intends to use its instruments “more robustly” to “preserve its interest in stability, sustainable economic development and good governance” (EC-HR 2019, 5). As for Japan, the EACS mentioned reinvigorating the EU–Japan transport dialogue and, more importantly, the need to “coordinate closely efforts to promote international standards and regional cooperation in Asia” (EC-HR 2018, 7). In terms of standard setting for international infrastructure projects, the EU thus sees Japan as an ally, sharing similar interests, while it views the PRC rather as a competitor. Such cooperation is already visible with respect to the G20 meeting in June 2019 in Japan. The 2018 EU–Japan Strategic Partnership Agreement does not mention infrastructure cooperation and connectivity, but the reference to multilateral, development, and industrial cooperation (Articles 10, 11, and 17) easily allows for such a focus.

Summing up, the EACS of 2018 still lacks rigor and a persuasive strategic vision in several respects, while it has already started to shape the way in which the EU sees its role in the ongoing evolution of East Asia-driven infrastructure initiatives. It is understandable, though still regrettable, that the European Commission and the External Action Service have not yet ventured further at this point in time: the major inhibiting factors are that member countries follow their own policies, which are possibly to some extent at odds with the EU level and among themselves, a new commission will take up office after the European Parliament elections in May 2019, and the budget framework for 2021–2027 has not passed yet, with Brexit and the budgetary issues following it making foresight even more problematic.

Before deriving policy recommendations for the future, there should be some stock taking of the main findings of this chapter on which to base the recommendations.

21.5 Conclusions and Policy Recommendations

The chapter set out to analyze the growing importance of infrastructure connectivity initiatives in recent years, which East Asian players, the PRC and Japan in particular, have largely driven. While both countries are following a wide range of projects as part of different policy lines, it is possible to interpret the BRI and the PQI as notable flagship projects that deserve special attention. The BRI is a major infrastructure initiative that started in 2013 with the proposal of a so-called “belt” across Eurasia with three routes and a maritime “road” with two routes. Besides infrastructure in a narrow sense, it covers policies, trade, finance, and people connectivity. In the meantime, the proposal has evolved considerably, for instance in terms of covering more
regions than Eurasia. The Japanese PQI in 2015 started as a regional infrastructure initiative for Asia in 2015, but it quickly turned toward the world at large in 2016. Its major proposition rather regards content, namely to promote so-called “quality” infrastructure. The EU has been active in infrastructure investment for a long time, including beyond its boundaries, for instance through the EIB. It only spelled out an explicit policy toward Asia in 2018. It is rather a summary of existing policies in various fields that will intensify vis-à-vis Asia, namely transport, digital connectivity, energy connectivity, and people-to-people connectivity.

Infrastructure is an important growth sector for the global economy, while there are considerable financial gaps. An initiative like the BRI makes sense for the PRC, because, despite the public good properties of such an initiative, it serves the interests of the PRC as an aspiring regional and possibly global leader, trying to make an impact on the multilateral order as well. As an incumbent major player in the region, Japan followed with its own initiative, the PQI. Both concepts are continuously evolving, and framing infrastructure as a market was helpful in understanding the dynamics better: in an oligopolistic market, suppliers will frequently react to each other, and temporary outcomes are less meaningful than adaptation and learning. Conflicts may occur, but cooperation is also possible; for both, there are already empirical cases. Regarding Japan, which cannot compete with the PRC on price, promising infrastructure “quality” and safeguarding it through multilateral agreements was a smart move.

The EU has not been a major player in the international infrastructure arena for a long time. Still, it cannot avoid taking a stance in that field: infrastructure is an important current and future market for the EU as well, and Eurasian connectivity, the original focus of the BRI, touches its vital interests. The impact of the BRI is very apparent in the 17+1 framework and the PRC’s interest in the Western Balkans, Italy, and elsewhere.

In recent years, the EU has already become more active, particularly by trying to synchronize and push forward relevant policies in the 2018 Joint Communication on Connecting Europe and Asia: Building Blocks for an EU Strategy. While it still lacks some rigor and a persuasive strategic vision, it already encompasses important policy proposals with which the EU takes a more active position in the ongoing evolution of infrastructure initiatives. Examples include measures to mobilize additional financial resources and extend the Trans-European Transport Network toward Eurasia, even if not all the proposals are entirely new. The EU sees Japan as a partner in setting up and safeguarding multilateral standards, while it views the PRC both as a partner and as a rival, which needs to respect a level playing field.
To sharpen its policies further, the EU should consider further measures that:

- increase the leverage of EU policies on infrastructure connectivity with Asia beyond its own budgetary means; and
- are in line with its self-proclaimed objectives, which include sustainability, comprehensiveness, rule-based mechanisms, openness, transparency, and good governance (EC-HR 2018, 2–3).

It is beyond the scope of this chapter to develop policy proposals systematically based on these fundamental considerations and in line with feasibility constraints, related to the various dimensions of infrastructure connectivity, the organizational structure of the EU, and its relationship with the business community and with potential external partners. Still, it is important to consider the following points, concentrating on institutional matters:

- Financing infrastructure will be a major challenge for all global players in view of the identified gaps. The 2018 Communication underlines this but lacks a concrete road map. The EU should sharpen the strategy in the not-too-distant future while allowing for flexible reactions to what happens elsewhere. The European Commission’s Investment Plan for Europe, known as the “Juncker Plan,” was a major effort from 2015 to 2017. The incoming commission should consider something similar for infrastructure, with a global perspective including Eurasia.

- Given the ambiguities of oligopolistic competition for major infrastructure projects, multilateral rules for environmental and social standards as well as for fair competition and good governance of projects are extremely important, both in their own right and because EU industry cannot win a competition race based on price and (lower) contract conditions. Japan is a natural ally to support this position jointly in regional and multilateral forums, like the G7, the G20, and the OECD. There is considerable scope for further EU–Japan connectivity cooperation under the umbrella of the Strategic Partnership Agreement to support common interests. The bilateral “Partnership on Sustainable Connectivity and Quality Infrastructure,” signed in September 2019, is an important step in this direction, which it is now necessary to activate (EU and Japan 2019). One obstacle to developing a more focused EU strategy is that member countries follow their own policies in view of their respective industrial interests. The
European Commission and its several Directorate Generals and the External Action Service should therefore closely and persistently coordinate themselves and work with members that have a strong position in the infrastructure market. A joint task force of the EU, national authorities, and business interests may be helpful as an organizational frame.
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22
Examining the Role of Institutions in Regional Economic Integration: A Comparison between Europe and Asia
Zhihai Xie

22.1 Introduction
Regional economic integration in Europe and Asia has been frequently compared. However, the role of institutions in regional economic integration has not caught enough academic attention. The establishment of transnational or supranational institutions can be said to be an achievement of regional integration. There is no doubt that institutions have facilitated regional economic integration for both Europe and Asia. But there exist significant differences when it comes to how much the institutions have contributed to regional economic integration in Europe and Asia.

For Europe, from the very beginning of regional integration, strong institutions have paved the way for its economic integration. The economic integration started with the establishment of European Coal and Steel Community (ECSC) in 1952. In 1957, the European Economic Community (EEC) was established under the Treaty of Rome. It helped create a common market and customs union. A single market was created within the EEC that allowed for the free movement of goods, capital, services, and people. Without these institutional arrangements, the establishment of the European Union (EU) could not have been realized in 1993.

For Asia, however, institutions are not the decisive driving force for regional economic integration. Asian institutional arrangements have
fallen behind those in Europe. Although the Association of Southeast Asian Nations (ASEAN) was established as early as 1967, a comprehensive regional institution has yet to come. Institutions centered on ASEAN, such as ASEAN+1, ASEAN+3, and the East Asia Summit, have become major regional institutions accommodating its economic integration. The 1997 financial crisis reminded Asian economies that the region needed stronger economic institutions. Since then, functional institutions in financial and monetary areas such as the ASEAN+3 Macroeconomic Research Office have been established and strengthened.

Among the literature on economic integration, studies on the role of institutions are lacking. The existing literature focuses on either the role of regional institutions in general or the institutional development in one of the two regions. For example, some researchers have studied the relationship between institutions and economic integration in Europe (Badinger 2018; Cameron 2010); others the motives, challenges, and achievements of institutional building in Southeast Asia, East Asia, or the whole of Asia (Acharya 1997; Asian Development Bank 2010; Capannelli and Tan 2012; Hu 2013; Zhang 2012).

The comparative approach is very useful to examine the similarities and differences, and provides not only vertical but also horizontal lessons for Europe and Asia. Among the existing comparative studies, some compare the different driving forces of economic integration in Asia and Europe (Berkofsky 2005; Capannelli and Filippini 2009), and others compare the different approaches to regionalism in Asia and Europe into “institutional regionalism versus networked regionalism” (Yeo 2010) or “structured regionalism versus soft regionalism” (Zhao 1998). But few comparative studies focus on the contribution that institutions have made to regional economic integration. Under such circumstances, this study aims to examine and compare the role of institutions in the process of economic integration in Europe and Asia.

### 22.2 Role of Institutions in European Economic Integration

#### 22.2.1 Brief Review of Institutional Development in Europe

European economic integration is widely recognized as the most successful case of regional integration so far. The achievements of European integration are the result of long-term efforts taken by European countries, as experienced over more than half a century (Taghizadeh-Hesary et al. 2020). It is also worth noting that there have
been ups and downs in the history of European economic integration, not only at the early stage, but also very recently. There is no doubt that Brexit will become a historic example of a setback for regional integration in Europe.

The first step of European economic integration was said to be the ECSC founded by the Treaty of Paris in 1951. The ECSC was an invention out of fear for war. The concept was to manage the production of coal and steel, which were the most important resources for war, to realize peace. This action was to “make war not only unthinkable, but materially impossible,” quoting the words of French former foreign minister Robert Schuman (Foundation Robert Schuman 2011). Later in 1957, the EEC and the European Atomic Energy Community were created, respectively, by the Treaty of Rome and the Euratom Treaty. In 1967, three communities were integrated into the European Community. In 1985, the Schengen Agreement was signed to allow the free movement of people. It was supplemented by the Schengen Convention in 1990, which eventually created the Schengen Area. In 1993, based on the Maastricht Treaty, the EU was formally established. The 1990s saw large-scale enlargement of the EU. In 2002, the common currency, the euro, was introduced in 12 member states and later enlarged to 19. In 2009, the Lisbon Treaty further reformed and strengthened the institutions of the EU. In the process of economic and political integration, the EU has continued to enlarge itself. Although the United Kingdom officially withdrew from the EU on 31 January 2020, the EU still has 27 member states, including most of the major European countries.

Economic integration can be classified into the following seven levels: free trade, customs union, common market, single market, economic union, economic and monetary union, and political union (Taghizadeh-Hesary et al. 2020). So far, Europe has experienced almost all the seven levels of integration. For the EU, institutions might have played different roles at different stages, but the importance of institutions increases with rising degrees of integration.

Institutional development started quite early in Europe compared to Asia. After the Second World War, major European countries had a strong will to avoid another large-scale war or conflicts on the continent. The political will led to economic cooperation at the early stage. Some argue that the most important factor in understanding European integration is to see it as essentially a political-ideological phenomenon, not driven by the careful calculation of economic costs and benefits, still less by trade negotiators, but by a grand vision that had fortunate economic side effects (Venables, Winters, and Yueh 2006). Nowadays, regional integration and institutional development are sometimes
decided by geopolitical and diplomatic consideration, but there are more occasions that economic interests play a major role in regional economic integration. The special historical background determined that political calculation was a core factor in the early stage of the European regional integration.

22.2.2 Current European Institutions

The EU is basically the most important institution in Europe. Within the EU, there is a set of comprehensive institutions covering different aspects of regional integration in Europe. Currently, the major bodies for the EU are the European Council, the European Commission, the Council of the European Union, and the European Parliament (Europa n.d.). In addition, there are other institutional arrangements, including the Court of Justice of the European Union, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions, and the European Court of Auditors (Europa n.d.). The EU has a set of advanced and comprehensive institutions that no other region can compete with. The highly developed institutions themselves demonstrate the high degree of regional integration in the EU.

The EU's comprehensive and mature institutional structure is quite similar to that of a nation-state, with the separation of legislative, executive, and judicial powers. Functional institutions cover almost all aspects such as politics, economy, military, culture, and society. Within the EU, the institutional arrangements make it a supranational organization that governs its member states. In the international society, the unique institutional characteristics make the EU an independent actor. At many international conferences, the EU can represent itself. For example, the president of the European Commission represents the EU when attending the G7 and G20 summits, together with the leaders of western European member states.

European states have realized the importance of institutions, both domestic and transnational. Within the framework of the EU, they created two sets of institutions: supranational institutions such as the European Commission, European Parliament, and Court of Justice; and intergovernmental institutions, such as the Council of Ministers and, later, the European Council, formed by the heads of state or government of the member states (Spolaore 2013). The coexistence of supranational and intergovernmental institutions is critical to the EU’s function. Therefore, the EU’s institutions do not only serve the EU as a region, but also help member states realize and protect their own interests. Balancing between the intergovernmental and supranational institutions makes the EU not a fragmental but a united entity.
22.2.3 Role of Institutions in European Economic Integration

In 2012, the EU received the Nobel Peace Prize for advancing the cause of peace, reconciliation, democracy, and human rights in Europe. The Norwegian Nobel Committee said its decision was based on the stabilizing role the EU has played in transforming most of Europe from a continent of war to a continent of peace (Europa 2012). Again, this comment focused on evaluating the political contribution by the EU, resonating with the political incentives of regional integration at the early stage. Although the Norwegian Nobel Committee did not mention it, the EU’s economic contribution cannot be ignored.

Economic and political factors were intertwined during the process of regional integration in Europe. However, economic integration is much easier to be achieved than political integration, and political integration has to be based on economic integration. The final stage of integration is political integration or political union. This represents the most advanced form of integration with a common government, wherein the sovereignties of member countries are significantly reduced. This is only found within nation-states, such as federations where regions have a level of autonomy from the central government (Rodrigue 2017). For Europe, the establishment of the EU as a political union is not derived from a political slogan. Substantial steps had previously been attempted toward economic integration such as free trade, customs union, common market, single market, economic union, and monetary union. Such economic arrangements paved the way for political integration and eventually led to the building of a political union in Europe.

Institutions are critical to the economic integration of the EU. Institutions have facilitated European economic integration in at least the following three aspects. First, institutional development has contributed to the economic growth in Europe. Economic development is an important driving force for economic integration. It is estimated that despite substantial variation across countries and over time, without European integration, per capita incomes would have been, on average, approximately 10% lower in the first 10 years after joining the EU (Campos, Coricelli, and Moretti 2019). The eurozone’s successful development of the dual growth model was largely attributed to its institutional supports (Iversen, Soskice, and Hope 2016). Institutional development has also facilitated trade liberalization in Europe. The accession to the EU’s single market means clear advancements in trade openness. This has definitely helped promote trade and business relations and thus contribute to economic growth in the region.
Second, institutional integration has enhanced economic integration in Europe. For Europe, institutional integration and economic integration are two processes that have happened at the same time. It is worth noting that integration and institutions have mutual impacts on each other. On the one hand, economic integration has facilitated institutional integration. The institutional development of the EU has been based on the broadening and deepening economic cooperation in the region. Deep integration can induce broad institutional change by providing incentives for simultaneous change in core state institutions (Bruszt and Campos 2018). On the other hand, as stated earlier, institutional development can help deepen and broaden economic integration. Therefore, institutional integration has enhanced economic integration in the region.

Third, institutional development has best facilitated functionalism to work out its effects. Functionalism is one of the most important concepts that contribute to European economic integration. Functionalism is about the dynamic effects of transferring specific “functions” to supranational institutions—for example, regulation of coal and steel production to the ECSC or monetary policy to the European Central Bank (Spolaore 2013). Functional institutions in specific economic and technology areas can create spillover effects in other areas such as trade and political relations—and thus contribute to regional integration. Functionalism as the major approach of regional integration in Europe has succeeded largely thanks to the bold institutional foundation established by the EU and its functional organizations.

Fourth, institutions have helped reduce the development gap and promote common prosperity in Europe. There are both advanced western European countries and less developed eastern European countries in the EU. Simply put, the rich can help the poor within the EU’s institutional framework. Through its functional institutions, the EU could collect and integrate the political and economic resources and redistribute them to its member states as it sees appropriate. One quick example is when, after the Greek government debt crisis, the EU devoted large amounts of its budget to help Greece get through and recover from the crisis. Meanwhile, the EU has made great efforts to close the economic gap in the region through a wide range of policies and initiatives.

All being said, it is also necessary to note that institutions do not always work in a positive way. Depending on the conditions, institutions might not work out their functions in the expected direction—and sometimes might even do harm to economic integration. The development of institutions is also a process of continuous improvement and revision. For example, it is now widely agreed that an important
driver of the European economic crisis has been the faulty original
design of the monetary union, and that substantial steps are urgently
needed toward the creation of truly European fiscal institutions (Farina
and Tamborini 2015). This does not mean that the Economic and
Monetary Union should be abandoned. Rather, it needs to be reformed
and improved so that its function can be strengthened and crises can
be prevented. In the history of Europe’s economic integration, the
founding fathers of the EU’s institutions did not always correctly predict
the future. Institutional arrangements need to be improved based on the
practical needs and trials.

22.3 Institutions in Asian Economic Integration

22.3.1 Brief Review on Institutional Development in Asia

Asia did not start to build regional institutions until the late 1960s,
much later than Europe. In 1967, ASEAN was established by the five
founding members—Indonesia, Malaysia, the Philippines, Singapore,
and Thailand—with the signing of the ASEAN Declaration. Brunei
Darussalam joined later in the 1980s; Viet Nam, the Lao People’s
Democratic Republic, Myanmar, and Cambodia in the 1990s joined
ASEAN and enlarged it to include all Southeast Asian countries (ASEAN
Secretariat 2019).

At the 11th ASEAN Summit in Malaysia in December 2005, the
Kuala Lumpur Declaration on the Establishment of the ASEAN Charter
was signed. It was from then that “One Vision, One Identity, One
Community” became the official motto for ASEAN. In December 2008,
the ASEAN Charter was launched. It codifies ASEAN norms, rules, and
values; sets clear targets for ASEAN; and presents accountability and
compliance (ASEAN Secretariat 2019).

In May 2012, the adoption of both the Declaration of ASEAN
Concord II (Bali Concord) and Cebu Declaration on the Acceleration
of the Establishment of an ASEAN Community by 2015 accelerated
the institutional development of ASEAN. Under the guidance of
such documents, the member states started to establish an ASEAN
community comprising three pillars or three communities: ASEAN
Economic Community (AEC), ASEAN Socio-Cultural Community, and
ASEAN Political-Security Community.

ASEAN has also been gradually institutionalized during its
development in the past half century. However, compared to the EU,
it still has its limits. Both institutions have supranational functions.
However, in terms of how much sovereignty the member states can
delegate to the supranational institution and the degree of the regional
identity, ASEAN still lags behind the EU. There have been attempts by member state governments to create a stronger ASEAN identity. However, the differences among ASEAN member states make it difficult to form a community (Murti 2016).

Of interest is that the establishment of ASEAN also had its political reasons—to counter the spread of communism in the region in the 1960s. Similar to Europe, rather than economic calculation, political consideration was one of the most important motives for the institutional development at the very early stage. However, unlike the EU, the establishment of ASEAN was not targeted at international reconciliation and regional peace, but to cope with ideological differences.

That being said, both the EU and ASEAN eventually became an important institutional foundation for regional economic integration, respectively in Europe and Southeast Asia. However, ASEAN has created just a common market, which is the third level of economic integration (Taghizadeh-Hesary et al. 2020), but the EU has reached the sixth level of economic and monetary integration, which is the common currency. Why could ASEAN not go further to higher levels of economic integration? The biggest reason is that ASEAN is basically an intergovernmental organization, while the EU is a supranational one. The institutional difference lies in how much the member states are rendering their sovereignty to the organization. The European Commission, the secretariat of the EU, is very powerful, and its policy decisions have compelling legitimate power over its member states. In contrast, the ASEAN Secretariat is much weaker and has no strong legitimate power over its member states. Another reason is the different decision-making system. ASEAN has to make decisions by consensus, while the EU can make decisions by vote. Therefore, the EU can make reformative and revolutionary decisions to push forward its regional economic integration, while it is difficult for ASEAN to play such a role.

Why is there no regional institution in other subregions of Asia? There is increasing need for economic cooperation in the region, but there is not enough political will to upgrade the economic integration and create a regional union. In fact, it is political confrontation resulting from historical issues and national sentiment that keeps the region apart. Ironically, the largest Asian economies such as the People’s Republic of China (PRC), Japan, and the Republic of Korea (ROK) all have signed free trade agreements (FTAs) or economic partnership agreements with ASEAN, but the negotiation of a PRC-Japan-ROK trilateral FTA has failed to make any substantial progress so far. Indeed, the three East Asian giants established the Trilateral Cooperation Secretariat (TCS) in 2011, but it is basically an administrative organization without policy decision power.
22.3.2 Current Institutional Entities for Regional Integration in Asia

Association of Southeast Asian Nations

ASEAN is the most advanced regional institution in Asia. Though its members only cover the Southeast Asian countries, ASEAN represents the highest level of regional economic integration in Asia. ASEAN has also become the epicenter for Asian economic integration. At times, these small and medium-sized ASEAN economies drive the large economies such as the PRC, Japan, and the ROK to take initiatives for regionwide cooperation.

The ASEAN Secretariat, based in Jakarta, Indonesia, was set up in February 1976 by the foreign ministers of the five founding member states. The ASEAN Secretariat’s basic function is to provide for greater efficiency in the coordination of ASEAN organs and for more effective implementation of ASEAN projects and activities (ASEAN Secretariat 2019). Under the guidance of the Office of the Secretary-General, there are four departments: ASEAN Political-Security Community Department, AEC Department, ASEAN Socio-Cultural Community Department, and Community and Corporate Affairs Department. The first three departments are mainly responsible for the establishment of three pillars of the ASEAN Community and the fourth department is mainly in charge of the cooperation and coordination within the ASEAN Secretariat. ASEAN progressed its economic integration after 2000, initially by strengthening the free trade area and then by deepening integration into the AEC (Pomfret 2019). The formal establishment of the AEC, as part of the ASEAN Community, on 31 December 2015, marks an important milestone in the economic integration agenda (ASEAN Secretariat 2017). It has made ASEAN realize a single market, which is the fourth level of economic integration.

ASEAN Centrality is one of ASEAN’s most important agendas on regional integration. ASEAN Centrality rests on the idea that ASEAN has the capacity to play a leading and driving role vis-à-vis regional agenda setting (Teodoro 2016). The concept of ASEAN Centrality not only requires ASEAN to unite in a centralized regional institution in Southeast Asia, but also aims to keep ASEAN at the center of Asia to promote regional cooperation and integration. That means ASEAN is an institution working for the economic integration not only of Southeast Asia, but also the entirety of Asia and its external relations with outside players.

ASEAN Connectivity is another course that ASEAN is engaged with to promote regional integration. Through the Master Plan on ASEAN Connectivity 2025, ASEAN Connectivity, which consists of physical,
in institutional, and people-to-people connectivity, aims to create a network of people and infrastructure to benefit all member states. To achieve such a goal, ASEAN has been closely collaborating with other Asian economies such as the PRC and Japan to improve its connectivity in the region through sophisticated infrastructure construction such as transportation and telecommunication.

ASEAN has progressed its regional integration in three main pillars through the arrangement of ASEAN and ASEAN+n Summits. These summits involve other countries in Asia and even in the Pacific to join the process of Asian regional integration. First of all, the ASEAN Summit, inaugurated in 1976, has become a biannual meeting in recent years. Not only leaders of the ASEAN member states, but also leaders from other Asian countries and regions join the summit. The ASEAN Summit has become an international meeting for regionwide members to discuss political, economic, and security affairs between ASEAN and the ASEAN’s partners.

ASEAN+n summits are meetings between ASEAN leaders and the leader of an Asian country, most commonly the PRC, Japan, or the ROK—the ASEAN+3 Summit convenes the leaders of ASEAN and these three East Asian countries together. The coexistence of both ASEAN+1 and ASEAN+3 is a very flexible arrangement to avoid the conflicts among the PRC, Japan, and the ROK. When historical issues, territorial disputes, or enthusiastic nationalism deteriorate the relationships, ASEAN+1 continues dialogues between ASEAN and East Asian leaders, and sometimes ASEAN plays the role of mediator and coordinator for the East Asian leaders.

It is worth noting that the PRC, Japan, and the ROK also initiated a trilateral summit, the TCS, in 2008. Although it has sometimes been suspended due to political issues, the summit has proven recent efforts to build new institutions within East Asia. With the budget shared by the three governments, the TCS was officially inaugurated in Seoul in 2011. The goal is to promote peace and co-prosperity among the PRC, Japan, and the ROK. However, compared to the ASEAN Secretariat, the TCS has quite limited power delegated from the three states, and thus can do very little to help promote regional integration. As mentioned, it is basically an administrative and executive organization to carry out policies that have been already decided by the three governments. Because the TCS is a relatively closed organization, there is also no sign that it can involve other Asian states to expand the cooperation from East Asia to the whole region.

ASEAN+6 is a summit consisting of ASEAN leaders and six other leaders—the PRC, Japan, the ROK, Australia, New Zealand, and India—
with altogether 16 countries in the group. ASEAN+6 has far-reaching political and economic influence on Asian regional integration. Based on the ASEAN+6 mechanism, the East Asia Summit (EAS) was started in 2005 as a political forum to discuss comprehensive regionwide issues. In 2011, the Russian Federation and the United States, two external countries that have strong interests in Asia, also joined the EAS. Economically, the ASEAN+6 mechanism paved the way for the negotiation of the Regional Comprehensive Economic Partnership (RCEP), a prospective mega-scale and regionwide FTA, which was signed by 15 countries on 15 November 2020. If RCEP is realized, it will become the world’s largest economic bloc, and Asian economic integration will definitely become much more deepened and broadened than now. Within both the EAS and RCEP, ASEAN has played the central role and provided the major driving force for regional integration. The ASEAN+6 mechanism could be the Asian way to move toward Asian economic integration.

### 22.3.3 Role of Institutions in Asian Economic Integration

Capannelli and Tan (2012) have categorized the institutions in Asia into three types: overarching, functional, and facilitating. All three types of institutions have contributed to the economic integration in Asia. In particular, as the most important overarching institution, ASEAN’s role in promoting economic integration is significant, but its limitation is also evident, as the ASEAN Secretariat is not able to make strong imperative policy orders to its member states as the EU can.

The functional and facilitating roles of Asian institutions are not to be denied. Asia has a plethora of overlapping organizations. None has the breadth or depth to play the same role as the EU, in a region far more complex, diverse, and populous than Europe (Pilling 2012). There is no doubt that Asian institutions centered on ASEAN have been playing a very important role in the process of Asian economic integration. However, unlike in Europe, institutions do not seem to be the most important driving force for regional economic integration in Asia. Compared to Europe, the approach of economic integration is different. There are factors other than formal institutions that have a bigger influence on the trajectory of Asian economic integration. For example, FTAs are another very important driving force for Asian economic cooperation and integration.

Economic integration in East Asia is the best example showing Asia’s way of economic integration is very different from that of Europe. In East Asia, the trade and investment integration has not been driven by top-down policy initiatives such as regional institutions like ASEAN and ASEAN+3—let alone “regional regimes” or “global governance”
(Sally 2010). Urata (2009) also argues that the type of regional economic integration emerged in East Asia can be characterized as market-driven regionalization rather than institution-driven regionalization. Although the situation in Southeast Asia might be slightly different with the existence of ASEAN, at the regional level in Asia, the incentives for economic integration come from market practices and free trade negotiations more than from institutions.

If Europe’s economic integration relies mostly on top-down institutional policies, then Asia’s economic integration counts more on bottom-up market operation. This is more or less understandable, because the institutions in Asia are not as strong as those in Europe. ASEAN does not enjoy as much supranational power as the EU in policy decisions for the region. ASEAN member states have a much lower degree of loyalty to the institution than in Europe, not to mention the non-ASEAN member countries in Asia.

Compared to Europe’s advanced institutions, Asia has adopted a “soft institutionalism” approach, which delineates an “informal intergovernmental process” to promote economic cooperation (Hu 2013). Asia has adhered to its “Asian way” and “Asian values.” The ASEAN way stresses informality, organizational minimalism, inclusiveness, and intensive consultations leading to consensus and peaceful resolution of disputes (Pan 2015). The “Asian values,” advocated by the Malaysian Prime Minister Mahathir Mohamad and Singapore Prime Minister Lee Kuan Yew in the 1990s, stress the principle of collectivism, rather than hard norms and regulations, to unify Asian countries and promote economic and social cooperation. Although it has also received criticism, this reflects the different thoughts about and approaches to regional integration in Asia and Europe.

### 22.3.4 Asian Free Trade Agreements and Economic Integration

Together with the development of institutions, the number of FTAs has also been increasing rapidly in Asia. As Table 22.1 shows, there were only three FTAs in Asia in 1989 and 39 in 2000. However, the number has more than tripled in the past 2 decades, with 165 Asian FTAs signed and in effect as of February 2020. The key role of an FTA is to promote market liberalization through institution building by signing legally binding agreements (Kawai and Wignaraja 2011). FTAs have been playing a major role in the process of Asian economic integration. Without a regionwide single market, Asian economies have tried to negotiate with each other to reduce trade barriers and tariffs. The FTA boom in the past 2 decades has greatly promoted free
trade and market liberalization in Asia, strengthened intraregional economic cooperation and provided a continuous stimulus for the deepening of regional economic integration.

The ASEAN FTA (AFTA) covers a large market size and is also the basis for the bilateral FTAs between ASEAN and other Asian countries. The AFTA was signed in 1992 and now comprises all 10 member states. The major mechanism for the AFTA is known as the Common Effective Preferential Tariff scheme, which allows member states to impose tariffs on goods entering from outside ASEAN based on different national schedules. Within ASEAN, the many bilateral FTAs under negotiation provide a further rationale for integration (Asian Development Bank 2008). Meanwhile, ASEAN has actively signed ASEAN+1 FTAs with the PRC, Japan, the ROK, India, Australia, and New Zealand. Through these ASEAN+1 FTAs, ASEAN has played a central role in promoting free trade and regionalization at the region level. In Asia, regional economic integration has mainly focused on trade in goods and services, and, to some extent, investment (Pangestu and Armstrong 2018). Without a regionwide single market and trade policy, it is the FTAs that help enhance trade and investment in the region. In that sense, FTAs are significantly important for Asia’s economic integration.

Based on the network of ASEAN+1 FTAs, the interest in forming a larger regionwide and inclusive mega-FTA has been confirmed by most Asian countries. As discussed earlier, the RCEP negotiation has been initiated based on the ASEAN+6 mechanism, as well as the ASEAN+1 FTAs. ASEAN, as a regional institution, has certainly played a large role in convening these Asian countries to sit at the negotiation table. However, the mechanism that works in Asia is different from the EU, as it is not mainly through institutional norms and regulations, but intergovernmental efforts on trade liberalization and economic cooperation.

In Asia, as the problem of creating a FTA “noodle bowl” looms, negotiations on creating mega-FTAs are becoming more necessary and even urgent. The emergence of mega-FTAs is not a random phenomenon,
but part of the evolution of 21st century regionalism (Kimura and Chen 2016). In particular, to integrate fragmented bilateral and multilateral FTAs, a regionwide and inclusive mega-FTA is urgently needed. Different momentums and proposals such as RCEP and an Asia-Pacific FTA for the prospective mega-FTAs demonstrate competing regime creation processes and multilaterally motivated regionalism. Although institutional development is also bearing more fruit in the region, FTAs will continue to help enhance economic integration in Asia.

22.4 Comparing the Role of Institutions in Europe and Asia

Based on the analysis of the role of institutions in the economic integration of both Europe and Asia, this section seeks to compare the role of European and Asian institutions in order to shed some light on the similarities and differences between the two. Having said that the European and Asian versions of economic integration are sharply different, there are also similar points about the roles of institutions in regional economic integration. First of all, both the EU and ASEAN as advanced regional institutions have been facilitating and enhancing regional economic integration. For Europe, the history of the EU’s development itself reflects the process of deepening and broadening economic integration. For Asia, although its economic integration does not always rely on institutional development, still the role of Asian institutions is worth noting. Second, as stated in earlier sections, the institutional development in both regions have contributed to economic integration, but at the very early stages both had the political consideration and incentive to build regional institutions.

Needless to say, there are more differences than similarities between Europe and Asia in terms of the role of institutions in economic integration. First, the driving forces for economic integration are greatly different, and they decide that institutions have different roles in European and Asian regional integration. It is said that there are two categories of regionalization: “de facto economic regionalization” and “de jure institutional regionalization.” The former refers to integration via the emergence of transnational space among private market actors, while the latter refers to integration led by the formal authority of government actors and through a treaty or agreement (Breslin and Higgott 2010). Comparing the regionalization and economic integration in Europe and Asia shows that Asia represents “de facto economic regionalization,” while Europe has the traits of “de jure institutional regionalization.” The European experience of interstate cooperation
is based on characteristics of its institutional architecture (Murray 2010). In Asia, institutions also contribute to the economic cooperation, but they are not the decisive driving force. It is the development of markets and trade that has largely pushed Asian states to cooperate. The different ways that Europe and Asia develop and integrate their regional economy show that they have a different understanding and needs for institutions.

Second, the approaches to regional economic integration have large differences and thus could influence the process of institutional development. Since the outset, the EU was conceived and designed as a single undertaking in which all member countries would eventually participate in full in all policies, though in some cases after a transition period (Demertzis et al. 2018). That is why Europe was able to create a single market much earlier than ASEAN—or rather, Asia has not yet realized a single market. It took 35 years for Europe to establish its internal market, but in this period there was no doubt about the path of economic integration to be followed (Dorrucci 2015). Such an approach would require first the central countries to lead the institutional arrangement and make rules and regulations for others. The EU was first based on advocates by major European powers such as Germany and France. However, ASEAN, as the most successful regional organization in Asia, is only a decentralized intergovernment and nongovernment congress that operates without centralizing power (Pan 2015). Large countries in East Asia were not interested in taking the initiative to build regionwide institutional arrangements until very recently. Instead of achieving a single market through institutional construction, they are busy signing bilateral or multilateral agreements to build networks and increase trade partners in the region. As Yeo (2010) points out, the biggest difference between the approaches to regionalism in Europe and Asia is that Europe’s model is based on institutions, while Asia’s model is based on networks.

Third, in the process of economic integration, Europe and Asia have taken very different stances and policies on institutional building, due to their historical, cultural, and political differences. Europe has emphasized the importance of institutions from the very beginning of its economic integration. The system and function of the EU have been continuously strengthened through different laws and regulations in the process of its enlargement. However, Asia has not been keen to establish a regionwide institution to this day. Being “institution-lite” is a major characteristic of Asian regionalism (Asian Development Bank 2008). It also could be said that ASEAN mechanisms differ from the EU, owing to different emphases on sovereignty (Murray 2010). European countries might feel comfortable to delegate sovereignty to the EU,
while Asian countries still have worries and fears in doing so. This is certainly an issue related to the degree of regional collective identity. European people have a much higher regional collective identity than Asian people.

22.5 Conclusion and Policy Recommendations

Institutions in both Europe and Asia have facilitated regional economic integration. For Europe, the institutions centered on the EU have best facilitated functionalism to work out its effects. The comparison can conclude that there are significant differences between the roles of European and Asian institutions in regional economic integration. European economic integration relies on formal institutions, while Asian institutions are more informal. Rules and concepts such as the “Asian way” and “Asian values” sometimes also play a very important role, in addition to institutions.

Institutional development has not only contributed to economic growth and economic integration, but also helped reduce the development gap and promote common prosperity in Europe. Compared to Europe’s advanced institutions, Asia has adopted the approach of “soft institutionalism.” There still exists no formal regionwide institution in Asia like the EU in Europe. As the most advanced institution in a subregion of Asia, ASEAN has not been delegated the same strong power from its member states as the EU, and thus is unable to further upgrade the level of regional integration in Asia. Institutions also contribute to regional economic integration, but they are not the most important driving force for economic integration. With the absence of a regionwide institution or single market, Asia has built a large number of FTAs to promote free trade and market liberalization, strengthen intraregional economic cooperation, and provide a continuous stimulus for the deepening of regional economic integration.

Based on the comparison of the role of institutions in European and Asian economic integration, the following policy recommendations should be stressed for both Europe and Asia to learn from their history of economic integration—and in particular also for Asia to learn some lessons from Europe to further promote its regional economic integration.

First, political will and political calculation have been very important in the history of institutional development in both Europe and Asia. The political factor still plays a very important role in strengthening regional institutions and promoting economic integration. Governments need to take both political and economic calculation into consideration in making national and regional policy decisions. The ultimate realization
of full economic integration requires a significant degree of social and political integration (Hansen 2015). Therefore, economic integration is not only about economic calculation. Politically, policy makers must consider the following aspects: to what extent is the surrender of sovereignty a regionally sensitive issue? And to what extent is the surrender of sovereignty a domestically sensitive issue (Hansen 2015)? This is particularly important for Asia if it is to build a regionwide supranational institution like the EU.

Second, culture is another important factor that needs to be taken into consideration during the process of institution building. Cultural differences determine that Europe and Asia are bound to have different approaches to and visions for their regional economic integration. Whereas building a united Europe is among the EU’s priorities, there is no appetite in Asia for creating a united Asia (Asian Development Bank 2008). For example, Asia should also take its advantage of “soft institutionalism” and achieve more in economic integration through soft institutional or non-institutional arrangements. As long as the “Asian way” or “Asian values” better suit its practical situation, Asia should adhere to its own way of economic integration.

Third, the importance of institutions in economic integration is recognized in both the cases of Europe and Asia. Both the European and Asian experiences have demonstrated that well-functioning institutions could contribute to economic growth for individual countries and strengthen economic cooperation and integration at the regional level. Therefore, countries should also look for new sources of economic growth in the aspect of regionwide institutional arrangements. Meanwhile, the limits of regional institutions should also be recognized. No matter how advanced the institutions have become, there still needs to be supplemental arrangements to enhance economic integration. Therefore, both Europe and Asia should take institutions and informal networks as complementary to each other.

Fourth, institutions in both Europe and Asia need to be reformed to catch up with new trends and needs. The EU’s original institutions are now in need of deep revision because of the evolving internal and external political and economic environment, as well as the enlargement of the EU (Capannelli and Tan 2009). For example, the necessity of a more flexible structure is increasingly recognized, including by heads of state and government such as President Emmanuel Macron of France, who has called for a “Europe of several circles” (Demertzis et al. 2018). For Asia, the situation is even more serious. The agenda for the reform of the ASEAN Secretariat is urgently needed for it to better facilitate the broadening and deepening economic integration in the region. The East Asian countries should also delegate more power to the TCS to strengthen
the trilateral cooperation and accelerate the negotiation process of the PRC–Japan–ROK trilateral FTA. Although a supranational regionwide institution might not be practical at the moment, Asia should not give up further strengthening the institutional arrangements at the regional level.

Fifth, a regional institutional arrangement must be considered in the global context to develop external relationships with countries outside the region. One region’s close interaction with other regions might help gain some external driving force for its integration. For example, Zhang (2012) argues that East Asia’s institution building should not be inward looking, but since the regional economies are highly integrated into the world economy, they should play a strong and active role in global governance. With the notion of ASEAN Centrality, ASEAN has been active in involving other subregions of Asia and playing a core role in regional integration. Since its connection with the outside world is also essential, East Asian countries should also undertake more initiatives. As Asia already accounts for about 45% of the world’s gross domestic product (International Monetary Fund 2019), and the interdependence between Asia and other regions keeps rising, connection and cooperation with economies outside the region will become more and more important.

Sixth, Asia has much to learn from the Europe in terms of making use of institutions to promote economic integration and social cohesion. For example, functionalism as a good approach for regional integration is worth learning. Functionalism is closely related with institution building and could greatly facilitate the development of institutions. In Asia, there should be more functions delegated to international institutions to create so-called spillover effects in economic, social, and political areas. Functionalism does not only bring economic benefits but also has the effects of socialization. The role of socialization that regional institutions have played in the process of regional integration cannot be ignored. There is little doubt that regional institutions have been critical in the socialization process, both before and after the target states became formal members (Acharya 2011). Asia should rely more on institutional functionalism to promote its socialization, which would lead to deepening regional integration.

Finally, as the EU’s experience demonstrates, historical reconciliation is a critical element in developing the necessary political will for cooperation and, ultimately, integration (Cameron 2010). The initial incentive for European institution building was to try to realize reconciliation after the war and prevent war happening again. As the fact that the EU was awarded the Nobel Peace Prize shows, the development of the EU and European regional integration in the past more than half
century has realized its initial goal. Europe has become a region of peace and prosperity thanks to the contribution of the EU, as the Norwegian Nobel Committee’s statement indicates. However, Europe has realized its political goals through economic means. Economic integration has been attached far more importance than political integration, but political achievements have also been reaped through economic integration. This has significant implications for Asia, a region in which historical reconciliation has not yet gained real meaning. Historical issues and nationalism sometimes can deteriorate political relationships overnight and damage the fruits of economic cooperation. Asia should learn from Europe to deepen economic interdependence and create conditions for historical reconciliation. The day when an Asian institution receives the Nobel Peace Prize will come if Asia can realize historical reconciliation through institutional development and regional integration.
References


PART V
Energy and the Environment
23


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23.1 Introduction

In this chapter, we explore how the Association of Southeast Asian Nations (ASEAN) grouping might advance its energy trilemma—the need for secure, affordable, and green energy—through greater energy cooperation and whether the efforts of the European Union (EU) on energy integration may hold lessons for ASEAN. This is particularly important since ASEAN countries have been described as climate and energy policy laggards (Razzouk 2018). To see whether EU energy collaboration holds lessons for the ASEAN grouping, it is important to understand the historical context of EU energy integration.

With the birth of the European project attributed to the European Coal and Steel Community (1951), energy matters were at the heart of European economic integration at its inception (McGowan 1994). However, progress toward a European energy policy and a single European energy market has been slower than in other areas due to the determination of national governments and national interests to retain control over energy matters (Andersen 2000). Despite setbacks along the way, European efforts have persisted over time, with the
Energy Policy for Europe (European Commission 2007) representing a watershed effort to increase European influence on energy matters. This policy set ambitious targets for energy efficiency, the adoption of renewables, and cuts to greenhouse gas emissions, as well as continuing efforts to create integrated and liberalized European energy markets. Thus, the Energy Policy for Europe sought to integrate energy and environmental policy at the EU level, which had hitherto functioned largely separately.

The birth of EU environmental policy was marked by the European Council’s 1972 declaration of the first Environment Action Programme (Gubb 2007). Subsequently, EU influence on environmental matters has grown as exemplified by the commitment to sustainable development in the Maastricht (1992) and Amsterdam (1997) Treaties and by the Lisbon Strategy (2000). Though there have been policy failures, such as the aborted proposals for an energy/carbon dioxide (CO$_2$) tax in the early 1990s (Andersen 2000), there have been numerous accomplishments. Of these, perhaps the most prominent were the leading role the EU played in global environmental negotiations, like the Kyoto Protocol, and the establishment of the EU Emissions Trading Scheme. Just as significant have been a raft of low-profile decisions, directives, and resolutions on a host of environmental issues, ranging from ensuring water quality to setting standards for waste disposal, and from protecting wildlife and fauna to increasing the energy efficiency of appliances and buildings (see Section 23.3.2). The EU is now on its seventh Environmental Action Plan, which runs until 2020.

Andersen (2000) reviews efforts at creating a European energy policy up to the turn of the century and identifies four distinct periods. The first covered the period 1946–1957 when energy cooperation, in particular concerning coal, drove wider political cooperation. This was followed by a period (1957–1972) when cheap imported oil replaced coal, resulting in energy policy becoming largely peripheral to the European project. The third period (1973–1985), heralded by the oil shocks of 1973 and 1979, created renewed interest in European energy cooperation, which ultimately failed.

Since 1985, the supranational influence of the EU in energy matters has steadily grown as the EU’s environmental and competition policies have become increasingly established and pervasive (Andersen 2000). As reviewed in Section 23.3, these efforts can be placed into a hierarchy of energy sector restructuring streams, as illustrated in Figure 23.1.

The liberalization objective or pillar contains one stream (Internal Energy Market); the decarbonization objective is comprised of two streams (Energy Efficiency and Renewable Energies); a miscellaneous objective contains one stream (Security of Supply).
As noted, the *Energy Policy for Europe* attempted to integrate the environmental and competition (liberalization and integration) pillars of the energy and environmental policy. Further, the policy sought to add an energy security pillar or objective by “promoting EU energy solidarity” (European Commission 2007). Though the EU has seen marked successes in the liberalization and environmental pillars of its energy policy, progress on energy security has been slower (see Section 23.4.1). Some might argue that a precondition to establishing a truly credible energy security policy is the creation of a broader foreign and security policy for the EU. If this is challenging for the EU, then the challenge for ASEAN is even larger.

The EU and ASEAN share a number of similarities, but they have important differences that strongly moderate the strength of integration and cooperation in any sphere, including energy policy. Both seek to integrate their economies, are involved in trade agreements, have regular political and economic dialogue, and seek to promote peace (Koh 2017). However, ASEAN is an intergovernmental organization, while the EU is a supranational organization where large elements of sovereignty have been “pooled” at the EU level. The EU has a parliament with the power to legislate and a powerful quasi-executive body in the form of the European Commission and the European Council. Crudely put, the EU can pass legislation that requires implementation of laws and regulation by member states in specific areas, which include energy
and environmental policy, while ASEAN has no such powers. These differences provide an important context for any lessons that ASEAN may glean from the EU’s efforts to create the Energy Policy for Europe.

23.2 Energy Transition Pathways

In response to growing concerns about climate change and the need to meet the social and economic needs of energy demand, new energy production and consumption paradigms have been advocated worldwide. Despite contrasting visions, techno-market approaches dominate (European Commission 2011; US DOE 2009; Verbong and Geels 2010), where the interaction between markets and technological innovation, such as smart appliances, smart grids, and electric vehicles, is envisaged. This approach emphasizes price signals as being central to directing change within the energy system, not only in altering the energy mix and moving supply from fossil fuels toward renewable energy, but also in creating more demand-responsive consumers.

There is a good deal of forward-looking work attempting to envisage the decarbonized energy system of the future as reflected with interest in “smart grids” (e.g., Battaglini et al. 2009; European Commission 2011; US DOE 2009). Smart grids can be understood as the marrying of information and communication technology and software (including artificial intelligence and blockchain) to the electricity grid in order to facilitate an electricity system that allows for demand-responsive consumers and effectively integrates renewable generation and new consumer technologies such as electric vehicles (see Section 23.2.1 for a fuller description of “smart grids” and “smart energy systems”).

As noted, a central tenet behind most visions of the “smart grids” of the future is the price signals that energy markets will deliver to facilitate effective and efficient resource allocation. Hence, smart consumers will charge their electric vehicles when prices are lowest and feed back to the grid when they are very high. This vision intertwines energy systems with electricity market liberalization and competition (see Section 23.3.1 for a related discussion in the European context). Thus, energy transition represents a technology-driven paradigm shift that involves doing things in “new ways” facilitated by technology and markets.

23.2.1 Paradigm Shift and Transition Pathways

Some of the key attributes of the “smart grids” or “smart energy systems” of the future include the following (see Lund et al. 2017; US DOE 2009; Valocchi, Juliano, and Schurr 2010; Verbong and Geels 2010):
• **Integration of renewables:** In particular, intermittent wind and solar photovoltaic (PV) generation, which has become cost-competitive relative to fossil fuels on a levelized cost of energy, or LCOE, basis. Indeed, in many countries, production of renewables is now cheaper than fossil fuel generation (Merchant 2018).

• **Demand-side management and price-responsive consumers:** Enabled by technological innovations such as smart appliances and smart meters, as well as the aforementioned “aggregators” and their new services.

• **“Prosumers”:** Consumers, being also producers, provide small-scale generating technologies such as PV generation and small-scale wind turbines. The ability to be a “prosumer” is enabled by technologies such as bidirectional smart meters.

• **New energy market participants and services:** An increased emphasis on energy services rather than energy consumption with new third-party market participants intermediating (often referred to as aggregators and/or energy service companies) between the energy system or market and end users.

• **Integration of electric vehicles (EVs):** Increasingly, EVs are seen not just as a drain on the system but as an integrated component for balancing due to the possibility of using EV batteries as a form of energy storage that can feed back into the grid (US DOE 2009). This is known as vehicle to grid, or V2G, and is possible since vehicles spend the vast proportion of their time idle (parked), so if they are idle and they are connected to the distribution network they can be used as batteries in the network to smooth out peaks and thus reduce costs.

• **Energy storage:** Storage is again expected to be facilitated by technological innovation such as improved battery technologies.

• **Green hydrogen:** Although many facets of the energy system are likely to be electrified (e.g., light vehicles fleet), there will remain a need for liquid fuels to deal with long-range transport, industrial processes, and winter heating needs. Green hydrogen is ideally placed to meet these needs in the energy sector and indeed some countries will seek to pursue the hydrogen economy more broadly (Lund et al. 2017; Clark II 2008).

Most visions of the future share these attributes; however, there are contrasting configurations of the future end state of the energy system within the boundaries of these attributes (Battaglini et al. 2009; Foxon, Hammond, and Pearson 2010; Verbong and Geels 2010).
Table 23.1: Alternative Visions for the Energy System in the Long Term

<table>
<thead>
<tr>
<th>Transition Pathway</th>
<th>Description</th>
<th>Network Change</th>
<th>Dynamic</th>
</tr>
</thead>
<tbody>
<tr>
<td>TP1: Transformation or “Hybrid Smart Grids”</td>
<td>Centralized generation continues to dominate but is complemented by renewables and small-scale distributed generation. Network infrastructure remains principally defined at the national level. Use of fossil fuels continues but Carbon Capture and Storage ensures the system is decarbonized.</td>
<td>Medium</td>
<td>Economic: the market as an organizing force</td>
</tr>
<tr>
<td>TP2: Reconfiguration or “Super Smart Grid”</td>
<td>Supranational/regional energy policy (e.g., European Union) results in the creation of a transnational super grid that geographically diversifies away the intermittency problem of renewables, thereby allowing for a fully renewable-based system.</td>
<td>High</td>
<td>Economic and political: the market and international collaboration as organizing forces</td>
</tr>
<tr>
<td>TP3: Realignment or “Distributed Smart Grids”</td>
<td>This TP can be seen as the opposite response to TP2 to energy policy challenges. There is an increased emphasis on energy conservation and local small-scale renewables generation. The national network is replaced by “loosely coupled regional and local grids (micro grids)” (Verbong and Geels 2010).</td>
<td>High</td>
<td>Localism: A decentralized and localized response to energy policy challenges</td>
</tr>
</tbody>
</table>

Source: Adapted from Battaglini et al. (2009); Hojčková, Sandén, and Ahlborg (2018); Verbong and Geels (2010).

These contrasting visions have been articulated using evolutionary paradigm shift models (Verbong and Geels 2010; Foxon, Hammond, and Pearson 2010). For instance, Verbong and Geels (2010) apply the Geels and Schot (2007) multilevel approach with alternative transition pathways to energy sector paradigm change. Specifically, they identify three transition pathways (TPs), which are described in Table 23.1 and which are assessed with respect to the degree of network change they imply relative to the existing network configuration and the principal dynamic driving change.

Although the TPs differ in terms of how radical they are with respect to network configuration, all three require large-scale investment (Verbong and Geels 2010, 1219). TP1 represents a nationally dominated...
energy transition, whereas TP2 represents a supranational solution. TP2 is appealing as it means that integrating renewables is easier because of generating portfolio and geographical diversification benefits—thus, in the EU context, if the wind is not blowing in northern Europe, the sun is likely shining in southern Europe, so the south can send energy to the north via a pan-European high-voltage direct current (HVDC) network.

TP3, on the other hand, represents a subnational “localized” vision of energy independence, which is appealing for rural communities that have hitherto not had access to electricity. Indeed, this highlights that TP2 and TP3 are not mutually exclusive. This is particularly relevant to ASEAN economies that (1) need to meet demand in large cities and connecting those cities across borders will allow for higher levels of renewables (TP2), and (2) at the same time, need to reap the social and economic benefits of providing electricity to the rural and remotely located populations (TP3). In the latter case, TP3 should be a cheaper approach to electrifying rural areas that under a national TP1 would require expensive building of transmission and distribution lines. Thus, an energy policy for ASEAN should explicitly pursue a dual TP2 and TP3 strategy.

23.3 EU Energy Policy and Integration

As noted in the Introduction, energy integration has been at the heart of the economic integration of Europe. Traditionally, the European energy supply was based on national and regional markets with vertically integrated companies that could produce, transmit, and distribute energy to nearby consumers with natural, regional monopolies. Since 1987, the EU has begun to make progress toward greater European integration, allowing the free movement of goods, persons, services, and capital across European borders. The overall objective was to increase transnational competition within the EU, thereby exposing inefficiencies in firm operations and slowly phasing out inefficient firms. Consequently, there have been a large number of legislative acts establishing common rules for a single European internal market for energy, replacing the national- and regional-based structures for the energy supply (Jamasb and Pollitt 2005).

In addition, as already noted, the energy sector has been exposed to a number of environmental objectives aimed at reducing carbon emissions through policy and market mechanisms, such as the EU Emissions Trading System (EU ETS). Thus, another major EU-led reform thrust that has built up particular momentum is related to the environmental objectives of the sector, or the “greening” of the energy supply. In addition to the EU ETS, this reform thrust has focused on reducing
demand through energy efficiency legislation and through policies that promote renewable energies. In addition to the liberalization and environmental policies, EU utilities have also been subject to a range of legislation related to the security of the energy supply. The following sections outline four distinct restructuring streams impacting the energy sector, which are depicted in Figure 23.1.

23.3.1 Liberalization Stream

The liberalization objectives of the energy sector are congruent with the overall goals of the EU community: to progressively create internal markets for specific sectors, removing all internal frontiers. The Single European Act (1987), the first major revision of the Treaty of Rome (1957), aimed to allow the free movement of goods, persons, services, and capital across European borders. The liberalization stream focuses on removing frontiers to gradually establish internal markets for electricity and natural gas, creating a competitive energy market. The removal of international barriers allows European energy utilities to create much larger customer bases throughout Europe. Nonetheless, it also exposes the energy utilities to potential reductions in demand, as competitors from other EU countries can now compete for incumbents’ domestic customer market segments. A gradual approach to introducing EU-level competition was chosen, designed to enable the sector to adjust in a flexible and ordered manner to its new competitive environment.

Within the EU legislation to liberalize the energy sector, there were three major reform initiatives, referred to as the “three packages.”

The first packages: The first packages for electricity (Directive 1996/92/EC) and gas (Directive 1998/30/EC) were published in 1997 and 1998, respectively. The packages represent the first attempts to remove national barriers in the EU. The packages resulted in only minor liberalization of the energy sector and minor commitments from member states; only high-volume commercial consumers were able to switch suppliers (Eikeland 2011). The first packages provided no clear rules on the transmission of energy through existing networks but required revenue unbundling of vertically integrated companies, recording generation and retail revenue separately. Regardless, vertically integrated companies still possessed monopolies over retail networks and therefore were able to survive any wholesale price shocks, while nonintegrated companies became bankrupt (Jamasb and Pollitt 2005). This provided an economic incentive for nonintegrated companies to integrate generation and distribution through asset acquisition or mergers. As a result, there was relatively little competition in the EU energy sector.
The second packages: Implementing the first packages was argued to have resulted in a variety of benefits, including increased efficiency, price reductions, higher standards of service, and increased competitiveness. However, the sector still lacked concrete provisions that ensured a level playing field in terms of generation and reduced the risk of market dominance. Further, member states’ idiosyncrasies caused delays in restructuring implementation, allowing vertically integrated utilities to continue to impede fair competition (Eikeland 2011; Erdogdu 2014). The second packages (Directive 2003/54/EC; Directive 2003/55/EC) for electricity and gas were published in 2003, with the objective of creating a truly open market in the EU, which allowed consumers to freely choose suppliers and suppliers to freely deliver to customers across Europe. The second packages aimed to achieve 1) legal unbundling of transmission system operators and distribution system operators from the remainder of the industries, 2) free entry to generation, 3) monitoring of supply competition, 4) a fully open market enabling household customers to switch suppliers, 5) promotion of renewable energy fuel sources, 6) strengthening of the role of the market regulators, 7) a single European market for energy, and 8) regulated access to energy grids (Jamasb and Pollitt 2005; Eikeland 2011). The rationale was that a legally independent transmission operator would charge equitable prices to competing generators, increasing the transparency of pricing. Further, a fully open market would allow consumers to freely choose energy suppliers.

The third packages: The third packages (Directive 2009/72/EC; Directive 2009/73/EC), published in 2009, were designed to address the unachieved liberalization objectives of the second packages (Eikeland 2011). The legislation highlighted that the legal and functional unbundling of vertically integrated companies did not lead to effective unbundling of transmission system operators. More than two-thirds of the European generation market share was owned by eight large utilities (Jamasb and Pollitt 2005). This ownership structure resulted in continued misuse of networks, with competing energy generators complaining of unfair grid access and network fees (ACER 2013). A clear and effective way to solve the discriminatory network access obstacle was the unbundling of ownership at the transmission level for vertically integrated companies, separating transmission and generation companies into two distinct entities. Further, the legislation also proposed the modernization of distribution networks into “smart grids” (see Section 23.2), encouraging decentralized generation and energy efficiency. Finally, the third packages addressed the issue that national regulators lacked independence from the government, and had insufficient powers and discretion to effectively regulate the sector.
To ensure restructuring legislation was enforced, market monitoring agencies were established to act as independent regulatory authorities. In 2003 and 2005 (Regulation 1228/2003; Regulation 1775/2005), fair rules for cross-border exchanges in electricity and gas were established. The European Regulators’ Group for Electricity and Gas (ERGEG) (Commission Decision 2003/796/EC) was established as a temporary solution to address failures of fair grid access. ERGEG sought to ensure that EU-level legislation was consistently applied, facilitating independent regulatory authority, consultation, coordination, and cooperation between regulatory bodies within member states. Despite ERGEG’s positive contribution, criticisms of discriminatory access to networks continued. As a result, in 2009, the Agency for the Cooperation of Energy Regulators (ACER) (Regulation 713/2009) was established in conjunction with the third packages. ACER monitors regional cooperation and seeks to ensure operational transparency and efficiency.

In summary, a variety of legislative changes relating to sector liberalization have been published over the last 2 decades. The sectors are becoming increasingly liberalized despite resistance from big utilities. Further, regulatory agencies have been established to counteract sector domination by some energy utilities. The EU experience in trying to create a single European energy market holds some valuable lessons for ASEAN. The process is challenging and slow but can benefit from supranational legal authority and perseverance (in the EU, it took three legislative packages over several decades to make meaningful progress). Also, to ensure a level playing field, the sector needs to be restructured, and ideally independent supranational regulatory agencies need to be created.

### 23.4 Energy Efficiency Stream

Besides sector liberalization, a second theme that has gained prominence in recent years is the “greening” of the energy supply. Agreed by EU leaders in 2007 (as part of the Energy Policy for Europe), environmental objectives aim, by 2020, to boost renewable energy use to 20% of total energy, reduce greenhouse gas emissions by 20%, and achieve a 20% increase in energy efficiency, commonly referred to as the 20-20-20 targets. There are two methods aimed at achieving climate change objectives: the economic (incentives) approach and the regulatory approach. The EU applied both in environmental policy. In the former case, the EU ETS provided general economy-wide incentives to reduce emissions (we do not present a detailed discussion on the EU ETS as it is well researched elsewhere; see, e.g., World Bank 2019). The latter approach prescribes policies or forbids processes, products, and
activities. These regulations and directives are the unsung heroes of energy transition in Europe and had a material impact on incumbents (see Tulloch, Diaz-Rainey, and Premachandra 2017). This section examines the legislation enacted to achieve greater energy efficiency, while Section 23.3.3 highlights the legislation that promoted renewables over and above the incentives provided by the EU ETS.

The Energy Efficiency stream was designed to reduce the rate of growth of internal energy consumption. The Energy Efficiency stream was implemented in two ways. First, it aimed to encourage manufacturers to make more energy-efficient appliances by informing the public of the energy consumption of common electrical household appliances. The Energy Efficiency legislation systematically identified energy-intensive end-user appliances and required comprehensive labeling of consumption. The labeling scheme implemented a standardized measure of energy efficiency, rating energy consumption. Appliances included space heating, air conditioning units, electric ovens, lights, washers, driers, refrigerators, and freezers. The legislation also set a maximum electricity consumption allowed per appliance. The rationale behind the stream was that end users, when faced with choices of similar appliances, would favor the appliance that consumed the least energy.

The second objectives of the Energy Efficiency stream were related to the energy consumption of buildings, which accounts for 40% of the EU’s total energy consumption (Directive 2010/31/EU). The legislation required objective information on the energy characteristics of buildings to help improve the transparency of the property market and encourage energy efficiency. In an effort to reduce emissions, the legislation required that buildings were to be billed for heating, air conditioning, and hot water based on actual consumption. Similarly to the appliance legislation above, home occupants were expected to self-regulate their own consumption and be incentivized by economic savings on fuel bills. Property legislation had a differential impact on old buildings compared with new buildings. Old buildings were to be improved through insulation, whereas new buildings were subjected to more regulation with the intention of being carbon-zero by 2020.

In summary, the energy efficiency legislation represents a change in the total end user demand for energy in the EU. The expectation is that the energy demand in Europe will fall by 10% to 20% by 2050 as a result of legislative changes (Delarue et al. 2011).

### 23.4.1 Renewable Energies Stream

Similarly to the Energy Efficiency stream, the Renewable Energies stream also focused on reducing carbon emissions in the EU. However,
the stream focused on the supply side. In 2001, Directive 2001/77/EC set an indicative target of 22.1% of gross electricity consumption from renewable energy sources (RES) by 2010. In 2007, the EU endorsed a mandatory target of a 20% share of final energy consumption from RES by 2020, ultimately becoming Directive 2009/28/EC. Emission reductions were expected to be achieved through increased RES use in electricity generation and transport.

The typical electricity market design assumes that thermal or hydro plants will supply the bulk of services. The low marginal cost of RES and nuclear energy means these generators can sometimes outbid all gas- and coal-fired generation, especially during periods of low demand (Green and Vasilakos 2010). This has been magnified by the renewable energy legislation, which focused on providing grid priority for electricity generated from RES and biofuels (Directive 2001/77/EC). Grid priority ensured that renewable energy generators were able to sell and transmit electricity, in accordance with connection rules, whenever the renewable energy source (solar, wind, hydro, etc.) became available. Put simply, they were afforded first access to the grid ahead of combustion fuel generators. This grid priority was uncapped, allowing the renewable generators to utilize their maximum capacity (Directive 2009/28/EC), thereby reducing the number of operating hours for conventional generators.

RES support schemes, such as feed-in tariffs and premiums, green certification markets, also incentivize RES, and the EU has played a major role in their design and in ensuring there is a level playing field in their use. For instance, the European Commission (2013) gave guidance on their design. The RES support schemes led to a rapid uptake of renewables in the EU (Davies and Diaz-Rainey 2011), with most large EU member states having implemented some form of support in the late 1990s.

Further, the renewable energies legislation focused on increasing technological improvements within energy utilities and, more importantly, setting targets for the electrification of neighboring sectors. The purpose of the objective was to reduce the EU’s reliance on imported energy (primarily oil). Specifically, the EU has set a mandatory target for the overall share of energy from renewable sources (both biofuel and viable alternatives) for the transport sector. Transport fuel accounts for more than 30% of final energy consumption (Directive 2003/30/EC), and is expanding as the EU community expands. Additionally, road transport accounts for 84% of transport-related CO₂ emissions. The 2020 targets for the transport sector were: 1) a minimum of 20% of conventional fuels being substituted by alternative fuels; and 2) a minimum of 10% of energy being derived from renewable energy sources, applicable
across all member states. The renewable energy legislation also focused on decentralizing renewable energy technologies, which was expected to increase the utilization of local energy sources, increase the energy supply, and reduce energy transmission losses—increasing the overall efficiency of energy generation. Naturally, such a rapid expansion of renewable energy requires labor, thereby creating local jobs for EU residents—also expected to increase value through corporate social responsibility.

### 23.4.2 Security of Supply Stream

The Security of Supply stream focused on reducing the harmful effects from difficulties in securing crude oil and petroleum products, for both energy and economic activity. The legislation requires member states to maintain minimum levels of crude oil reserves and petroleum products, determined by various levels of inland consumption (Kanellakis, Martinopoulos, and Zachariadis 2013). The intention was to release strategic reserves of oil into the international market in the event of a supply disruption that required market-level intervention to bridge the supply gap. Supply gaps could arise through a variety of situations, including, but not limited to, price developments in the commodity markets or disruptions in the supply of natural gas. Accordingly, the member states are obliged to maintain minimum stocks of crude oil and/or petroleum products, distribute these stocks to users, impose restrictions on oil consumption, and give priority of supplies to certain groups. The overall objective is to grant competent authorities the necessary powers to partially regulate oil prices in order to prevent abnormal price rises (Council Directive 73/238/EEC).

A second major objective of the Security of Supply stream is to reduce the overall financial burden of energy costs on the final consumer (Council Directive 2009/119/EC). Typically, this has involved establishing one central stockholding entity per member state, set up for the purpose of holding sufficient supplies of oil stocks (Council Directive 2009/119/EC). The purpose of the central stockholding entity is to also allow fuel switching in the case of disruptions, using crude oil and petrol products in energy production (Council Directive 2009/119/EC). From 2004 to 2006, legislation (Council Directive 2004/67/EC; Directive 2005/89/EC) also began to focus on maintaining the security of supply of natural gas and electricity. Specifically, there is an emphasis on minimum targets for storage of natural gas and establishing long-term supply contracts, which is connected to the Internal Energy Market legislation. For electricity, the legislation focused on maintaining adequate generation capacity, a balance between supply
and demand, and appropriate interconnections between member states. The legislation also established bilateral oil supply agreements between member states to ensure backup oil reserves were available when needed, as well as the Gas Coordination Group, which facilitated the security of supply of natural gas at the community level in the event of major supply disruptions. To ensure compliance with the Security of Supply objectives, the 2009 legislation established an additional consulting agency comprised of representatives from member states: the “Coordination Group” for oil and petroleum products.

Overall, the EU energy security stream has established reactive measures to energy security risks by ensuring that member states hold a minimum level of prudent reserves, via the ability to switch fuels and by partly regulating prices in terms of crises. These reactive measures are important but a far cry from a common EU foreign policy that could target energy security risks proactively (see related earlier discussion at the start of the chapter).

23.5 ASEAN Energy Transition

23.5.1 ASEAN Energy Context and Cooperation

The ASEAN region is one of the fastest-growing economic regions in the world. With its growing populations and dynamic economies, the region has been facing challenges in addressing the increasing energy demand (Rakhmah and Li 2016; Shi 2016). Therefore, the region adopted ASEAN Vision 2020 on energy cooperation in 1997 that aimed for an “ASEAN partnership in dynamic development aimed at forging closer economic integration within the region” (Tongsopit et al. 2016). The vision emphasized better energy cooperation via interconnected electric grid and gas pipeline networks across the region, depending more on renewable energy and promoting energy efficiency in the future. Hence, the ASEAN Plan of Action for Energy Cooperation (APAEC) 1999–2004 was formulated and subsequently updated for 2004–2009, 2010–2015, and 2016–2025 (Tongsopit et al. 2016). Thus, current cooperation in the energy sector within the region is directed by APAEC 2016–2025. The theme of this plan is “enhancing energy connectivity and market integration in ASEAN to achieve energy security, accessibility, affordability, and sustainability for all.” This document outlines seven priority programs with action plans:

- ASEAN Power Grid
- Trans-ASEAN Gas Pipeline
- Coal and Clean Coal Technology
- Energy Efficiency and Conservation
• Renewable Energy
• Regional Energy Policy and Planning
• Civilian Nuclear Energy

APAEC strongly emphasizes ASEAN energy market integration and connectivity to accelerate the realization of the ASEAN Economic Community (Andrews-Speed 2016b). However, as intimated in the Introduction, these programs do not have the legal standing that equivalent EU directives and legislation have (see Sections 23.3.1–23.3.4).

The ASEAN Power Grid (APG) aims to facilitate multilateral electricity trading, while the Trans-ASEAN Gas Pipeline (TAGP) aims to connect liquefied natural gas regasification terminals. In addition, APAEC 2016–2025 encourages clean coal technologies, promotes strategies for energy efficiency and renewable energy sources, and focuses on nuclear capacity building for future energy security. It also offers an avenue for collaboration between ASEAN’s dialogue partners, international organizations, businesses, and academics in an effort to share their expertise.

The APG has been a flagship initiative of APAEC 1999–2004 under the ASEAN Vision 2020 since 1997, aiming for an integrated regional power grid. However, due to regulatory, policy, and fiscal barriers, progress toward establishing integrated energy market has lagged behind expectations (Andrews-Speed 2016b). In September 2014, ministers from the Lao People’s Democratic Republic, Thailand, Malaysia, and Singapore agreed to initiate a pilot project to evaluate the likelihood of cross-border power trading. Andrews-Speed (2016b) notes that no initiative has been undertaken so far under this proposed pilot and blames the lack of liberalization of the ASEAN power sector for hindering the integration process. According to the ASEAN Energy Cooperation Report 2017 (ACE 2017b), as of 2016, eight APG projects have been completed out of a planned 16 projects with a capacity of about 1,723 megawatts, thereby bringing the total capacity of the APG to 5,212 megawatts.

Another ambitious project that ASEAN has sought to promote is called the Trans-ASEAN Gas Pipeline (TAGP), which is an integrated natural gas pipeline network connecting regional gas reserves in the Gulf of Thailand, Myanmar, and Indonesia to the rest of the region (Sovacool 2009). The project aims to increase energy security and promote cooperation and dialogue among the regional counterparts. The ASEAN Centre for Energy (ACE 2017b) highlights that, so far, 3,673 kilometers of pipelines linking six countries and six liquefied natural gas regasification terminals, with a total capacity of 22.5 million tons per annum, have been built. However, these are the result of a bilateral approach as opposed to a more integrated and planned approach.
As noted earlier, the ASEAN region has been growing rapidly, meaning that meeting associated growth in power demand, particularly uninterrupted electricity demand, is a considerable challenge for ASEAN governments (Rakhmah and Li 2016; Shi 2016). The population, urbanization, and industrialization have kept energy demand high. To meet this demand, electricity installed capacity increased by an average of nearly 8% per year between 2005 and 2015. ACE (2015) estimates that energy demand is projected to rise by an average of 4.7% per year between 2013 and 2035.

Given this expected increase in energy demand, cooperation among ASEAN countries is important if this extra demand and existing demand are to be “greened” via renewables—as noted in Section 23.2.1, a “Super Smart Grid” in line with TP2 makes the integration of renewables much easier. This approach would thus support the growing power demand and limit greenhouse gas emissions. However, the current power supply path in the ASEAN region is not sustainable due to clusters of energy poverty (lack of access to electricity or clean cooking facilities) and a rising power demand met largely via fossil fuels (IRENA 2018; Shi 2016). Shi (2016) describes the ASEAN energy mix as brown and expects that CO₂ emissions will double in coming decades under current trajectories. Further, although there are a rising number of interconnectors in the region, ASEAN energy market integration has been slower than planned and restricted to bilateral relations (see Andrews-Speed 2016a and Section 23.4.3).

Figure 23.2: ASEAN Primary Energy Supply Structure by Fuel, 2017

<table>
<thead>
<tr>
<th>Fuel</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil</td>
<td>35.08</td>
</tr>
<tr>
<td>Gas</td>
<td>19.88</td>
</tr>
<tr>
<td>Coal</td>
<td>19.79</td>
</tr>
<tr>
<td>Biofuels</td>
<td>18.40</td>
</tr>
<tr>
<td>Geothermal</td>
<td>4.58</td>
</tr>
<tr>
<td>Hydro</td>
<td>2.16</td>
</tr>
<tr>
<td>Other renewables</td>
<td>0.11</td>
</tr>
</tbody>
</table>

ASEAN = Association of Southeast Asian Nations.
Source: Compiled from IEA (2019).
The total primary energy supply in the region is dominated by fossil fuels (Figure 23.2). In 2017, oil had the largest share of total primary energy supply with more than 35% for the ASEAN region, while gas and coal contributed approximately 20% each. Biofuels hold the highest share in renewable sources at 18.40%, followed by geothermal and hydro at 4.58% and 2.16%, respectively. Other renewable sources (solar, wind, etc.) were underutilized as they amounted to less than a 1% share.

Indonesia, Malaysia, Thailand, and Viet Nam have the highest energy needs in the region (Figure 23.3). However, all four countries depend heavily on either oil, gas, or coal. On the other hand, a few countries, such as Cambodia and Myanmar, rely more on renewable sources (Figure 23.4), particularly on biofuels and waste. Malaysia and Viet Nam are leading the way in terms of hydro projects, and Indonesia has the largest geothermal sector, followed by the Philippines, in ASEAN. Energy trading has been growing in the region due to the rise of the People’s Republic of China and India (Wu 2016). According to ACE (2017a), the key energy commodities for export are coal and gas. Malaysia and Viet Nam are the main exporters of gas, Indonesia
exports considerable amounts of coal, and the Lao People’s Democratic Republic is a hydropower exporter in the region, whereas Thailand and the Philippines import energy commodities, particularly oil and gas.

Although ASEAN depends heavily on fossil fuels for energy production (Tongsopit et al. 2016), the region has abundant renewable resources, which could be harnessed to contribute to regional energy security (Huang et al. 2019). In 2015, the region announced an intention to increase renewable energy to account for at least 23% of the energy mix by 2025 (ACE 2017b). In line with our earlier augment in favor of a TP2-type architecture (see above and Section 23.2.1), Huang, Kittner, and Kammen (2019) and IRENA (2018, 156) note that the region can transition toward a low-carbon future cost effectively by integrating RES on an interconnected grid.

23.5.2 Renewables Diffusion and Policy

Wind and solar are the two key competitive “new” renewables whose levelized cost of energy has dropped substantially around the world to make them increasingly competitive relative to coal and gas generation. Indeed, in many parts of the world, they are now cheaper than fossil fuel generation (see Section 23.2.1). As such, regions and countries

![Figure 23.4: ASEAN Primary Energy Supply Structure by Sources, 2017](image-url)
experiencing rapid diffusion of these technologies will be making good progress in energy transition. Figures 23.5 and 23.6, respectively, show the diffusion of wind and solar PV. From the figures, it is evident that the material level of diffusion started to come about in a limited number of countries from 2010 onward. Yet these are still extremely low levels of market penetration. For instance, the Philippines (along with Thailand) is one of the leaders in wind energy in ASEAN with about 1,000 GWh, which represents about 1.2% of generation in 2016 (Figure 23.5). To put this number into context, the UK generated around 12% and Denmark around 40% of its electricity from wind energy in 2016. A green finance gap may be contributing to this low level of diffusion (Sachs et al. 2019).

This low level of diffusion is not surprising given the low level of policy support (see Appendix A23). Policies that are regarded as “key” or substantial by the International Renewable Energy Agency (IRENA) did not start to appear in the region until 2011 and policies were nationally defined. This contrasts with the EU experience, which has seen a raft of policies at EU level since 2001 and a whole host of national policies well before then. The focus of many EU renewable directives was to ensure a level playing field across Europe in terms of national policies (see Section 23.3.3).

Figure 23.5: Wind Energy Diffusion in ASEAN Countries (GWh)

ASEAN = Association of Southeast Asian Nations, GWh = gigawatt-hour.
Source: Compiled from IEA (2019).
23.5.3 Integration and the Asian Super Grid

A major element of energy transition in theory and practice is market coupling across borders (integration), since it permits higher penetration of renewables due to portfolio and geographical diversification (see TP2 in Table 23.1 and Section 23.3.4) but also leads to competition that drives cost-efficiency and innovation (Section 23.3.1).

Figure 23.7 provides a proxy of ASEAN countries’ electricity integration with neighboring countries (includes all interconnectors to ASEAN and non-ASEAN neighbors). The solid line aggregates for the ASEAN countries’ import and export (in gigawatt-hours). This is akin to the volume of electricity traded across borders. The dashed line divides this aggregate ASEAN total gross production (in gigawatt-hours), giving us a ratio of total import and export to total gross production. It is clear from the chart that in absolute and relative terms, ASEAN electricity systems are becoming more integrated, yet by 2017 import and export represented less than 2% of the total electricity consumption.

This increased integration may be attributed, at least in part, to ASEAN policy efforts in the guise of ASEAN Power Grid (APG) interconnections. Halawa et al. (2018, 12) note that heads of ASEAN power utilities/authorities have adopted a gradual and incremental
strategy driven initially by bilateral agreements, but they believe this will evolve to a subregional and then to a regional basis. Efforts or proposals for integration, however, go beyond the ASEAN realm and cover Asia as a whole as articulated by the vision for an Asian Super Grid (that would interlink Asia with HVDC links) and a potential Australian–Asian Power Grid that would bring Australian renewable power to Asia (via HVDC links).

### 23.5.4 Carbon Pricing and Climate Risks to the Energy Sector

It is perhaps not surprising from the preceding discussion, especially Sections 23.4.1 and 23.4.2, that ASEAN energy-related CO₂ emissions continue to rise dramatically. This rise is depicted in Figure 23.8. Table 23.2 shows the absence of carbon pricing in the region, which undoubtedly will have contributed to this situation – there was no price on carbon until 2019 when Singapore implemented a weak carbon tax of $4 per metric ton of CO₂ equivalent. Contrast that with European carbon prices of €27 ($30.7) in June 2019, which, in turn, could be far from the social cost of carbon.
Figure 23.8: ASEAN Emissions from Fuel Combustion (metric ton of CO₂)

ASEAN = Association of Southeast Asian Nations, GWh = gigawatt-hour.

Note: Left axis GWh, right axis (import+export)/total GWh aggregated for ASEAN.

Source: Compiled from IEA (2019).

Table 23.2: Carbon Pricing and Climate Risk in the ASEAN Energy Sector

<table>
<thead>
<tr>
<th>ASEAN Country</th>
<th>Carbon Pricing</th>
<th>Generating Units and Climate Risk</th>
<th>Units Incompatible with 1.5°C Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Current</td>
<td>Planned</td>
</tr>
<tr>
<td>Brunei Darussalam</td>
<td>No</td>
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<td>Thailand</td>
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<tr>
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<td>Considering</td>
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<td>116</td>
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</tbody>
</table>

ASEAN = Association of Southeast Asian Nations, Lao PDR = Lao People's Democratic Republic.

Compiled from World Bank (2019); Caldecott, McCarten, and Triantafyllidis (2018).
The above suggests that most ASEAN countries, if not all, are unlikely to meet their Paris Agreement targets. This poses a real political risk for ASEAN economies as they trade with nations that are taking much more proactive steps to mitigate emissions. Further, Asia is highly vulnerable to the physical risk of climate change and it is one of the regions contributing most to emission increases (Prakash 2018). This situation must change. Should ASEAN economies turn to accelerated transition to meet the Paris goal of staying below 1.5°C warming, ASEAN energy systems and companies would find that the majority of their generating fleet would become stranded (Table 23.2).

23.6 Conclusions: The Future of ASEAN Energy Collaboration

To recap, the EU and ASEAN share a number of similarities yet they have important differences that strongly moderate the strength of integration and cooperation in any sphere, including energy policy. ASEAN is an intergovernmental organization, while the EU is a supranational organization with a parliament and with the power to legislate, and powerful quasi-executives bodies in the form of the European Commission and the European Council. This power to legislate has led to EU directives and policies on integration, renewables, and energy efficiency that have set the EU on the path to decarbonization and have created a level playing field for EU nation states to cooperate and companies to compete.

The EU experience in trying to create a single European energy market (outlined in Section 23.3.1) holds some valuable lessons for ASEAN. The process is challenging and slow but can benefit from supranational legal authority and perseverance (in the EU, it took three legislative packages over several decades to make meaningful progress in liberalization and integration). Also, to ensure a level playing field, the sectors need to be restructured, and ideally independent supranational regulatory agencies need to be created.

Sections 23.3.2 and 23.3.3 highlight that carbon pricing may not be enough, suggesting that a mix of instruments best achieves the complex needs of energy policy (Diaz-Rainey 2009). Regulation and directives on energy efficiency and renewable energy are the unsung heroes of energy transition in Europe; their impact is evident by how they affected incumbents’ stock market returns (see Tulloch, Diaz-Rainey, and Premachandra 2017). Regulation on energy efficiency has led to falls in demand, while regulation on renewables has ensured that renewables have grid access (and priority) to ensure that their
Sections 23.4.2 and 23.4.4 show that ASEAN is a climate and renewable energy laggard. While the EU has had carbon pricing since 2005 in the form of the EU ETS, and EU-wide renewables targets since 2001 (see Section 23.3.3), ASEAN countries do not have a coordinated approach to carbon pricing and did not have any carbon pricing until 2019 when Singapore implemented a low-carbon tax ($4 per metric ton of CO₂ equivalent) (Table 23.2). However, Section 23.4.2 shows that the process of integration has advanced in ASEAN with a steady increase in the import and export of electricity in absolute and relative terms (Figure 23.7); however, this is the result of bilateral relations (see Andrews-Speed 2016a), rather than that of an overarching ASEAN framework. Further, Section 23.4.4 highlights that ASEAN faces serious climate risks—most notably, political and physical climate risks from failing to meet the Paris Agreement and the risk of stranded assets if accelerated transition is achieved.

Informed by the EU experience, we argue that an Energy Policy for ASEAN should explicitly pursue a dual transition pathway strategy to yield the best outcome in terms of the energy trilemma, that is, TP2 and TP3 as outlined in section 23.2.1 and Table 23.1. First, TP1, as an “ASEAN Super Grid” supported by a single energy market, would “green” urban and industrial demand. Second, TP3’s “Distributed Smart Grids” would help reap the social and economic benefits of providing electricity to the rural and remotely located populations that have hitherto not had access to electricity. This is a dual transnational and local approach that contrasts with energy transition defined at national level (i.e., TP1). This interconnected approach should yield security and peace dividends. As noted in the Introduction, the EU project was born out of energy cooperation and indeed the need to interconnect Europe so that conflict would not once more blight the continent. For all the contemporary criticism of the EU, it is beyond question that it has delivered peace and prosperity in the region. Energy integration has played a big part in this, with concomitant social, economic, and environmental benefits.

Thus, the articulation of an Energy Policy for ASEAN that envisions a dual TP1 and TP3 strategy is critical from a social, environmental, and economic perspective. Unlike in Europe, such a statement of intent in ASEAN would not have the supranational top-down legal architecture that the EU has in implementation. So the question remains, how could delivery of such a vision be ensured in an ASEAN context dominated by
bilateral relations? The answer lies in multiple sources of internal and external pressures galvanizing around the vision.

Pressure will come from the Paris Agreement—other parties (countries) to the agreement and multinational organizations will apply pressure to ASEAN countries to ratchet up their implementation plans and ambitions with respect to renewables and decarbonization. A cogent example of this is the United Nations Secretary-General’s recent call for Asia to overcome its “coal addiction” (BBC 2019). Pressure will also come from ASEAN citizens as they start to feel the impacts of climate change—as noted, Asia is one of the most vulnerable regions in the world to the physical risks of climate change.

Another source of important pressure will be investors and multinational banks as they seek to “green” their investment and lending activities. For instance, by 2019, investors managing approximately $90 trillion worth of assets in the world had become signatories to the United Nations Principles for Responsible Investment, meaning that they will increasingly take into consideration climate change and the environment in investment decision-making. This applies as much to buying government bonds as it does to buying shares. ASEAN governments or energy utilities that are seen as not serious about energy transition will find raising capital increasingly difficult or expensive. Further, banks and investors are keen to invest in energy decarbonization via financing mechanisms such as syndicated loans and green bonds. But banks and bond investors will have a strong preference for liberalized electricity markets given the concerns about property rights and political risk in state-dominated electricity systems. Thus, electricity market liberalization is important to unlock investment in energy transition and will provide the price signals to drive integration (see Section 23.4.1 and Andrews-Speed 2016b).

Following on from the above, the biggest driver of change will be market forces. Europe needed strong policies to drive integration and renewables because, when it started, energy transition-related technologies were not cost-competitive, so strong policies were needed then. This is no longer the case as renewables and related storage and grid technologies (e.g., HVDC interconnectors) have become cheaper. Renewables have reached, or are close to reaching, grid parity even in Asia and the Pacific (IRENA 2018). Economics and market forces will mean that households, companies, investors, and cities will help drive energy transition forward and apply pressure to national governments. The main role for ASEAN governments will be to coalesce around a shared vision of an Energy Policy for ASEAN, provide common energy efficiency standards to drive regional product innovation (see Section 23.3.2), and liberalize electricity markets so that market forces can drive energy transition.
References


### Appendix A23: Renewable energy policies in ASEAN countries

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<tr>
<td>1996</td>
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<td>Tax Incentive for Energy-saving Equipment</td>
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<tr>
<td>1997</td>
<td>Philippines</td>
<td>New and renewable energy programme (Exec. Order 462)</td>
<td>In force</td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>Philippines</td>
<td>Investment Priorities Plan (IPP)</td>
<td>In force</td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>Thailand</td>
<td>Strategic Plan for Renewable Energy Development: 8% Target</td>
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<td></td>
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<tr>
<td>2007</td>
<td>Singapore</td>
<td>Solar Pilot/Test-bedding programmes</td>
<td>In force</td>
<td></td>
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<tr>
<td>2007</td>
<td>Singapore</td>
<td>Clean Energy Research Programme (CERP)</td>
<td>In force</td>
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<tr>
<td>2007</td>
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<td>Feed-in premium for renewable power</td>
<td>Superseded</td>
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<tr>
<td>2008</td>
<td>Singapore</td>
<td>Solar Energy Research Institute of Singapore (SERIS)</td>
<td>In force</td>
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<tr>
<td>2008</td>
<td>Thailand</td>
<td>Solar hot water hybrid system promotion project</td>
<td>In force</td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>Thailand</td>
<td>Renewable Energy Development Plan (REDP) 2008–2022</td>
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<tr>
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<td>Power purchase from solar photovoltaic plants (No. 17/2013)</td>
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<tr>
<td>2013</td>
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<td>Feed-in tariff for distributed solar systems</td>
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*continued on next page*
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<tr>
<th>Year</th>
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<th>Status</th>
<th>Key Policy IRENA</th>
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<td>2014</td>
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<td>2014</td>
<td>Philippines</td>
<td>Accelerating Household Electrification through Regulated Solar Home Systems</td>
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<tr>
<td>2014</td>
<td>Thailand</td>
<td>Feed-in Tariff for Very Small Power Producers (VSPP) (excluding solar PV)</td>
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</tbody>
</table>

ASEAN = Association of Southeast Asian Nations, IRENA = International Renewable Energy Agency.
Source IRENA policy database.
24

Energy Security and Economic Integration: A Comparative Analysis of Europe and Asia-Pacific

Farhad Taghizadeh-Hesary, Tapan Sarker, Aline Mortha, and Chul Ju Kim

24.1 Introduction

Rising concerns over climate change in the recent years have increased the importance of energy for policy makers, and energy security is a central concept in energy policy. In particular, Asia and the Pacific (hereafter Asia-Pacific) and Europe are two regions facing numerous challenges related to energy. The European Union (EU) is the world’s largest economy, as well as the largest trading bloc, but it is relatively poorly endowed when it comes to energy resources. As a consequence, the EU remains quite dependent on its energy imports. Conversely, Asia-Pacific is a fast-developing region, with an increasing demand for energy, due to a growing middle class and a large population. As shown on Table 24.1, the world total energy consumption grew from 8,761 million tons of oil equivalent (Mtoe) in 1990 to 14,126 Mtoe in 2017. Around 70% of this change was initiated by the energy consumption of the Asia and Pacific region, which increased its global share from 25% (1990) to 41% (2017). This energy consumption dynamic of Asia-Pacific contrasts with the energy consumption of Europe, which has remained stable during the same period. Hence, the consumption ratio between Asia-Pacific and Europe rose from 1.2 (1990) to 3.2 (2017). Contrary to the EU, some countries in Asia-Pacific and Oceania (e.g., Australia and Brunei Darussalam) are fully endowed with energy resources, while others (e.g., Japan and the Republic of Korea) are very much reliant on energy...
imports. In addition, the majority of the region’s energy comes from fossil fuels, which are faced with environmental and health issues. The uneven distribution of energy resources coupled with the rising demand pose many challenges at the national, subnational, and regional level in terms of the region’s energy security and environmental sustainability. Consequently, there is a need to establish effective regional energy integration strategies in the region, which build on energy cooperation as well as possible regional energy partnerships to help protect the environment.

<table>
<thead>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Europe (%)</td>
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</table>

Mtoe = million tons of oil equivalent.
Source: Table prepared by the authors based on data from ENERDATA (2019).

Drawing on the case of the EU, a global leader in energy cooperation and energy integration, this chapter seeks to investigate the impetus toward energy integration between Europe and Asia-Pacific. In particular, the chapter highlights the similarities and differences in their approaches as well as obstacles to energy integration in terms of energy security based on regionalism and regionalization. This study’s findings are important for policy makers as it investigates the relationship that exists between energy security and regional integration and makes a case for the active pursuit of an energy-secure Asia-Pacific as an avenue to further the continent’s regional economic integration objectives.
24.2 Conceptualization of Energy Security

24.2.1 Definition and Usual Metrics

This section is dedicated to defining energy security, a central concept for policy makers. Despite being the subject of many studies in the past decade, the definition of the term “energy security” remains a debated issue among scholars, and is used to represent many different notions. Winzer (2012: 36) even stated that “energy security has [...] become an umbrella term for many different policy goals.” This section will examine the evolution of the term.

The first occurrence of the term dates from the 1960s, and it was popularized by the oil crises of the 1970s (Cherp and Jewell, 2014: 415). Yergin (1988) showed that throughout the 1970s and 1980s, energy security implied a reliable supply of energy, at an affordable price. In addition, some authors later included the notion of economic equilibrium in their definition. For instance, Bielecki (2002: 237) interpreted the notion of “reasonable price” as based on prices determined by supply and demand balances. The concept of energy security was one-dimensional until the early 2000s and was solely related to the economic aspect. The rationale behind this limited definition was based on the large price spikes experienced after the oil shocks of the 1970s.

The early 2000s saw the emergence of a more multidimensional concept, with studies adding more components to the definition. It was not before the early 2000s that geopolitics and governance made their way into the definition of energy security in academic studies. Examples of studies including governance or political and geopolitical aspects can be found in Stern (2002), Vivoda (2010), and Johansson (2013), among others. Rising concerns of climate change during the early 2000s also led to the addition of the environmental and sustainable development component to the definition. The earliest example can be found in European Commission (2000: 2), which defines its long-term energy security strategy as directed to ensure the well-being of its citizens and the functioning of the economy, as well as maintaining an uninterrupted supply of energy products at an affordable price while respecting environmental concerns. This component was later included in studies such as APERC (2007) and Watcharejyothin and Shrestha (2009). Interestingly enough, the definition provided by the European Commission also includes the concept of welfare, which was earlier introduced by Bohi and Toman (1993), and adopted by Joode et al. (2004) and Ölz et al. (2007). Another notion that was added to the concept of energy security is the level of reliability of the energy system.
Economic Integration in Asia and Europe: Lessons and Policies

(Stern 2002) or the “operational reliability of energy systems that ensure services are delivered to end users” (O’Leary et al. 2007: 13). Finally, Grubb, Butler, and Twomey (2006: 4050) argued that the “diversity of fuel source mix” is another dimension. Diversifying its fuel source mix is a hedging strategy, hence increasing the overall security of the energy system (Grubb, Butler, and Twomey 2006).

In an attempt at combining these different approaches, the Asia Pacific Energy Research Centre (APERC) created the 4As framework in 2007, which defines energy security through four dimensions: energy resource availability, accessibility barriers, environmental acceptability, and investment cost affordability (APERC 2007: 2). The availability of resources tended to refer to the physical level of availability of fossil fuels (coal, oil, natural gas, etc.) or any other form of energy, including renewables. Accessibility encompasses various aspects, including geopolitical and political factors, infrastructure development, human resources, and financial issues encountered by investors (APERC 2007: 1). The third dimension, environmental acceptability, is defined by the degree of acceptance of new forms of energy such as renewable energy (RE) sources, carbon capture and storage, and nuclear energy (APERC 2007: 2). Finally, investment cost affordability captured geopolitical issues and imbalances between demand and supply, as well as price volatility movements (APERC 2007: 2). Combining the two economic aspects of the old-fashioned definition, APERC (2007) also included the new dimensions of the recent years: political, social, and environmental aspects of energy security, as well as infrastructure and human resource development in its accessibility component. The report proposed various metrics including the diversification of supply sources, import dependency, and non-carbon based portfolio, among others (APERC 2007: 2). Although the 4As framework of analysis suffers from shortfalls, it is broadly used by many authors in recent studies tackling energy security in renowned energy journals (Ren and Sovacool 2014; Yao and Chang 2014; Erahman et al. 2016; Mišík 2016; Guivarch and Monjon 2017; Taghizadeh-Hesary et al. 2019a).

The complexity and broadness of the 4As framework has led to some backlash and criticisms in the past years (Cherp and Jewell 2014), leading some studies to come back to some more basic definitions. For instance, as of 2019, the International Energy Agency’s definition of energy security looks very similar to the basic one, as they only include two aspects of energy security—availability and affordability (IEA 2019), which is the definition followed by Chalvatiz and Ioannidis (2017). Definitions and approaches of energy security vary depending on the analysis. With rising concerns over climate change, studies taking into account environmental sustainability have also become a majority
Energy security is a complex concept, and has been evolving since the 1970s, reflecting the energy concerns of each decade. In this study, we will define energy security through the 4As framework developed by APERC (2007) and put into practice by Yao and Chang (2014).

24.2.2 Overview of Key Energy Indicators in Europe and Asia-Pacific

After discussing the concept of energy security, this section examines the features and key indicators of energy in the two regions, as summarized in Table 24.2. One blatant feature is the spectacular increase in both energy production and consumption in Asia-Pacific in the past 3 decades. Both production and consumption have more than doubled in the region, while Europe has witnessed a slight increase in consumption and a modest decrease in production in the same period. Both regions have been relying more on energy imports, although for different reasons. While Europe’s decreased energy production is the reason behind its higher reliance on imports, Asia-Pacific’s balance of trade reflects its inability to catch up with its ever-increasing demand.

The share of RE sources in electricity production has been increasing in both regions, although at a faster rate in Europe. At the same time, carbon dioxide (CO₂) emissions of Europe have been steadily decreasing in the past 3 decades. This decrease could be partially attributed to the rising use of RE sources, and could also be the result of increased energy efficiency in all sectors, particularly in the sectors of power, transportation, housing, and industry. In comparison, despite an increased share of RE sources in electricity production, emissions in Asia-Pacific have more than tripled in the same period. Finally, the last indicator we chose to show is CO₂ intensity, measuring the CO₂ emitted to generate one unit of GDP. This metric is expressed at a constant exchange rate and removes the inflation effect, to reflect differences in general price levels and relate energy consumption to the real level of economic activity. Using a particular metric instead of exchange
rates increases the value of GDP in regions with a low cost of living, and therefore decreases their energy intensity. It is interesting to note that, when looking at CO₂ intensity, emissions have been decreasing significantly in both Europe and Asia-Pacific. Therefore, we can conclude that the high level of CO₂ emissions previously observed comes from the remarkable growth experienced by the region in the recent years.

To illustrate this fact, Table 24.3 shows the energy consumption of the largest economies in Asia-Pacific that experienced dramatic growth in the past decades. For instance, together the People’s Republic of China (PRC) and India represent 85% of the change in energy consumption in the region, boosted by their large population. Mature economies such as
Australia; Taipei, China; and New Zealand saw a modest increase in their energy consumption. Japan is even experiencing a negative growth in its consumption, probably driven by its aging population. The Republic of Korea, Indonesia, Malaysia, and Thailand also experienced a steady increase in their energy consumption.

### 24.3 Assessment of Energy Security between Europe and Asia-Pacific

After discussing the concept of energy security and looking over the key indicators in the two regions, this section discusses in detail the four dimensions of energy security in Europe and Asia-Pacific.

#### 24.3.1 Availability

In most studies, the availability component referred to energy supply or the “geological existence of fossil energy resources” (Tongsopit et al. 2016: 62). Studies examining this issue used the reserve to production

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Table 24.3: Energy Consumption by Selected Economies in Asia–Pacific (Mtoe)

<table>
<thead>
<tr>
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<tbody>
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<td>871</td>
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<td>Republic of Korea</td>
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<td>256</td>
<td>296</td>
<td>106</td>
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<tr>
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<td>4,971</td>
<td>5,909</td>
<td>2,895</td>
<td>100.0</td>
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</table>

Mtoe = million tons of oil equivalent, PRC = People’s Republic of China.
Source: Table prepared by the authors based on data from ENERDATA (2019).
(R/P) ratio of various energy sources (Yao and Chang, 2014; Tongsopit et al. 2016) or the degree of reliance on imports and diversity of the energy mix (Chalvatiz and Ioannidis 2017; Vivoda 2019).

Europe, with EU countries in particular, has been heavily relying on energy imports over the years (Table 24.4). Small countries such as Luxembourg, Malta, and Cyprus are almost fully relying on imports to meet their energy demand. While the few countries that are endowed with fossil fuels, like the United Kingdom, the Netherlands, and Poland, were able to meet their energy demand with their own production in the 1990s, they have become net importers in recent years. Chalvatiz and Ioannidis (2017: 466) highlighted that the EU imported more than half of

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>7.97</td>
<td>45.00</td>
<td>23.71</td>
<td>13.8</td>
<td>85.71</td>
<td>63.23</td>
<td>56.14</td>
<td>45.16</td>
</tr>
<tr>
<td>Austria</td>
<td>67.30</td>
<td>65.75</td>
<td>64.83</td>
<td>62.42</td>
<td>69.28</td>
<td>52.52</td>
<td>78.44</td>
<td>75.04</td>
</tr>
<tr>
<td>Belgium</td>
<td>72.66</td>
<td>76.37</td>
<td>74.26</td>
<td>76.26</td>
<td>99.15</td>
<td>98.1</td>
<td>97.2</td>
<td>96</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>34.39</td>
<td>29.23</td>
<td>32.56</td>
<td>22.73</td>
<td>100</td>
<td>100</td>
<td>99.42</td>
<td>98.38</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>65.94</td>
<td>46.84</td>
<td>40.75</td>
<td>36.55</td>
<td>99.15</td>
<td>96.83</td>
<td>93.81</td>
<td>90.01</td>
</tr>
<tr>
<td>Croatia</td>
<td>39.64</td>
<td>49.17</td>
<td>45.1</td>
<td>45.86</td>
<td>7.82</td>
<td>23.28</td>
<td>16.3</td>
<td>19.77</td>
</tr>
<tr>
<td>Cyprus</td>
<td>99.55</td>
<td>97.93</td>
<td>96.35</td>
<td>94.03</td>
<td>49.26</td>
<td>42.47</td>
<td>43.88</td>
<td>51.77</td>
</tr>
<tr>
<td>Czechia</td>
<td>17.4</td>
<td>25.25</td>
<td>28.7</td>
<td>28.99</td>
<td>–0.74</td>
<td>10.74</td>
<td>33.21</td>
<td>28.39</td>
</tr>
<tr>
<td>Denmark</td>
<td>41.93</td>
<td>–48.84</td>
<td>–19.86</td>
<td>9.94</td>
<td>79.78</td>
<td>84.36</td>
<td>75.31</td>
<td>71.67</td>
</tr>
<tr>
<td>Estonia</td>
<td>44.64</td>
<td>32.53</td>
<td>12.31</td>
<td>3.4</td>
<td>34.41</td>
<td>21.81</td>
<td>21.57</td>
<td>16.78</td>
</tr>
<tr>
<td>Finland</td>
<td>57.43</td>
<td>53.92</td>
<td>52.24</td>
<td>46.2</td>
<td>30.16</td>
<td>13.5</td>
<td>32.4</td>
<td>28.78</td>
</tr>
<tr>
<td>France</td>
<td>50.06</td>
<td>48.13</td>
<td>48.16</td>
<td>43.49</td>
<td>75.22</td>
<td>64.34</td>
<td>65.18</td>
<td>58.83</td>
</tr>
<tr>
<td>Germany</td>
<td>46.99</td>
<td>59.82</td>
<td>60.66</td>
<td>60.88</td>
<td>46.26</td>
<td>51.7</td>
<td>48.21</td>
<td>44.5</td>
</tr>
<tr>
<td>Greece</td>
<td>57.1</td>
<td>63.13</td>
<td>65.82</td>
<td>61.97</td>
<td>61.6</td>
<td>74.1</td>
<td>73.05</td>
<td>69.36</td>
</tr>
<tr>
<td>Hungary</td>
<td>48.97</td>
<td>53.53</td>
<td>57</td>
<td>55.61</td>
<td>37.11</td>
<td>35.82</td>
<td>35</td>
<td>28.27</td>
</tr>
<tr>
<td>Ireland</td>
<td>65.02</td>
<td>84.36</td>
<td>87.25</td>
<td>84.26</td>
<td>46.12</td>
<td>42.87</td>
<td>40.41</td>
<td>27.21</td>
</tr>
<tr>
<td>Italy</td>
<td>82.73</td>
<td>83.58</td>
<td>81</td>
<td>75</td>
<td>–1.01</td>
<td>–22.21</td>
<td>26.57</td>
<td>39.67</td>
</tr>
</tbody>
</table>

EU = European Union.
Source: Table prepared by the authors based on data from World Bank (2019).
its energy in the form of crude oil or natural gas. Availability is a serious issue for EU countries and has been at the top of its policy agenda, as almost all oil-importing countries face negative supply shocks in case of an oil shock (Taghizadeh-Hesary et al. 2019b).

On the other hand, many Asia-Pacific countries are naturally endowed with energy resources, and fossil fuels in particular. Australia, Brunei Darussalam, Indonesia, Malaysia, and Viet Nam are net energy exporters (Table 24.5). In contrast, advanced economies such as Japan, the Republic of Korea, and Singapore are relying heavily on imports to meet their energy demand. Using a comprehensive index based on R/P ratios, Tongsopit et al. (2016) evaluated the level of availability of the Association of Southeast Asian Nations (ASEAN) region and found that its score has been decreasing since 2005. The authors argued that new resource discoveries in the region would not be sufficient to keep up with the growth in oil and gas production and that the rate of increase

---

**Table 24.5: Energy Import as a Percentage of Energy Use in ASEAN and Non-ASEAN APEC Members**

<table>
<thead>
<tr>
<th></th>
<th>1990</th>
<th>2000</th>
<th>2010</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>-82.37</td>
<td>-116.05</td>
<td>-153.61</td>
<td>-192.02</td>
</tr>
<tr>
<td>Brunei Darussalam</td>
<td>-805.79</td>
<td>-725.51</td>
<td>-473.19</td>
<td>-357.39</td>
</tr>
<tr>
<td>Cambodia</td>
<td>N/A</td>
<td>20.34</td>
<td>31.67</td>
<td>33.12</td>
</tr>
<tr>
<td>PRC</td>
<td>-1.17</td>
<td>0.55</td>
<td>11.45</td>
<td>15.02</td>
</tr>
<tr>
<td>Indonesia</td>
<td>-70.86</td>
<td>-52.57</td>
<td>-79.05</td>
<td>-103.09</td>
</tr>
<tr>
<td>Japan</td>
<td>83</td>
<td>79.81</td>
<td>80.14</td>
<td>93.98</td>
</tr>
<tr>
<td>Malaysia</td>
<td>-121.53</td>
<td>-58.61</td>
<td>-21.7</td>
<td>-5.51</td>
</tr>
<tr>
<td>Myanmar</td>
<td>0.24</td>
<td>-20.06</td>
<td>-60.89</td>
<td>-32.97</td>
</tr>
<tr>
<td>New Zealand</td>
<td>10.18</td>
<td>16.38</td>
<td>8.14</td>
<td>17.08</td>
</tr>
<tr>
<td>Philippines</td>
<td>40</td>
<td>51.12</td>
<td>41.71</td>
<td>45.77</td>
</tr>
<tr>
<td>Singapore</td>
<td>99.39</td>
<td>98.92</td>
<td>97.69</td>
<td>97.68</td>
</tr>
<tr>
<td>Republic of Korea</td>
<td>75.65</td>
<td>81.69</td>
<td>82.02</td>
<td>81.7</td>
</tr>
<tr>
<td>Thailand</td>
<td>36.64</td>
<td>39.2</td>
<td>40.11</td>
<td>41.57</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>-2.32</td>
<td>-38.92</td>
<td>-12.69</td>
<td>N/A</td>
</tr>
</tbody>
</table>

APEC = Asia-Pacific Economic Cooperation, ASEAN = Association of Southeast Asian Nations, PRC = People’s Republic of China.

Notes: Data not available for Papua New Guinea and the Lao People’s Democratic Republic. N/A represents the unavailability of the data for a given year. Negative data mean that the country is a net exporter.

Source: Table prepared by the authors based on data from World Bank (2019).
in RE is not enough to compensate for fossil fuel resource depletion (Tongsopit et al. 2016: 64). These findings show it is likely that the high level of energy supply security of the region is short term.

24.3.2 Accessibility

The “accessibility” component of energy security is defined by APERC (2007: 19) as “the ability to access available energy resources,” and its barriers include economic, political, and technological factors. In contrast, Yao and Chang (2014) defined this second dimension as “applicability” and focused on the technological feasibility and maturity, which will be examined as well.

Given the relatively homogenous level of development in the EU, most of the obstacles to accessibility lie in political and geopolitical factors. In addition to the high level of reliance on energy import in the EU, most of the countries tend to rely on a single partner (Chalvatiz and Ioannidis 2017: 466), namely the Russian Federation, which has been providing one-third of the EU’s energy in recent years (Aalto and Temel 2014: 761). The 2014 dispute between the Russian Federation and Ukraine, which is a transit country for gas pipelines, has provoked gas shortages in some EU countries (Chalvatiz and Ioannidis 2017: 466). The EU has made attempts to create a diplomatic dialogue with the Russian Federation by involving the country in the Energy Charter Treaty, with little success (Vogler 2013: 632). Vogler (2013) argued that the Russian Federation is unwilling to commit to a unified EU discipline, as it can achieve more advantageous bilateral deals with member states. In addition, Syria and Libya, two of the EU’s trading partners at the beginning of the 2000s, have experienced political turmoil, severely affecting their exporting capacities. Libya, in particular, was the EU’s third-top exporting partner in oil and petroleum products throughout the 2000s and dropped to 12th in 2011 (UN Comtrade 2019). Since then, the EU has reduced its import dependence and decreased its imports from Libya (UN Comtrade 2019). In comparison, Asia-Pacific is characterized by its relatively low level of reliance on external imports, with politically stable trade partners (Australia, Indonesia, and Malaysia, among others). Nevertheless, the region still highly depends on Middle East economies (Saudi Arabia, Qatar, Iran, the United Arab Emirates, and Iraq), some of which are politically unstable (Iraq). In particular, the recent tensions between Iran and Saudi Arabia, as well as in the Persian Gulf and the Gulf of Oman, have revived fears of a supply shock for economies that heavily rely on the Middle East region.

In addition, Asia-Pacific includes various developing countries, with low levels of infrastructure development. Table 24.6 shows the share of
Energy Security and Economic Integration: A Comparative Analysis of Europe and Asia-Pacific

The rural population with access to electricity in developing countries, which is low in most cases, albeit increasing rapidly.

The technological applicability of both Europe and Asia-Pacific is quite different depending on the countries. One indicator of applicability that is favored in academic studies (Yao and Chang 2014; Tongsopit et al. 2016) is the energy intensity, as defined in section 24.2.2. Energy intensity is said to measure the “success of the deployment or diffusion of energy technologies” (Yao and Chang 2014: 598). There is a clear trend in Europe and Asia-Pacific of decreasing energy intensity, hence a clear gain in energy efficiency. Such trends for Europe and Asia-Pacific are illustrated in Figures 24.1 and 24.2, respectively.

Table 24.6: Access to Electricity in Developing Asia-Pacific

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mongolia</td>
<td>25.8</td>
<td>25.1</td>
<td>16.8</td>
<td>44.2</td>
<td>31</td>
<td>953</td>
<td>532</td>
</tr>
<tr>
<td>Indonesia</td>
<td>48.4</td>
<td>79.7</td>
<td>89.4</td>
<td>94.8</td>
<td>45</td>
<td>118,796</td>
<td>6,209</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>0.7</td>
<td>28.3</td>
<td>57.2</td>
<td>80.3</td>
<td>65</td>
<td>4,458</td>
<td>877</td>
</tr>
<tr>
<td>Cambodia</td>
<td>9.0</td>
<td>18.8</td>
<td>36.5</td>
<td></td>
<td>77</td>
<td>12,320</td>
<td>7,828</td>
</tr>
<tr>
<td>Myanmar</td>
<td>20.3</td>
<td>28.9</td>
<td>34.3</td>
<td>39.8</td>
<td>69</td>
<td>36,825</td>
<td>22,172</td>
</tr>
<tr>
<td>Philippines</td>
<td>40.1</td>
<td>58.5</td>
<td>75.8</td>
<td>86.3</td>
<td>53</td>
<td>55,607</td>
<td>7,641</td>
</tr>
<tr>
<td>Timor-Leste</td>
<td>2.9</td>
<td>24.0</td>
<td>49.2</td>
<td></td>
<td>70.0</td>
<td>907</td>
<td>461</td>
</tr>
<tr>
<td>Papua New Guinea</td>
<td>4.4</td>
<td>9.0</td>
<td>15.5</td>
<td></td>
<td>86.0</td>
<td>7,096</td>
<td>5,998</td>
</tr>
<tr>
<td>Pacific islands</td>
<td></td>
<td></td>
<td>71.0</td>
<td>61</td>
<td>1,476</td>
<td>428</td>
<td></td>
</tr>
<tr>
<td>India</td>
<td>29.7</td>
<td>48.2</td>
<td>65.7</td>
<td>77.6</td>
<td>66</td>
<td>884,400</td>
<td>197,852</td>
</tr>
<tr>
<td>Pakistan</td>
<td>98.8</td>
<td>63</td>
<td></td>
<td></td>
<td>124,110</td>
<td>1,480</td>
<td></td>
</tr>
<tr>
<td>Bangladesh</td>
<td>68.9</td>
<td>64</td>
<td></td>
<td></td>
<td>104,960</td>
<td>32,695</td>
<td></td>
</tr>
<tr>
<td><strong>Total Rural Population Asia-Pacific without access to Electricity</strong></td>
<td><strong>284,171</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Lao PDR = Lao People’s Democratic Republic.
Source: Table prepared by the authors based on data from World Bank (2019).
**Figure 24.1: Energy Intensity Ratio of EU and Energy Community Members**

EU = European Union.

Source: Figure prepared by the authors based on data from World Bank (2019).

**Figure 24.2: Energy Intensity Ratio of ASEAN and Non-ASEAN APEC Members**

APEC = Asia-Pacific Economic Cooperation, ASEAN = Association of Southeast Asian Nations, Lao PDR = Lao People's Democratic Republic.

Source: Figure prepared by the authors based on data from World Bank (2019).
24.3.3 Acceptability

The third component of energy security is defined under the APERC framework as a measure of environmental sustainability (APERC 2007: 2).

Environmental sustainability has been one of the three pillars of the EU for the past 2 decades, led by its 20-20-20 targets: to reach a 20% share of RE sources, 20% of increase in energy efficiency, and 20% lower greenhouse gas (GHG) emissions by 2020 (Aalto and Temel 2014: 765). Both the cut in emissions and increase in RE share are on track (Lund 2012). In 2015, the average share of RE in the electricity mix was 32%, with extreme disparities among the member states. For instance, while Austria, Croatia, and Denmark produce more than 65% of their electricity from renewable sources, Cyprus and Malta’s share is below 10%. When extending this analysis to the rest of the members of the Energy Community of South East Europe, which are legally bound by the treaty to reform their energy sectors in line with EU policies (Mihajlov 2010: 872), the disparities widen. Figure 24.3 shows the share of renewable energy in total final electricity consumption and illustrates these disparities. For instance, renewable energy represents above 50% of final consumption in Albania, while this figure is not even 5% for Ukraine. While the EU is on the path for high environmental acceptability,
the other members of the Energy Community are left behind. Mihajlov (2010) estimated that Kosovo and Bosnia and Herzegovina in particular have made very little progress in implementing the EU legislation in environmental protection.

The diversity of Asia-Pacific is also reflected in their level of acceptability and environmental sustainability. While ASEAN members share common environmental and energy strategies through the Plan of Action on Energy Cooperation since 1995, the rest of the region is quite heterogeneous. The share of RE in the electricity mix within ASEAN itself is quite variable, with countries endowed with energy resources (Brunei Darussalam, Malaysia, and Indonesia) having a remarkably low share. Tongsopit et al. (2016: 67) also included in their evaluation per capita CO₂ emission, showing a diminishing score in acceptability, mostly driven by Thailand, Indonesia, and Viet Nam. The authors also highlighted that targets for carbon emission reductions within ASEAN are not legally binding, which could explain the steady

**Figure 24.4: Share of Renewable Energy in Total Final Electricity Consumption in ASEAN and Non-ASEAN APEC Members (excluding hydroelectricity)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Australia</th>
<th>ASEAN average</th>
<th>People’s Republic of China</th>
<th>Japan</th>
<th>Republic of Korea</th>
<th>New Zealand</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>45.4%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>44.2%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>42.6%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>40.5%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td>38.3%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>36.2%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

APEC = Asia-Pacific Economic Cooperation, ASEAN = Association of Southeast Asian Nations.

Source: Figure prepared by the authors based on data from World Bank (2019).
increase of emissions. Non-ASEAN members have witnessed a slight increase in their share of electricity produced from RE sources. In addition, Australia, New Zealand, Japan, and the Republic of Korea have experienced a slowed down growth in their CO₂ emissions in recent years (World Bank 2019). Given that the level of development of these countries is quite homogenous, such evolution does not come as a surprise. Figure 24.4 shows the share of renewable energy in total final electricity consumption, although it does not display the diversity of electricity consumption within ASEAN. The figure also illustrates another challenge for Asian economies—that is, the growth of the electricity demand coming with higher development.

### 24.3.4 Affordability

The last dimension of energy security proposed by APERC (2007) is the price affordability, which is defined by Tongsopit et al. (2016: 65) as “the ability of an economy or society to access energy resources at a reasonable price.”

The ability of the population in the EU and its neighbors to afford electricity prices is illustrated in Figure 24.5. Reflecting the price in purchasing power standard, the figure shows great disparities in energy prices in Europe. In particular, countries from Northern Europe (Denmark, Finland, and Sweden) are enjoying extremely low prices of electricity. However, it is worth mentioning that countries such as Malta and Hungary have managed to bring down their electricity prices, despite a growing demand. However, Belgium, Czechia, Spain, Cyprus, and Romania have witnessed a significant increase in their electricity tariffs, lowering their level of energy security in the affordability dimension. Within the EU, efforts have been made to ensure single market rules and liberalization of the energy market. The standardization of the market aimed at increasing energy efficiency, driving costs down thanks to economies of scale, and promoting the overall competitiveness of the economy (Aalto and Temel 2014: 762).

Taking into account the volatility of gas prices, as well as retail electricity tariffs in ASEAN countries, the study of Tongsopit et al. (2016) gives a good overview of the level of energy security with respect to affordability in ASEAN. The authors showed that the countries that were most affected by price volatility were Singapore, Cambodia, and the Lao People’s Democratic Republic, due to their lack of energy resources and dependence on foreign imports (Tongsopit et al. 2016: 67). Singapore had expensive and volatile retail electricity prices, while Thailand, Viet Nam, Myanmar, Malaysia, Cambodia, and the Lao People’s Democratic Republic showed stable price trends in the
period of analysis (Tongsopit et al. 2016: 67). In addition, Taghizadeh-Hesary et al. (2016) argued that the impact of oil price fluctuations is larger on developing economies, hence making them more vulnerable to price shocks. Overall, the affordability of energy in the region has been steadily decreasing between 2005 and 2010.

Based on the 4As framework, the study reviewed the state of energy security of Europe and Asia-Pacific, mostly focusing on the EU and ASEAN. Given its poor endowments in energy resources, it became clear in the study that Asia-Pacific has a secure level of energy security in the “availability” component. In addition, the high reliance of energy imports on the Russian Federation has lowered the “accessibility” score of the EU. Nevertheless, the EU’s high sustainability score and environmental engagement, as well as its renewed efforts to lower prices contributed to increasing its overall energy security status. Erahman et al. (2016) established an energy security index, mostly based on the 4As framework. The results showed that Sweden, France, Finland, the United Kingdom, and Denmark were among the top 10 performers,
while ASEAN countries ranked poorly. Energy security has been shown to be on the decline in ASEAN (Tongsopit et al. 2016) and in the PRC (Yao and Chang 2014). With respect to accessibility, acceptability, and affordability, ASEAN indeed still has room for improvement.

24.4 Energy Integration

After discussing the various dimensions of energy security, this section explores the state and dynamics driving the integration of Europe and Asia-Pacific with respect to energy. The section examines political, institutional, and energy integration.

24.4.1 Political and Institutional Integration

This section provides an overview of the institutional, political, and legal dynamics behind energy policies in Europe and Asia-Pacific.

Given its advanced level of integration, it is not surprising that the EU possesses a highly developed institutional and legal framework regarding energy, in particular energy security. Many EU policy documents as early as the 1990s have laid out the basis of the union’s energy security conception (Aalto and Temel 2014: 761), as well as introducing regulatory measures. The EU’s regulatory work regarding energy policy was finalized in 2007 with the Third Energy Package, which entered into force in 2009. The main objective of the Third Energy Package was to induce the liberalization of the energy markets by deconstructing the vertical integration of energy companies through unbundling (Aalto and Temel 2014: 768), in an attempt to create a single internal energy market within the EU. In addition, the Athens Agreement (2003) paved the way for the creation of the Energy Community. Members included the EU, Croatia, Romania, Bulgaria (which later became part of the EU), Bosnia and Herzegovina, Serbia, Montenegro, North Macedonia, Albania, and the Interim UN Administration for Kosovo–UNMIK, as well as Moldova and Ukraine from 2009 and 2011 onward, respectively. Non-EU members agreed to implement the EU’s regulations in environment and energy (Mihajlov 2010). The effects of the Third Energy Package are mixed. Vogler (2013) highlighted that the unbundling of the energy generation in the EU has had little effect on prices or competition. The author also argued that it did not contribute in increasing the small amount of electricity traded within the EU borders (Vogler 2013: 641).

The partial failure of the EU’s energy policy also comes from weak legislation in this area. According to Article 176A of the Treaty of Lisbon of 2007, the EU’s policy on energy aims at “ensur[ing] the functioning
of the energy markets, ensuring security of energy supply [...] promote energy efficiency and energy saving and the development of new and renewable forms of energy; and promote the interconnection of energy networks” (Official Journal of the European Union 2019). Energy policy is a shared competence between the EU and its member states, meaning that measures taken by the EU “shall not affect a Member State’s right to determine the conditions for exploiting its energy resources, its choice between different energy sources and the general structure of its energy supply” (Official Journal of the European Union 2019). In practice, a shared competence implies that a member state loses its ability to legislate if the EU decides to regulate. Given the importance of energy policy at the national level, shared competence in this area is delicate, and is often met with resistance, hence preventing the EU from regulating at all. Aalto and Temel (2014: 765) highlighted that there are many issues with putting energy policy into practice due to national sovereignty over energy resources of the member states, as stated in the Lisbon Treaty. Nevertheless, the EU has created an internal energy market, and has attempted to promote competitiveness within its economies, although its implementation is hindered by institutional tensions within the EU (Aalto and Temel 2014: 762).

In addition, neither the Third Energy Package nor the Lisbon Treaty fully implement a unified external energy policy, for instance vis-à-vis trade partners of the EU, although most of the EU’s energy resources are based on imports. Mišík (2016) proved that there exists a large difference in attitude of EU member states with respect to energy security and external energy importers. Under these conditions, it is easy to see that, despite efforts to create common regulations and create a unified energy market, the EU lacks unified goals with respect to its external policy, which represents the largest part of its energy policy, given the lack of resources in the region.

In contrast, the level of integration with respect to energy in ASEAN remains relatively low, with energy markets in most Asian countries being very much national (Nangia 2019: 1265). However, efforts toward more integration of electricity and natural gas markets have been made in recent years. For instance, ASEAN countries have participated in interconnection projects, for a total capacity of 5,212 megawatts (Nangia 2019: 1265). In addition, 3,673 kilometers of natural gas pipelines have been built under the Trans-ASEAN Gas Pipeline project (Nangia 2019: 1265). The study by Nangia (2019) provided a complete overview of the institutions and cooperation initiatives with respect to energy in Asia. Although the organizations and treaties cover various areas related to energy (trade and investment, money and financial development, infrastructure, security, etc.), the vast majority of the decision-making
process is based on consensus, and hence has no binding power for the parties. This is the case for the Asia-Pacific Economic Cooperation (APEC) forum, which has a working group on energy, the Shanghai Cooperation Organization, and ASEAN+3 (ASEAN plus the PRC, Japan, and the Republic of Korea). The sole organization whose decision-making is based on qualified majority and consensus is the Greater Mekong Subregion (GMS) Economic Cooperation Program (Nangia 2019). The author highlighted that most of the ongoing programs in Asia are “informal and aspirational” (Nangia 2019: 1265), with the exception of the Eurasian Economic Union, created in 2014 and bringing together Armenia, Belarus, Kazakhstan, the Kyrgyz Republic, and the Russian Federation. However, the author remained optimistic concerning the path of energy integration in ASEAN+3, arguing that the region has “achieved regional integration levels within the striking distance of Europe without the elaborate institutional structures” (Nangia 2019: 1267).

24.4.2 Economic Integration via Energy Trade

If the EU is particularly advanced regarding institutions and regulations, trade integration within the EU (or even extended to the Energy Community) is rather limited when it comes to energy. According to Vogler (2013), electricity traded within the EU represents around 5% of the total amount in the union. As a whole, imports of mineral fuels (including coal, petroleum, gas, and electricity) within EU countries were 7% on average, peaking at 9.4% in 2012 (Eurostat 2019). Figure 24.6 displays the EU’s top trading partners with respect to mineral fuels. Together, the Russian Federation and Norway represent more than 40% of the EU’s energy imports. The Middle East and Central Asia (Saudi Arabia, Kazakhstan, Iraq, Azerbaijan, Iran, Qatar, and Kuwait) are the second main regions for the EU’s imports, with 21.6%. Africa, and especially Maghreb countries (Algeria and Libya), which are geographically closer, follows with 12.9% of the total imports. Given the region’s lack of energy resources, it is unlikely that any increase in intraregional trade will reduce substantially the reliance of the EU on its neighbors. In the EU’s case, energy trade cannot enhance energy security to the extent that resources in the region are not sufficient. In this regard, the only solution for the EU to increase its energy security must be increased integration with respect to institutions and regulations, in order to be able to offer common policies and objectives to its trading partners. If the EU successfully manages to speak with a unified voice regarding energy, then it will increase the weight of its member states in negotiations with energy trade partners, especially the
In addition, it will increase the level of energy security of member states whose diplomatic relationships with energy exporters are tense.

In comparison, ASEAN, and Asia in general, is more prompt to trade with its neighbors. Over the years, the region has formed many regional trade agreements (RTAs), such as APEC and the Trans-Pacific Partnership. ASEAN, for instance, has formed RTAs with Australia, India, Japan, the Republic of Korea, and New Zealand. In general, however, bilateral trade agreements remain the norm. Zaman and Kalirajan (2019) have shown that RTAs in the region have had a positive impact on trade. Unlike the EU, the region’s top energy trade partners are located within the region (Figure 24.7). For instance, more than 68% of ASEAN’s gas comes from its members, namely Indonesia, Myanmar, Malaysia, and Viet Nam. A similar statement can be drafted for countries in developed Asia-Pacific, whose top trading partners include Australia, Malaysia, Indonesia, Papua New Guinea, and...
Brunei Darussalam. Only 30% of the gas imports in developed Asia-Pacific comes from external sources, such as the Middle East or Africa. The PRC and the Republic of Korea (or Eastern Asia) show a significantly lower reliance on Asia-Pacific countries, as they tend to rely more on countries from Central Asia or the Middle East, probably as a consequence of the Belt and Road Initiative launched by the PRC in 2013.

**Figure 24.7: Top Import Partners of the Various Asian Subregions for Natural Gas, 2017**


Note: “Developed Asia-Pacific” refers to Australia, Japan, and New Zealand. “Southeast Asia” comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People’s Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Timor-Leste. “Eastern Asia” refers to the People’s Republic of China and the Republic of Korea.

Source: Authors’ compilation based on data from UN Comtrade (2019).
Despite many Asia-Pacific countries being self-reliant with regard to energy, studies have shown that strengthened energy cooperation through trade (ADB 2009; Zaman and Kalirajan 2019) or connection of electricity transmission networks (Tongsopit et al. 2016) could increase the level of energy security in the region. In particular, Zaman and Kalirajan (2019) proved through the use of a stochastic frontier gravity model that trade in energy could be a solution to fill demand–supply gaps in South Asia and Asia-Pacific. Their model showed that institutional quality, better infrastructure, market efficiency, and technological readiness could also increase energy exports in the region. In addition, the Asian Development Bank (2009) prepared a strategy for the GMS to optimize energy systems in the region, the Model of Energy Supply Systems Alternatives and their General Environmental Impacts. Identifying energy flows from primary energy to “useful energy” demands, the model covered the 20-year span from 2005 to 2025 and used various estimates for costs. Creating four scenarios (base, GMS integrated, high-growth risk, and low-carbon), all scenarios concluded that energy integration and regional cooperation can contribute to a reduction of energy costs, as high as 19% in the GMS integrated scenario (ADB 2009: 46). Recently, a study by Rasoulinezhad et al. (2019) also highlighted the importance of trade integration in improving energy security in East Asia, analyzing the case of trade between the Russian Federation and the rest of East Asia.

24.5 Conclusion and Policy Recommendations

Given the surge in demand for energy in the recent years, Asia-Pacific is expected to increase its level of energy security in order to maintain economic development. This study proposed to compare energy security in two regions that show different levels of energy integration, Europe and Asia-Pacific. Examining the levels of integration and energy security, as well as the dynamics and challenges behind it, this research attempted to examine the relationship between energy security and energy integration.

Summarizing the evolution of the concept of energy security, this research first analyzed the various dimensions that have appeared in recent academic studies. Drifting away from the one-dimensional vision of energy security as the continuity of energy supply at an affordable cost, recent years have seen the emergence of more multidimensional indicators, taking into account the sociopolitical context, technological advances and infrastructure development, efficiency, and the environmental and sustainability component of energy.
Following the definition of APERC (2007), this study chose to analyze energy security using the 4As framework. From the perspective of energy supply (availability), Europe and Asia-Pacific are extremely different. The EU countries are very much dependent on imports from their close neighbors (Norway and the Russian Federation) and the Middle East, while many countries in Asia-Pacific are net exporters of oil, gas, and electricity. Nevertheless, studies have shown that for many Asia-Pacific countries, particularly in ASEAN, the rate of depletion of natural resources in order to meet the rising energy demand is extremely fast. Hence, the relative supply security in Asia-Pacific should be understood as being short term.

Regarding the accessibility or applicability of energy, Europe and Asia-Pacific are yet again facing very different challenges. While accessibility is constrained by diplomatic tensions and political instability with their import partners in the EU, Asia-Pacific’s applicability is limited by its low level of technological maturity and is yet to improve its energy infrastructure.

With respect to acceptability, the EU’s efforts toward environmental soundness and sustainability have certainly been paying off, as the region’s emissions have been cut, and the level of electricity coming from RE sources has been increasing. Asia-Pacific is characterized by its steadily growing level of GHG emissions, with the exception of Australia, Japan, New Zealand, and the Republic of Korea. Sustainability hence remains a challenge in Asia-Pacific. Finally, with its unified energy market, the EU has been showing steadily decreasing electricity prices in recent years, while studies have shown that many countries in Asia-Pacific are extremely vulnerable to energy price volatility, and that the affordability component in the region has been on the decline. The EU’s efforts toward sustainability and reducing prices have contributed to the increase in overall energy security in the region, while the level of energy security in Asia-Pacific (especially in ASEAN and the PRC) has been on the decline.

Reviewing institutional, political, and legal levels of integration between the two regions, the study has found that the EU has been constructing a unified legal energy framework and building a common energy market over the years. ASEAN and other Asia-Pacific countries, however, are limited in their level of political and legal integration to the extent that treaties regarding energy and intraregional organizations do not provide a legally binding framework, and are on a voluntary basis. As a result, energy markets in Asia-Pacific very much remain national. Integration of energy markets is extremely advanced in Asia-Pacific, as the majority of the region imports its energy from its neighbors.
Various RTAs have been shown to increase trade in energy in the area. The low level of energy endowment in Europe is the main reason behind the relatively low level of intraregional trade in the EU, despite the creation of a unified energy market since 2009.

In general, the dynamics of integration in the EU and Asia-Pacific are at opposite ends. Asia-Pacific’s integration is market driven and fueled by trade, which could contribute to an increase in the overall level of energy security in the region (Zaman and Kalirajan 2019). However, energy security is endangered by rapidly depleting resources and steadily increasing demand, with no legally binding framework. Therefore, in order to increase its level of energy security, Asia-Pacific is advised to increase its intraregional energy trade, focusing on RE, which will not be as quickly depleted as fossil fuels. The EU’s integration with respect to energy, comparatively, relies on already existing institutions and legal frameworks, while trade between member states is extremely limited. Further integration in the EU is motivated by the need of having a unified voice in negotiations for energy exports and constrained by the sovereignty of member states, especially those with good diplomatic relations with exporters. In general, both regions need to increase their share of RE in order to have a higher level of energy security. Higher production from RE sources translates into an increase in the availability and acceptability parameters, as it lowers the level of reliance on external import partners and reduces GHG emissions.
References


25

Integrated Regional Energy Markets: Principles and Prospects

Youngho Chang

25.1 Introduction

Exchanging goods and services between two persons will bring them benefits from trading. This case could go beyond the simple two-person economy to the economy with many people who are exchanging goods and services. Various types of integration have occurred in areas like international trade or relations. There are a few examples of such integration. For instance, the United Nations is a notable example for international relations. The General Agreement on Tariffs and Trade or GATT is a distinct example for international trade, and the World Trade Organization is another example for global trade. A typical example is a free trade agreement, which is a mutually exclusive integration for trading goods and services between two countries. The International Energy Agency (IEA) is a slightly different example but is built on the same principles of economic integration. Developed oil-importing economies formed the IEA after enduring two oil shocks in the late 1970s and early 1980s. The IEA is a good example of a collective effort, especially geared for multinational cooperation in energy. Under the IEA, however, the collective effort did not lead to the integration of energy markets across member countries as its main objective is coordination in energy policies. The prototype of the European Union (EU), an agreement for coal and steel for European countries in 1951, is a better example of the integration of energy markets in a region (Chang 2009).

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1 This is called a comparative advantage, which was first introduced by David Ricardo (1772–1823).
The underlying themes of such an integration effort and forming an integrated market in world economies and international relations present the premise that cooperation makes the parties involved better-off than an effort by individuals or countries does. This, in turn, brings the world to explore which one between “control and confinement” and “cooperation and coordination” will work better in issues relating to energy. It boils down to the question of control and confinement of energy resources by a single country over cooperation and coordination in developing and using energy resources. This chapter identifies principles of integrating energy markets in the Association of Southeast Asian Nations (ASEAN) and explores prospects of how well the integrated energy market in the region proceeds. It also assesses possible gains the integrated energy market would bring to the region and suggests pathways to a full-fledged, integrated energy market in the region.

This study scans principles of existing integrated regional energy markets for the definitions, scope, and characteristics of an integrated energy market. With this, it identifies principles applicable for developing an integrated energy market in a region. The study also presents specific gains that the integrated energy market in a region will bring to the region. In sum, the study aims to prove the premise that such an integrated energy market in a region would enhance the level of welfare for the people in the region.

This study also aims to identify lessons learned from existing integrated energy markets in other regions such as the EU and West Africa throughout the entire period of their initial effort of launching an integrated market to continued efforts of making it full-fledged. Such lessons include, but are not limited to, how to set goals, identify objectives, establish the time lines of integrating energy markets, and design and implement common energy policies. From a critical review of existing integrated energy markets, it draws key factors of promoting economic integration through energy markets among developing countries. Following the identification of those key factors, this study suggests what best suits each factor for completing the integration of energy markets in the region.

25.2 Economic and Energy Market Integration

Economic integration typically takes five stages: preferential trade arrangements, a free trade area, a customs union, a common market, and finally an economic union (Salvatore 2015). A typical economic analysis takes capital and labor as the two key inputs for production in which energy is nested in capital, as using energy requires machines
specifically or capital generally. After two oil shocks, however, energy has been separated from capital and treated as a third production factor, which reflects the fact that energy is crucial for a properly functioning economy. This also indicates that energy deserves an in-depth and separate analysis to understand how energy influences economic growth and the welfare of a society. Like economic integration, energy market integration could follow the five stages that economic integration takes. Two neighboring countries in the region can have preferential trade arrangements for energy or electricity, form a free trade area especially for energy, establish a custom union for energy, construct a common energy market, and eventually create an energy union.

Launching and sustaining an integrated market in the EU sheds light on how integration should progress for other countries in the world that intend to integrate markets or energy markets. The Economist claims, in a special report, that “the European Union has been far more successful than anyone expected when the Treaty of Rome was signed half a century ago,” though the EU faces a few big problems that need to be solved (Economist 2007). The EU started as a regional coalition for coal and steel set up in 1951 and developed further. The Treaty of Rome established the European Economic Community (EEC) officially. Six European countries—France, Germany (then West Germany), Italy, Belgium, the Netherlands, and Luxembourg—signed the Treaty of Rome in 1957. They launched a common market soon after. There are two events that had promoted the formation of the EEC. The French National Assembly’s rejection of the proposed European Defence Community in 1954 was the first stimulus. The Suez Crisis in 1956 was the second stimulus. The former strengthened the importance of the nation-state in Europe, while the latter reinforced the urgency of forming the European Community (Chang 2009).

The EU successfully implemented a common currency in 1999. Since then, it has established various types of integrated markets in the community such as for trading electricity, energy resources, and carbon emission rights. One example of such an integrated market, which has been working successfully, is the integration of Nord Pool and the Danish and Dutch electricity markets. The successful integrated electricity pool can shed some light on how and what a region should do to integrate electricity markets in the region. Valuable lessons can be learned from the common electricity market throughout the EU for any region where integrating energy markets is moot.

The experiences of integrating economic markets in the world suggest key factors and broadly defined principles that appear to be essential for a successful integrated market and economic community.
They are people, institutions, transparency, nondiscrimination, and fair allocation of benefits and burden or cost sharing.

The EU is the most successful case of an integrated economic community that comprises numerous sovereign countries. People and institutions are the most critical factor for sustaining an integrated market. This is well reflected in the statement of Monnet, one of the early pioneers of European integration movements: “nothing is possible without men, nothing is lasting without institutions” (Grosser 1980, cited in Leonard 2005).

As the formation process of the European Community shows, transparency and nondiscrimination are key principles that should be well reflected in any kind of integrated market to perform well and persist once it has started (Leonard 2005). The process of making policies should be transparent from the beginning of discussions to the adoption of the policies. Every member country should be treated equally once they become a member of an integrated market or economic community, regardless of economic power, land size, or the size of its population.

Progress in the economic integration among developing countries has not been as good as expected. A key reason is the uneven distribution of benefits among member countries (Salvatore 2015). In the early days of economic integration, amid huge obstacles toward true economic integration, one key cause was that each member country had to give up sovereignty to some degree (King 1995). This is still a valid argument against integrating economies or energy markets in ASEAN.

There exist many differences between the ASEAN and EU countries in terms of geography, economic growth, culture, religion, and society. Among these differences, the difference in geography makes the form of energy market integration in the ASEAN region distinctly different from the one in the EU. The ASEAN countries consist of a peninsula, islands, and an archipelago, which suggests that the integration of energy markets in the region can proceed best by geographical clusters. The current effort of integrating electricity markets in the region is proceeding with three geographical clusters: Northern, Southern, and Eastern. This is to further discussed in the later part of this chapter.

Table 25.1 presents the status of economic development such as per capita gross domestic product (GDP) as well as population and energy-related indicators such as total population with access to electricity and primary energy supply.

There are wide differences in per capita GDP among ASEAN countries. Singapore has the highest per capita GDP at $56,741 (in constant 2010 US dollars), while Cambodia’s was the lowest in 2017 at $1,135—an almost 50 times difference. The difference in population is also wide. The largest country is Indonesia and the smallest is Brunei.
Darussalam, an extreme case. Indonesia’s population is almost 47 times larger than Singapore’s. In terms of access to electricity, most ASEAN nations have achieved 100% or close to 100% of the population having access to electricity. In a few countries like Cambodia and Myanmar, about 50% of the total population have access to electricity, and in the Lao People’s Democratic Republic (Lao PDR) and the Philippines, it is about 90% of the total population. The amount of primary energy supply also varies widely among the ASEAN countries from as large as 230.2 million tons of oil equivalent in Indonesia to as low as 3.0 million tons of oil equivalent in Brunei Darussalam.

There is interregional natural gas trade by pipeline and liquefied natural gas (LNG), although the volume of trade is small. Table 25.2 presents the volume of major intraregional natural gas trade by pipeline and Table 25.3 the volume of major intraregional natural gas trade by LNG in 2017.

### Table 25.1: The Status of Economic Development and Energy Supply in ASEAN

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Brunei Darussalam</td>
<td>31,440</td>
<td>0.4</td>
<td>100</td>
<td>3.0</td>
</tr>
<tr>
<td>Cambodia</td>
<td>1,135</td>
<td>16.0</td>
<td>50</td>
<td>7.6</td>
</tr>
<tr>
<td>Indonesia</td>
<td>4,131</td>
<td>264.0</td>
<td>98</td>
<td>230.2</td>
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<td>Lao People’s Democratic Republic</td>
<td>1,730</td>
<td>6.9</td>
<td>87</td>
<td>N/A</td>
</tr>
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<td>Malaysia</td>
<td>11,521</td>
<td>31.6</td>
<td>100</td>
<td>89.0</td>
</tr>
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<td>Myanmar</td>
<td>1,484</td>
<td>53.4</td>
<td>57</td>
<td>19.3</td>
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<tr>
<td>Philippines</td>
<td>2,891</td>
<td>104.9</td>
<td>91</td>
<td>54.8</td>
</tr>
<tr>
<td>Singapore</td>
<td>56,741</td>
<td>5.7</td>
<td>100</td>
<td>27.4</td>
</tr>
<tr>
<td>Thailand</td>
<td>6,126</td>
<td>69.0</td>
<td>100</td>
<td>138.5</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>1,835</td>
<td>95.5</td>
<td>100</td>
<td>81.0</td>
</tr>
</tbody>
</table>

ASEAN = Association of Southeast Asian Nations, GDP = gross domestic product, mtoe = million tons of oil equivalent.

Source: ESCAP (n.d.).
For natural gas trade by pipeline, Indonesia and Myanmar are the exporting countries and Malaysia, Singapore, and Thailand are importing ones. Thailand and Singapore are importing almost an equal amount of natural gas from Myanmar and Indonesia, respectively.

Unlike natural gas trade by pipeline, more countries trade natural gas by LNG, though the amount of trade is quite small compared to that by pipeline. LNG trade is still at an early stage. Brunei Darussalam, Indonesia, and Malaysia are the exporting countries of LNG, and Malaysia, Singapore, and Thailand are the importing countries.

### Table 25.2: Major Intraregional Natural Gas Trade Movement by Pipeline, 2017

<table>
<thead>
<tr>
<th>From</th>
<th>To</th>
<th>Amount (billion cubic meters)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>Malaysia</td>
<td>0.7</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Singapore</td>
<td>7.3</td>
</tr>
<tr>
<td>Myanmar</td>
<td>Thailand</td>
<td>8.2</td>
</tr>
</tbody>
</table>

Source: ESCAP (n.d.).

### Table 25.3: Major Intraregional Natural Gas Trade Movements by Liquefied Natural Gas, 2017

<table>
<thead>
<tr>
<th>From</th>
<th>To</th>
<th>Amount (billion cubic meters)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brunei Darussalam</td>
<td>Malaysia</td>
<td>1.1</td>
</tr>
<tr>
<td>Brunei Darussalam</td>
<td>Thailand</td>
<td>0.1</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Thailand</td>
<td>0.3</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Singapore</td>
<td>0.3</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Thailand</td>
<td>0.4</td>
</tr>
</tbody>
</table>

Source: ESCAP (n.d.).

Unlike intraregional natural gas trade by pipeline and LNG, interregional electricity trade is more active in ASEAN and the volume of trade is large. The intraregional electricity trade occurs mainly in the Great Mekong Subregion (GMS) and Borneo (Kalimantan) areas. It does not occur in other ASEAN countries such as the Philippines and
Table 25.4: Interregional Electricity Trade, 2016

<table>
<thead>
<tr>
<th>From</th>
<th>To</th>
<th>Amount (gigawatt-hour)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lao People's Democratic Republic</td>
<td>Thailand</td>
<td>20,134</td>
</tr>
<tr>
<td>Lao People's Democratic Republic</td>
<td>Viet Nam</td>
<td>1,213</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Indonesia</td>
<td>24</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Thailand</td>
<td>25</td>
</tr>
<tr>
<td>Thailand</td>
<td>Cambodia</td>
<td>401</td>
</tr>
<tr>
<td>Thailand</td>
<td>Lao People's Democratic Republic</td>
<td>832</td>
</tr>
<tr>
<td>Thailand</td>
<td>Malaysia</td>
<td>132</td>
</tr>
<tr>
<td>Thailand</td>
<td>Myanmar</td>
<td>109</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>Cambodia</td>
<td>2,129</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>Lao People's Democratic Republic</td>
<td>81</td>
</tr>
</tbody>
</table>

Source: ESCAP (n.d.).

Singapore. Table 25.4 shows the amount of intraregional electricity trade among ASEAN nations in 2016.

The Lao PDR is the key exporting countries of electricity, followed by Viet Nam and Thailand. Malaysia exports electricity to neighboring countries like Indonesia and Thailand in a small scale and also imports electricity from Thailand. Both the Lao PDR and Viet Nam export electricity to and import electricity from neighboring countries. Cambodia, Indonesia, and Myanmar only import electricity from neighboring countries. The current form of electricity trade in the ASEAN region is bilateral, which is an earlier stage of integration.

As shown in Tables 25.2–25.4, as an initial step, a regional integrated energy market can form a common market for energy resources that are abundant in the region. This is a necessary step toward forming an integrated energy market. Electricity and natural gas are relatively abundant in the region, and an integrated regional energy market can be formed especially for these resources.

The ASEAN region has huge potential in hydropower and a relatively large amount of proven reserves of natural gas. The share of proven reserves of natural gas in Asia and the Pacific is 9.2% at the end of 2018 compared to 2.8% for the share of proven reserves of oil (British Petroleum 2019).2 The GMS has 168,000 megawatts of exploitable hydro

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2 Countries in Asia and the Pacific include Australia, Bangladesh, Brunei Darussalam, India, Indonesia, Malaysia, Myanmar, Pakistan, Papua New Guinea, the PRC, Thailand, and Viet Nam.
potential. The total exploitable hydro potential is more than 15 times of the installed hydro capacity of 11,204 megawatts in the region in 2001 (Yu 2003). There are some obstacles in making this potential into reality. The hydro potential is too large for a country alone to develop and bear the cost. A regional power grid-based market can eliminate such obstacles as the countries involved in establishing an integrated power market can share not only the total costs required for the development but also the entire amount of electricity produced by the hydro potential.

The provision of a portal for energy trading is required, necessary, and appropriate for an integrated energy market to function. The portal for energy trading should have enough liquidity for making such a market function well. For instance, for oil trading in a regional integrated energy market, it is necessary to set up an oil trading exchange. Building storage capacities or launching a common oil stockpile could make the integrated energy market work better as such physical storage space in the region could act as a buffer in times of uncertainties due to a short-term fluctuation in oil supply or supply shortage. The realized effects of physical storage capacities on the global oil market, however, appeared to be small or nil as shown in the cases of oil stockpile in other countries or the Strategic Petroleum Reserve of the United States. The verdict on the effect of oil stockpiles seems to be that it has a relatively small impact on buffering highly volatile oil prices, but physical storage capacities give the oil market a psychological safety net.

It appears to be a viable strategy of electricity supply in West Africa to quickly retire old and obsolete power plants and coordinate new investment projects at the level of the whole subregion (Gnansounou et al. 2007). This strategy appears to be better than an “autarkical” strategy in which a stand-alone decision on adequately expanding national power generation systems is made and exchange in electricity among the countries in subzones follows. The simulation results from the optimization model of such bottom-up electricity system expansion planning show that the integration of various electricity markets in the region would bring various benefits such as reduced capital expenditures, lowered electricity supply cost, and enhanced system reliability. ASEAN can replicate such benefits in an integrated electricity market in the region. The ASEAN Power Grid (APG), connecting the Indonesian archipelago, Singapore, Peninsular Malaysia, Kalimantan, the Philippines, and the GMS through an integrated network, is

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3 The GMS consists of Cambodia, the Lao People’s Democratic Republic, Myanmar, Thailand, Viet Nam, and Yunnan province of the PRC.

4 The countries in the region are Benin, Burkina Faso, Cape Verde, Côte d’Ivoire, the Gambia, Ghana, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, and Togo.
expected to bring the same benefits as suggested in the West African integrated electricity market to the ASEAN region. The amount of the benefits realized under such an integrated electricity grid, however, remains to be seen.

An initial step to build an integrated energy market in the region such as bilateral electricity trade has been taken in the GMS (Table 25.4). Natural gas in the region is more abundant than crude oil as stated above. The total amount of the proven reserves of natural gas is enough for the countries in the region to consume about 30 years, given the current level of consumption. Together with the current status of the proven reserves of natural gas in the region (Tables 25.2 and 25.3), this could imply that building a supply chain for natural gas would bring benefits to the region. Possible supply chains in the region are pipelines, LNG terminals, and LNG tankers. Net gains among countries in the region can be realized if a full-fledged network for natural gas trade is constructed (Chang and Pan 2006). Such a finding is derived from a hypothetical setting, but it appears to be promising and could strengthen the necessity of integrating energy markets in the region. The Trans-ASEAN Gas Pipeline (TAGP) could accelerate the integration of energy markets in the region. The Pan-Asian gas trade model by Chang and Pan (2006) examined how countries in the Middle East, ASEAN, East Asia—such as Japan, the People’s Republic of China (PRC), and the Republic of Korea—and the Russian Federation would be affected in an integrated natural gas market. Trade of natural gas in a full-fledged network in the region appeared to cause the general price level to decrease and the trade volume to increase. A few countries, however, appeared to bear higher prices than what they used to pay compared to the case of gas trade in a full-fledged network.

25.3 An Integrated Energy Market in ASEAN: Beginning

Enhancing energy security in the region is a blanket policy agenda for ASEAN countries to initiate an integration of energy markets in the region. Energy security can be defined as “supplying energy in a reliable and stable way at a reasonable price.” This definition has been applied collectively in the ASEAN context since 1986 when six states as parties

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5 The reserve–production ratio for Asia and the Pacific is about two-thirds of the ratio for world proved reserves of natural gas. This is far larger than that for North America but smaller than that for other regions like South and Central America, the Middle East, and Africa. The world total proved reserves of natural gas are 179.83 trillion cubic meters and for Asia and the Pacific 14.84 trillion cubic meters at the end of 2005.
signed the ASEAN Petroleum Security Agreement in Manila (Lye and Chang 2004). Various energy cooperation initiatives and programs have been undertaken in ASEAN. With regard to an integrated energy market, the Prime Minister of Singapore emphasized the merits of integrating energy at the regional level at the East Asia Summit (EAS) in Cebu in mid-January 2007. Other EAS leaders supported his views, which led to the promotion of “the development of open and competitive regional energy markets geared towards providing affordable energy at all economic levels.” The EAS member countries are all 10 ASEAN member states, plus the PRC, Japan, the Republic of Korea, India, Australia, and New Zealand.

One of the key messages presented at the EAS was how the integration of regional energy markets can benefit countries in the region. The key objective of energy policy at the EAS is to ensure efficient supply of energy at affordable prices. Having efficient and flexible international and regional energy markets is a critical strategy to meet the stated goal in the long term for the EAS. As noted earlier in the chapter, forming a coalition of individuals or countries and trading among them would bring benefits to them.

There is, however, the possibility of an empty core in a coalition if the number of participants increases. This means no coalition is formed or trade occurs. Participants will not get any benefits from such an empty coalition. The situation where a core is empty should be avoided, especially during the early stage of forming a coalition. The optimal number of players making the coalition should be large enough to ensure benefits accrued to the players but small enough to prevent an empty core. The negotiations involving international consensus and agreements such as the Doha Round or the Kyoto Protocol have shown that forming a coalition on the issues at hand with large numbers of participants is extremely difficult, if not impossible.

Upon noticing the possibility of having an empty core, a coalition to integrate energy markets can start from a relatively small scale—but not too small—any number between 5 and 10 countries. With a workable number of countries for a coalition, two principles should be applied for the successful workings of an integrated energy market: transparency and straightforwardness. For instance, providing electricity all the time at the lowest cost possible is set as a goal of the integrated energy market. Another goal for the market is that it should not be affected by market power and/or influenced by political discord.

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6 The Treaty of Rome was signed by six European countries. ASEAN started in 1967 when five countries in the region (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) formed a coalition.
There has been a cooperative effort to integrate energy markets in the region. It comes with or without economic cooperation and development. Three key examples are GMS economic cooperation and development, the APG and the TAGP. The GMS, a subregional economic cooperation program formed in 1992, was aided by the Asian Development Bank. The program has helped its member countries achieve economic growth, but its potential for economic growth has been underutilized.

An interconnection master plan of the APG was completed in March 2003. Various steps for fully operationalizing the APG were pointed out, and efforts were increased to make it fully operational. Such attempts, however, faced obstacles in commercial justification and a lack of funding availability. A memorandum of understanding on the TAGP, signed in July 2002, would have facilitated joint studies on cross-border issues such as tariffs, transit rights, and the security of supply. The APG and the TAGP in ASEAN were the groundbreaking initial steps for integrating energy markets in the region. The slow progress in further enhancing the common infrastructure for trading electricity and natural gas in the region is clear evidence that clearing such obstacles is necessary before a full-blown integrated energy market can function well. Integrating energy markets has a long-term horizon but can serve as a short-term target. Such a short-term target can be achieved by integrating energy markets within a small group of countries or scale such as a coalition of two or three countries for sharing electricity or natural gas (Chang 2009).

Unlike countries in the EU where most member countries are within one continent, except the northern countries such as Scandinavia and the United Kingdom, countries in ASEAN or Asia are physically adjacent but scattered across seas. This constraint places obstacles in integrating energy markets across the ASEAN countries. The region has put up effort integrating energy markets at a small scale, however. As shown in Table 25.4 above, the GMS has a successful integration of their electricity markets. What ASEAN should do now is study how to replicate that successful model for the entire region. Such efforts led to the development of the Brunei Darussalam–Indonesia–Malaysia–Philippines East ASEAN Growth Area (BIMP-EAGA) model, which starts with bilateral electricity trade and eventually multilateral power trade will follow. The BIMP-EAGA model consists of Peninsular Malaysia, Kalimantan (Borneo), and the Philippines. Once successful, the model could shed light on how to integrate electricity markets of the entire region of the ASEAN including its southern neighbors such as Singapore and the rest of Indonesia and its northern neighbors in the GMS.
25.4 An Integrated Energy Market in ASEAN: Prospects

Many studies have proposed and presented the strong plausibility of integrating energy markets in ASEAN (e.g., Wu, Shi, and Kimura 2012; Chang and Li 2013, 2014, 2015; Li and Chang 2015; Li and Kimura 2016a; Her et al. 2018; Anbumozhi, Kutani, and Lama 2019). Such plausibility has been shown for South Asia as well (Timilsina 2018; Timilsina and Toman 2016, 2018). The possible benefits of energy market integration appear to be huge after netting out transmission costs and losses (Chang and Li 2013), but the verdict might be different if the costs of grid interconnection are taken into account in real terms as the cost of transmission infrastructure is high. However, the resulting benefits, albeit small, even after netting out the costs of grid interconnection, transmission costs, and losses could be positive (Li and Chang 2015).

Energy market or electricity market integration is expected to bring various benefits to the region such as meeting the increasing energy demand, developing more renewable energy, and promoting economic growth. Energy market integration in East Asia through cross-border power trading is expected to help reduce the burden of meeting pressing energy demands and spread the possible demand shock in the region. It also appears to help remove subsidies in the electricity sector (Wu, Shi, and Kimura 2012). Electricity market integration is a key starting point of energy market integration (Wu 2013). Such integration in the energy market in East Asia appears to promote more development of renewable energy that is deployed into the power system (Kimura, Phoumin, and Jacobs 2013). The integration of energy markets appears to promote economic development and help meet the increasing energy demand in East Asia (Sheng, Shi, and Zhang 2012).

A gradual integration of energy markets in the region could work better considering the number of countries involved and the degree of issues tackled during the integration process. Before interconnecting the entire power grid in ASEAN, interconnection at the subregional level such as BIMP-EAGA has been suggested as an interim stage toward full-fledged integration. A four-stage development is suggested: incremental development of grid interconnection in BIMP-EAGA, incremental intra-BIMP-EAGA power trading, incremental inter-BIMP-EAGA power trading, and finally full-fledged regional power trading (Li and Kimura 2016b).

ASEAN plans to interconnect its power grid across the region. It has three main regions: Northern, Southern, and Eastern. The Northern region consists of countries in the GMS such as Cambodia, the Lao PDR, Myanmar, Thailand, and Viet Nam. It extends into Yunnan province
of the PRC. The Southern region consists of Indonesia except Borneo, Malaysia (Peninsula), and Singapore. The Eastern region consists of Brunei Darussalam, Borneo of Indonesia, Malaysia (Peninsula and Borneo), and the Philippines.

Along with the integrated energy markets in the GMS and the BIMP-EAGA region, the last puzzle piece of integrating energy markets in ASEAN is to include Singapore and Indonesia (other than Borneo). Integration of electricity markets from the Lao PDR to Singapore via Thailand and Malaysia has started. Once complete, the ASEAN region can integrate its entire electricity markets.

An integrated ASEAN electricity market may help develop more renewable energy in the region. In developing renewable energy, feed-in-tariffs could be more cost-effective than renewable energy portfolio standards in the region (Chang and Li 2015). Power grid interconnection in Northeast Asia is expected to promote electricity trading of renewable energy generated in Mongolia to the rest of the region.\(^7\) As the cost of cross-border interconnection seems to be very high, domestic transmission networks need to be developed beforehand (Lī and Kimura 2016a). Natural gas is another energy commodity that can help the energy market integrate further in the Asia and Pacific region. An integrated natural gas market through gas pipelines and LNG tankers and terminals could promote the general welfare in the region (Chang and Li 2014).

There are various potential gains from expanding regional electricity trading in South Asia, such as cost savings for electricity supply of up to $9 billion per year (Timilsina and Toman 2016). Cross-border electricity trading in South Asia could help climate change mitigation through carbon pricing (Timilsina and Toman 2018). Cross-border electricity trade is expected to help develop hydropower, unless otherwise untapped in South Asia, and make electricity flow without interruption across the borders (Timilsina 2018). States in northeast India and neighboring countries can promote their economic growth through improved grid connectivity (Anbumozhi, Kutani, and Lama 2019).

Economic integration in the region has started from the integration of electricity markets. The regional integration of electricity markets is at the center of the EU energy policy (Boffa and Sapio 2015). Vis-à-vis the European Community, for which cooperation in ensuring coal supply in the region more than 70 years ago led to a full-fledged economic community, ASEAN may follow suit by replicating what worked well for Europe and avoiding what went wrong in the process.

\(^7\) Northeast Asia includes the north and northeast of the PRC, Japan, Mongolia, eastern Russian Federation, and the Republic of Korea.
25.5 Concluding Remarks

How the common European market was formed and transformed over the years could shed some light on initiating an integrated energy market and making it operational. The hypothetical integration of electricity networks in West Africa appears to benefit the participating countries by lowering electricity supply costs and enhancing system reliability. This chapter examined the principles of integrating energy markets and explores prospects of an integrated energy market in Southeast Asia. It identifies five key factors and principles that are essential for a successful integration of energy markets in the region: population, institutions, transparency, nondiscrimination, and fair allocation of benefits and burden-sharing.

Population is the key to start an integrated energy market, while institutions keep the integrated energy market going and working. Transparency should be applied to all policy making, and nondiscrimination must be applied to all members regardless of differences in economic power, land, and population. Once a country joins any integrated energy market, each country should expect to give up some of their sovereign power in decision-making. Fair allocation of benefits and burden sharing should be implemented in any policies.

ASEAN has taken an initial step to integrate its energy markets. This is evident in the GMS economic cooperation and energy development, the AGP, and the TAGP. The integration of energy markets was spearheaded by the EAS in January 2007. This is expected to spur the movement and speed up the integration energy markets in the region.

ASEAN has made appropriate attempts at integrating energy markets in the region. Specific ways of integrating energy markets and making the regional integrated energy market operational have been proposed and examined. The verdict seems to be that an integrated electricity market in the region is feasible and actually is on the way to make power trading across borders possible. The integrated energy market is expected to bring benefits to the region after netting out all the costs of interconnection, transmission costs, and losses. A Pan-Asian natural gas trade model shows that a full-fledged trade network for natural gas connecting all the participating countries via pipelines, LNG terminals, and LNG tankers will benefit the participating countries. Although there is still a long way to go, a first step of integrating energy markets has been made, with various additional efforts. An integrated electricity market is expected to function and serve well the ASEAN Economic Community in the near future.
As the EU model shows, an integrated energy market brings benefits to the member countries. This could be the case for the ASEAN countries. However, given the huge differences in geography, economic status, culture, religion, and energy endowments, how to integrate the region should be different from the EU model. As shown earlier, the GMS has a successful integrated energy market. The BIMP-EAGA model has started and the integration model from the Lao PDR to Singapore via Thailand and Malaysia is in the works. Once all three models are complete, ASEAN will have a successfully integrated regional energy market to act as a good example of how the integration of energy markets is a good starting point for economic integration of various sovereign nations.
References


PART VI
Financial Inclusion and Legal Approaches
The Impact of Financial Inclusion and Trade Openness on Economic Development in the European Union

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26.1 Introduction

Why have some countries such as the United States and those in Western Europe become rich, while others remain poor and struggle with low economic opportunities? To understand this, economic theorists argue that trade openness could be one of the great channels to promote economic activity by allowing resources to cross freely across the countries, through the reallocation of, in particular, knowledge and technology flows (Balassa 1978; Grossman and Helpman 1991; Aghion and Howitt 1998; Edwards 1993; Taghizadeh-Hesary et al. 2019). Economic progress has been visible since the liberalized policies adopted all over the world in the 1980s that came with rapid economic integration. Despite the strong support for the notion that trade improves welfare outcomes, counter-theoretical arguments (Redding 1999; Young 1991) hold that trade may yield negative results in certain conditions (Kim 2011; Chang, Kaltani, and Loayza 2009). However, continued weaker economic activity needs further explanation from time to time to address the persistent economic sluggishness. This may arise due to the inability to allocate resources efficiently, particularly financial resources; even after the adaptation of liberalized financial and trade policies—despite the growth—some people, households, and firms across the world are being denied access to financial resources. Therefore, the answer to the slow growth in some countries/regions may lie in the development of
a financial system. What kind of financial development have countries achieved across the world? Do these unequal distributions of financial resources and the denial of financial access to some sections yield adverse effects on real income? The present work aims to address this question along with the role of economic integration in the process of economic development. The role of trade openness and financial development has been widely investigated in the literature, but financial inclusion has been ignored for several reasons. However, burgeoning literature on this topic shows that it has a wide range of socioeconomic implications; hence, it is appropriate to add some knowledge to the ongoing policy debate, as well as the academic literature.

The denial of financial services may have detrimental effects on various segments of the economy. Recent literature focusing on several angles has opened up discussions on this issue, albeit limited. Such discussions have focused, for example, on women (Ghosh and Vinod 2017; Botric and Broz 2017), small-scale industrial units (Morgan and Pontines 2018; Garcia and Jose 2016), rural, remote areas, and poverty (Bhatia and Chatterjee 2010; Goedecke et al. 2018; Chibba 2009; Dawood et al. 2019; Park and Mercado 2015) and have provided useful comments and insights concerning overall development through financial inclusion. These are the weaker and vulnerable segments in any society and face several challenges, including constraints in accessing economic resources, and are ultimately unable to find economic opportunities and hence experience poverty and low growth.

However, financial inclusion is taking place. According to data released by the Global Findex database, financial access for the adult population increased from 51% to 69% from 2014 to 2017; during the Findex survey periods, financial access reached 700 million and 515 million people in 2011–2014 and 2014–2017, respectively. However, between-country and within-country differences are significant in terms of the distribution of financial access. The number of individuals with access to a bank or other type of financial institution has been very high in the euro area compared to other developing or underdeveloped regions. For instance, between 2014 and 2017, some form of financial access was extremely common in the euro area, according to the Findex data, at around 95%, while it was lower in other regions such as East Asia and the Pacific (increase from 69% in 2014 to 70% in 2017), and very low in sub-Saharan Africa (from 29% to 33% during the same period). Within

\footnote{Some notable studies for more details: on openness – Grossman and Helpman (1991); Edwards (1993); Barro and Sala-i-Martin (1997); Baldwin, Braconier, and Forslid (2005); on financial development – Schumpeter (1911); King and Levine (1993); Beck, Levine, and Loayza (2000); Rajan and Zingales (1998).}
the European Union (EU), we notice huge variations across countries also. For instance, high-income countries such as Norway and Sweden have full access to financial institutions, but low-income countries such as Albania (increase from 38% in 2014 to 39% in 2017) and Ukraine (from 53% to 63%) have lower access, and other countries like Hungary and Poland (from 72% to 78%) are catching up with the rest.

At this stage, it is important to ask: How does such access to the financial entities and banks help the financial institutions to grow? How do real sectors benefit from being associated with these financial institutions and instruments? What are the basic channels that help get the ball rolling? Generally speaking, financial inclusion provides some form of financial accessibility, say owning an account at a formal financial firm, which allows individuals to borrow, save, and invest. Theoretically, this channel not only strengthens individuals but also the financial system, providing better services where households and firms are better-off and pathways are opened to create new businesses and new opportunities for skilled labor. At the individual level, it helps to get access to essential needs such as health and education, firm-level business ventures may create demand for labor participation and thus inclusive and equitable growth, which eventually leads to the end of poverty and better living standards. It is also possible that financial inclusion will improve financial stability, where institutions expand their base in terms of increasing branches across unbanked areas, mobilizing funds, and offering credit facilities in new areas that have recently opened up to banks; such financialization improves stability (Ahamed and Mallick 2017). Further studies also confirmed that financial inclusion improves macroeconomic aspects such as controlling persistent poverty and economic inequality (Park and Mercado 2015).

As mentioned, in the era of rapid globalization, “financialization” helps by driving technological and knowledge flows, where modern financial instruments are associated with information and communication technology (ICT), such as mobile telephony, internet banking, and mobile apps, which ease financial transactions and are revolutionizing the modern financialization. It is possible in a technology-driven world that intra- and interregional trade and the use of digital transactions will become available to the masses, and enhance financial inclusion of low- and middle-income classes and further real growth. The role played by technology is immense; therefore, it should be made available across the developing world whose populations can then take advantage of it and begin to catch up. Given the depth of globalization, and interdependency across countries, particularly in Europe, the euro area, and other Eastern European countries (Keppel and Prettner 2015), the present research focuses on these regions, segregating them based
on the economic growth that they have achieved. We compare them in terms of financial inclusion and economic growth. In particular, we examine the impact of financial inclusion on economic output by accounting for potential key factors in the model, such as capital, energy use, labor, and trade openness.

For the purpose of analysis, we use annual data from 1995 to 2015, collected from World Bank publications such as the World Development Indicators and Findex data banks. Given the nature of the analysis, we employed panel data econometric models for the various subsamples throughout the analysis. The results of the analysis are robust and significant, coming from the standpoint of financial inclusion and trade openness. In particular, various indicators of financial inclusion in regard to economic development provide proper guidance to the policy makers in these countries, in terms of where and the level of financial inclusion required to inject in order to boost the economic development in the EU countries. This research offers several policy implications, and findings can be categorized as follows. First, financial inclusion significantly boosts economic growth along with trade openness and other traditional inputs such as energy consumption. Second, financial inclusion in the form of financial breadth is beneficial to the countries under study. Third, subpanels such as newly joined and lower-income EU nations are more prone to reap the benefits from financial inclusion, particularly the Eastern European nations.

26.2 Literature Review

This section explores previous literature for insights on which to base further investigation into how best to improve welfare outcomes in the context of EU nations, particularly in low- and middle-income nations such as those in Eastern Europe where financial access is relatively low. It is known that, compared to Western Europe (high-income countries), Eastern Europe (low- and middle-income countries) lags far behind in many socioeconomic indicators. Despite some ambiguity in the literature from the perspective of trade, we pay more attention to financial inclusion, which is also associated with trade and technological diffusion toward economic growth, which is highly relevant for a cross-country examination like this. However, the literature indicates that domestic financial development is complementary to cross-country inflows such as financial and technology imports, know-how, etc., and would hasten financial inclusion via fintech revolutions, which is particularly true for transition and developing countries.

Several studies have found beneficial effects from financial inclusion. For instance, a study was carried out by Burgess and Pande (2005) in the
Indian context investigating whether extending financial facilities would alleviate poverty, particularly through the public-led bank facilities provided to rural India. This was tested during the second phase of banking nationalization between 1990 and 1997, and it was found there was a substantial positive association in reducing rural poverty. During this time, the licensing policy 1:4 was critical in opening up branches in less financially developed states, as well as districts and rural areas. The extensive outreach of rural branch networks helped rural households obtain access to savings, and pool deposits and loans at cheaper rates as reflected in welfare maximization. Another study by Dawood et al. (2019) investigated whether eliminating barriers to financial resources would really take people and households out of poverty in the context of Indonesia. Despite having a higher number of financial institutions, the country is in severe poverty. Using binary models with household-level data, the study findings reveal that financial inclusion had significant beneficial effects in terms of reducing absolute poverty. Similarly, the literature was extended in this area by Park and Mercado (2018) who investigated the factors that influence financial inclusion, and also the impact of financial inclusion on poverty and income inequality across the world covering 176 countries, including 37 from developing Asia. Empirical analysis suggests that per capita income, rule of law, and demographic factors influence the inclusion drive across the world, including in the subsample from developing Asia. In the next stage, it was tested whether financial inclusion reduces poverty and income inequality, with results indicating that financial inclusion correlates significantly with lowering poverty levels and income inequality, but the inequality relationship is not so true in the context of the Asian sample.

Using Global Findex data, Fungaciva and Weill (2015) compared the inclusion drive in households of the People’s Republic of China with their BRICS counterparts (Brazil, the Russian Federation, India, and South Africa). Despite good growth, Chinese people are less confident and tend to use less formal financial instruments, with transactions mostly taking place informally, due to insecurity and a lack of confidence, among other reasons. These findings are quite common even in other countries in the group, but the Chinese case is clearly relatively less financialized. Also, the level of income, the quality of education, and gender play a key role, among other factors. Le, Chuc, and Taghizadeh-Hesary (2019) examined the trend of financial inclusion in Asia and its impact on financial efficiency, financial sustainability, and economic development using a sample of 31 Asian countries during the period spanning from 2004 to 2016. Their findings revealed that financial inclusion is associated with the same key underlying factors, such as macroeconomic stability and economic growth. In addition, they found
that economies with higher expected gross domestic product (GDP) levels are more likely to experience an expansion of financial and credit services.

Studies have been conducted on several aspects across countries in various dimensions associated with mobile technologies, prioritization of gender participation, microfinance, socially disadvantaged sections, and so on, with the aim of bringing people into the financial networks to strengthen the inclusion drive. In terms of stability aspects, using data from 86 countries, Ahamed and Mallick (2017) provided international evidence in investigating the relationship between financial inclusion and financial stability. The findings of the study reveal that financial inclusion has a significant positive association with financial stability, where the financial system increasing its depth and breadth in terms of extending services such as branches, diversifying loan portfolios, and mobilizing deposits across the extended spectrum of the masses facilitate a stable financial system. Similarly, studies on stability (Morgan and Pontines 2018; Garcia and Jose 2016) have not confirmed access to the finance into new territory, results from these studies are inconclusive, the effect of financial inclusion on financial stability is ambiguous, and the association needs further investigation. In particular, Morgan and Pontines (2018) explored whether increasing financial access to small and medium-sized enterprises (SMEs) improved financial stability. The authors found that it is helpful to the financial institutions to diversify risk and improve stability in terms of reducing nonperforming loans by spreading loan portfolios across SMEs, which also raises concerns over defaulting among new entities into the basket of inclusion drive.

The ICT revolution, including mobile telephony, has facilitated access and reduced banking transaction costs, thereby encouraging people and broadening the financial system. Studies from across the world, including Asia, Africa, and elsewhere (e.g., Tchamyou, Erreygers, and Cassimon 2019; Mushtaq and Bruneau 2019; Lashitew, van Tulder, and Liasse 2019; Loubere 2017), have shown that it accelerates economic growth overall despite some issues; therefore, these studies suggest that promoting ICT may stimulate growth, but conditions need to be put in context and the levels of financial depth and economic growth matter, among other things. Other parts of the world suggest that, broadly speaking, ICT, mobile banking, and the Internet of Things are helping financial instruments reach out the unbanked areas through digital connectivity, further facilitating the efficient allocation of resources through inclusive banking.

Studies into gender aspects have investigated the gender dimensions of financial inclusion, where within households people may be discriminated against in terms of gaining access to finance
based on gender. Evidence from Central and Eastern Europe was provided by Botric and Broz (2017) who measured financial inclusion in terms of having an account with some form of financial institution. Their findings reveal that, in general, inclusion is higher among males than females. Moreover, the authors examined this in further detail, finding that several other factors explain this low inclusion in the case of females, such as the low level of labor participation and educational attainments, which favor males. In fact, inclusion in terms of financial access is higher among males across the countries under investigation here. Ogunleye (2017), using data from the 752 microfinance banks in Nigeria for the period 2011–2014, found positive effects from the inclusion of microfinance for female clients, which is largely due to their enhanced repayment capability. Similarly, using data from micro-, small, and medium-sized enterprises, Kairiza, Kiprono, and Magadzire (2017) examined the relationship between financial inclusion and the gender gap in the context of Zimbabwe. The results derived from tobit and ordinary least squares regressions confirmed that female entrepreneurs are weak in formal sectors in given conditions. There is clear evidence that, in the case of informal firms, inclusion is less likely than among their male counterparts, but firm performance is relatively better among firms associated with informal financial sources headed by female entrepreneurs.

Promoting financial inclusion through microfinance and its challenges are elaborately reviewed by Ghosh (2013), who provided a critical assessment, and also drew on some findings from a case study of Andhra Pradesh, India. In this investigation, the author argues that microfinance can only be considered a strategic tool for financialization for the poor, providing regulatory and subsidized interventions for the small and marginalized. Another study in the context of Southeastern Europe by Brown, Guin, and Kirschenmann (2015) investigated the expansion of the branch network through ProCredit banks (microfinance) and the impact on financial inclusion using data from the period 2006–2010. The study finds largely positive effects: Low-income households are able to open an account in the nearest branch, and this is also significant in terms of accounts held by the poor, and elderly account holders who are dependent on these transactions.

There are studies that produce negative yields from the inclusion drive in various forms. For instance, the expansion of basic bank accounts associated with economic development was investigated by Dupas et al. (2018) in the context of Uganda, Malawi, and Chile. In the case of these countries, policies related to financial inclusion successfully implemented and increased the financial base but failed to deliver the welfare in the observed cases, as suggested by the data. Another
study by Inoue (2019) in the case of Indian states using data from 1973 to 2004, using the generalized method of moments, investigated the effect of financial inclusion on poverty. The results revealed that it has a statistically significant negative effect on the poverty ratio when applied to public sector banks, but this is not the case for private sector banks. Based on these findings, the author suggests that the promotion of public sector banks in terms of depth and breadth will have a lasting effect on lifting people out of poverty. Therefore, in light of the above findings, it is suggested that more studies are needed to frame robust policies with regard to the role of financial inclusion in economic development.

26.3 Data and Methodology

26.3.1 Description of Data

The main purpose of this study is to investigate the impact of financial inclusion on economic growth in a sample of 27 EU countries and make use of yearly data from 1995 to 2015. The selection of the sample period is due to the availability of data. We exclude only one country (Malta) from the EU group due to unavailability of data for the selected sample period. The countries are again classified into four different categories: old-EU (those that joined the EU before 2000), new-EU (those that joined the EU after 2000), low-income EU (on average, the countries with GDP per capita of less than $20,000 during the study period), and high-income EU (on average, the countries with GDP per capita of more than $20,000 during the study period). The list of EU economies and subsamples is available in Appendix A26. These classifications will further help us to understand the nature and degree of the association between financial inclusion and economic growth across all EU nations as well its subsamples.

The measurement of the variables is as follows: economic output (EO) is proxied with GDP in constant 2010 United States dollars, while financial inclusion is measured through financial institutions access (FIA), with data compiled on bank branches and ATMs per 100,000 adults. Again, for the purpose of robustness, we also consider three other measures of financial inclusion: the depth of the financial institutions (FID), which is built using the information on bank credit to the private sector, pension fund assets, mutual fund assets, insurance premiums, life, and nonlife to GDP; the efficiency of the financial institutions (FIE), which is constructed using the information on net interest margin, lending-deposits spread, noninterest income to total income, overhead costs to total assets, return on assets, and return on equity; and overall
development of financial institutions (FI), with data compiled on the accessibility, depth, and efficiency of the financial institutions. The study also includes a number of control factors in the model, measured as follows: capital (CAP) is proxied with gross fixed capital formation in constant 2010 United States dollars; energy use (EC) is measured in kilograms of oil equivalent per capita; labor (LBR) is proxied with total labor force; and finally, trade openness (TO) is the sum of total exports and imports as a percentage of GDP. The data on EO, CAP, EC, LBR, and TO are sourced from the World Bank, while data on financial inclusion indicators are obtained from the International Monetary Fund.

### 26.3.2 Estimation Strategies

As mentioned previously, this study is designed to examine the impact of financial inclusion on economic output in EU nations by accounting for key determinants of output in the model, such as capital, energy use, labor, and trade openness. Based on the prevailing theoretical and empirical literature, we develop the following model:

\[ EO_{it} = \beta_0 + \beta_1 CAP_{it} + \beta_2 EC_{it} + \beta_3 LBR_{it} + \beta_4 TO_{it} + \beta_5 FI_{it} + \mu_{it} \]

where EO, CAP, EC, LBR, TO, and FI represent economic output, capital, energy consumption, labor force, trade openness, and financial inclusion indicators, respectively. Similarly, \( i \) and \( t \) refer to the cross-section and time period, respectively, while the error term is denoted by \( \mu \).

To undertake empirical investigation, we employ three panel unit root tests such as Levin, Lin, and Chu (2002), Breitung (2000), and Im, Pesaran, and Shin (IPS) (2003). The null hypothesis of unit root is tested against the alternative hypothesis of no unit root.\(^2\) To investigate the long-run equilibrium association among the variables, we employ Fisher-type Johansen cointegration test. This methodology is developed by Maddala and Wu (1999) by making use of Johansen and Fisher approaches. The null hypothesis of no cointegration (long-run equilibrium relationship) is tested against the alternative of cointegration. Finally, to estimate long-run parameters, we utilize grouped-mean fully modified least squares (FMOLS) method of Pedroni (2000, 2001). This approach computes the average of individual cross-section. This method is more appropriate in the presence of heterogeneity as it offers more reliable estimates of

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\(^2\) Please note that the alternative hypothesis for the IPS test is “some cross-sections without unit root.”
the sample mean of the cointegrating vector as compared to pooled and weighted estimators.

### 26.3.3 Preliminary Investigation

We begin our preliminary investigation by looking at the average statistics on the selected variables and countries during the study period, i.e. 1995 to 2015. The summary (average) statistics are displayed in Table 26.1. The average statistics imply that among the selected 27 EU economies, Estonia, Cyprus, Latvia, and Lithuania are the smallest economies in terms of GDP (EO), while Germany, France, and the United Kingdom (UK) are the largest economies. Likewise, our estimates show that Cyprus, Estonia, Latvia, Lithuania, Luxembourg, and Bulgaria have the lowest capital (CAP), whereas Germany, France, Italy, and the UK have the highest. The per capita energy consumption is significantly higher in countries like Luxembourg, Finland, Sweden, and Bulgaria, whereas lower consumption is observed in Romania and Latvia. A number of selected EU economies had labor forces of fewer than 1 million workers, on average, during the study period, such as Luxembourg, Cyprus, and Estonia, whereas Germany, the UK, France, Italy, and Spain had more than 20 million. The trade openness (TO) of all the EU economies is at least more than 50% of their respective GDP. Among the financial inclusion indicators, our main interest is in the access to the financial institutions (FIA). The statistics imply that financial inclusion (FIA) is significantly higher in Portugal, Spain, and Luxembourg, while lower financial accessibility is noted in countries like Finland, Hungary, and Romania. These average statistics imply that there is a considerable heterogeneity in the selected EU economies and variables.

Table 26.2 reports the average growth rates in the EU economies. The growth rates reveal that all the EU economies have shown positive growth in GDP over the last 2 decades. Only Italy and Greece have less than 1% growth in GDP, while 5% growth is observed in Ireland. The growth rates of capital accumulation are positive in all the countries with the exception of Cyprus, Greece, and Portugal. Interestingly, a number of EU countries showed negative growth in terms of per capita energy consumption during the study period. More specifically, countries like the UK, Denmark, Romania, Luxembourg, Cyprus, the Netherlands, Italy, Belgium, Sweden, the Slovak Republic, Bulgaria, France, Germany, Ireland, the Czech Republic, Poland, and Hungary have negative growth, while the remaining countries have positive growth but none of them have more than 1% positive growth. The labor force growth rates are also positive in most countries, with the exception of Romania, Lithuania, Latvia, Bulgaria, Croatia, and

<table>
<thead>
<tr>
<th>Country</th>
<th>EO</th>
<th>CAP</th>
<th>EC</th>
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<th>TO</th>
<th>FIA</th>
<th>FID</th>
<th>FIE</th>
<th>FI</th>
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<td>62.81</td>
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<td>84.84</td>
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<td>70.70</td>
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<td>42.42</td>
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<td>83.09</td>
<td>71.29</td>
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<td>80.21</td>
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<td>102.41</td>
<td>63.36</td>
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<td>74.55</td>
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</table>

CAP = capital, EC = energy consumption, EO = economic output, EU = European Union, FI = financial inclusion, FIA = financial institutions access, FID = depth of financial institutions, FIE = efficiency of financial institutions, LBF = labor force, TO = trade openness.

Notes: The summary (average) statistics were calculated using data from 1995 to 2015; EO, CAP, and LBF are in millions, while all other variables are as defined in the data section.

Source: Authors’ calculation.
Table 26.2: Average Growth Rates in Selected EU Economies, 1995–2015

<table>
<thead>
<tr>
<th>Country</th>
<th>EO</th>
<th>CAP</th>
<th>EC</th>
<th>LBF</th>
<th>TO</th>
<th>FIA</th>
<th>FID</th>
<th>FIE</th>
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<tbody>
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<td>0.73</td>
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<td>0.00</td>
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<td>3.71</td>
<td>2.68</td>
<td>2.73</td>
</tr>
<tr>
<td>Slovenia</td>
<td>2.54</td>
<td>2.19</td>
<td>0.26</td>
<td>0.37</td>
<td>2.44</td>
<td>2.47</td>
<td>3.19</td>
<td>2.43</td>
<td>2.48</td>
</tr>
<tr>
<td>Spain</td>
<td>2.11</td>
<td>2.17</td>
<td>0.14</td>
<td>1.69</td>
<td>1.97</td>
<td>0.48</td>
<td>2.17</td>
<td>0.34</td>
<td>0.79</td>
</tr>
<tr>
<td>Sweden</td>
<td>2.50</td>
<td>3.51</td>
<td>-0.46</td>
<td>0.64</td>
<td>1.19</td>
<td>1.44</td>
<td>3.78</td>
<td>0.32</td>
<td>1.93</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>2.18</td>
<td>2.03</td>
<td>-1.44</td>
<td>0.81</td>
<td>0.69</td>
<td>-0.15</td>
<td>1.09</td>
<td>-0.88</td>
<td>0.09</td>
</tr>
<tr>
<td>Sample average</td>
<td>2.57</td>
<td>3.63</td>
<td>-0.16</td>
<td>0.49</td>
<td>2.41</td>
<td>1.77</td>
<td>2.42</td>
<td>1.29</td>
<td>1.52</td>
</tr>
</tbody>
</table>

CAP = capital, EC = energy consumption, EO = economic output, EU = European Union, FI = financial inclusion, FIA = financial institutions access, FID = depth of financial institutions, FIE = efficiency of financial institutions, LBF = labor force, TO = trade openness.

Note: The growth rates were calculated using before log conversion data.
Source: Authors’ calculation.
Estonia. The growth rates in trade openness imply that all EU countries have positive growth, except Cyprus. The average growth rates of access to financial inclusion are considerably higher for countries like Romania, Poland, Croatia, and Latvia, whereas some countries have negative growth such as the Netherlands, Denmark, Cyprus, Germany, Portugal, the UK, and Luxembourg. These average growth rates also suggest significant divergence in terms of growth rates in the selected sample countries.

The conditional correlations among the variables are presented in Table 26.3. The economic output is positively correlated with all the variables, with the exception of trade openness. The economic output is highly correlated with capital, labor force, and financial inclusion indicators. It is important to note that the capital is not highly correlated with financial inclusion indicators. Therefore, there is no severe multicollinearity among the selected variables. Based on these correlations, we argue that the economic output is positively correlated with basic inputs (capital and labor), energy, and financial indicators. However, the correlations between economic output and trade openness seem to be negative, but we need to undertake rigorous empirical investigation to understand the nature of their relationship in the long-term.

Table 26.3: Unconditional Correlations, 1995–2015

<table>
<thead>
<tr>
<th></th>
<th>EO</th>
<th>CAP</th>
<th>EC</th>
<th>LBF</th>
<th>TO</th>
<th>FIA</th>
<th>FID</th>
<th>FIE</th>
<th>FI</th>
</tr>
</thead>
<tbody>
<tr>
<td>EO</td>
<td>1.000</td>
<td>0.992</td>
<td>0.262</td>
<td>0.880</td>
<td>−0.530</td>
<td>0.247</td>
<td>0.580</td>
<td>0.309</td>
<td>0.491</td>
</tr>
<tr>
<td>CAP</td>
<td>1.000</td>
<td>0.279</td>
<td>0.869</td>
<td>−0.511</td>
<td>0.255</td>
<td>0.582</td>
<td>0.355</td>
<td>0.504</td>
<td></td>
</tr>
<tr>
<td>EC</td>
<td>1.000</td>
<td>−0.091</td>
<td>0.333</td>
<td>0.007</td>
<td>0.583</td>
<td>0.467</td>
<td>0.415</td>
<td></td>
<td></td>
</tr>
<tr>
<td>LBF</td>
<td>1.000</td>
<td>−0.707</td>
<td>0.045</td>
<td>0.203</td>
<td>0.000</td>
<td>0.135</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TO</td>
<td>1.000</td>
<td>0.019</td>
<td>0.054</td>
<td>0.143</td>
<td>0.050</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FIA</td>
<td>1.000</td>
<td>0.497</td>
<td>0.479</td>
<td>0.802</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FID</td>
<td>1.000</td>
<td>0.643</td>
<td>0.890</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FIE</td>
<td>1.000</td>
<td>0.767</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FI</td>
<td>1.000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

CAP = capital, EC = energy consumption, EO = economic output, FI = financial inclusion, FIA = financial institutions access, FID = depth of financial institutions, FIE = efficiency of financial institutions, LBF = labor force, TO = trade openness.

Note: The correlations were estimated using log data.
Source: Authors’ calculation.
26.4 Results and Discussion

To begin our rigorous empirical investigation, we begin with panel unit root tests. These tests have become an integral part of the estimation procedure as they determine a suitable methodology that can be used for the empirical investigation to achieve the study objectives. Bearing that in mind, we employ three unit root tests to examine the integration of the variables. The results of these tests are displayed in Table 26.4. The tests reveal that none of the variables is stationary at the data level, while all variables are stationary at their first-order differences. This evidence confirms that the null hypothesis is not rejected for the data-level analysis but is strongly rejected for their first-difference data series.

<table>
<thead>
<tr>
<th>Method</th>
<th>LLC Level</th>
<th>Breitung t-stat</th>
<th>IPS W-stat</th>
<th>LLC First difference</th>
<th>Breitung t-stat</th>
<th>IPS W-stat</th>
</tr>
</thead>
<tbody>
<tr>
<td>EO</td>
<td>–0.090</td>
<td>0.862</td>
<td>2.533</td>
<td>–6.877***</td>
<td>–4.478***</td>
<td>–5.133***</td>
</tr>
<tr>
<td>Prob.</td>
<td>0.464</td>
<td>0.806</td>
<td>0.994</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td>CAP</td>
<td>–0.155</td>
<td>0.577</td>
<td>0.173</td>
<td>–5.595***</td>
<td>–2.615***</td>
<td>–5.431***</td>
</tr>
<tr>
<td>Prob.</td>
<td>0.439</td>
<td>0.718</td>
<td>0.569</td>
<td>0.000</td>
<td>0.005</td>
<td>0.000</td>
</tr>
<tr>
<td>Prob.</td>
<td>0.250</td>
<td>1.000</td>
<td>1.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td>LBF</td>
<td>–0.455</td>
<td>4.610</td>
<td>2.883</td>
<td>–6.629***</td>
<td>–7.990***</td>
<td>–5.852***</td>
</tr>
<tr>
<td>Prob.</td>
<td>0.325</td>
<td>1.000</td>
<td>0.998</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td>TO</td>
<td>16.172</td>
<td>0.892</td>
<td>2.029</td>
<td>–10.198***</td>
<td>–10.082***</td>
<td>–7.890***</td>
</tr>
<tr>
<td>Prob.</td>
<td>1.000</td>
<td>0.814</td>
<td>0.979</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td>Prob.</td>
<td>0.998</td>
<td>1.000</td>
<td>1.000</td>
<td>0.000</td>
<td>0.001</td>
<td>0.000</td>
</tr>
<tr>
<td>FID</td>
<td>1.506</td>
<td>1.524</td>
<td>0.514</td>
<td>–8.406***</td>
<td>–6.715***</td>
<td>–9.055***</td>
</tr>
<tr>
<td>Prob.</td>
<td>0.934</td>
<td>0.936</td>
<td>0.697</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td>FIE</td>
<td>1.875</td>
<td>–0.067</td>
<td>0.367</td>
<td>–11.866***</td>
<td>–3.446***</td>
<td>–12.016***</td>
</tr>
<tr>
<td>Prob.</td>
<td>0.970</td>
<td>0.473</td>
<td>0.643</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td>FI</td>
<td>–0.032</td>
<td>4.390</td>
<td>2.332</td>
<td>–6.646***</td>
<td>–5.039***</td>
<td>–7.385***</td>
</tr>
<tr>
<td>Prob.</td>
<td>0.487</td>
<td>1.000</td>
<td>0.990</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
</tbody>
</table>

CAP = capital; EC = energy consumption; EO = economic output; FI = financial inclusion; FIA = financial institutions access; FID = depth of financial institutions; FIE = efficiency of financial institutions; IPS = Im, Pesaran, and Shin (2003); LBF = labor force; LLC = Levin, Lin, and Chu (2002); TO = trade openness.

Notes: The panel unit root tests were estimated using log data; the above results account for constant and trend in the models; *** implies the rejection of the null hypothesis at the 1% significance level.

Source: Authors’ calculation.
Our estimates from the panel unit root tests indicated that there may be a long-run association among the variables of the study. This is because all the variables are integrated with the same order of integration. Hence, we examine the cointegration relationship by using the Fisher-Johansen panel cointegration test. The cointegration test results are displayed in Table 26.5. We apply the cointegration test to four models; in each of these models, we use various financial inclusion indicators, such as access, depth, efficiency, and overall development of the financial institutions. The results on all the models reveal a significant long-run association among the variables. This indicates that the economic output is strongly cointegrated with capital, energy consumption, labor, trade openness, and financial inclusion indicators. Given this evidence on the long-run association of the variables, we argue that these variables have a significant association in the long run. However, to further understand their nature and degree of association, we undertake additional investigation in the following.

### Table 26.5: Johansen-Fisher Panel Cointegration Test

<table>
<thead>
<tr>
<th>Hypothesized No. of CE(s)</th>
<th>Fisher Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>trace</td>
</tr>
<tr>
<td>[ \text{EO} = f (\text{CAP, EC, LBF, TO, FIA}) ]</td>
<td><strong>None</strong> 1,528.000*** 779.400*** 1,331.000*** 683.800*** 1,403.000*** 728.800*** 1,441.000*** 702.600***</td>
</tr>
<tr>
<td></td>
<td>At most 1 817.000*** 518.400*** 856.400*** 516.100*** 815.200*** 510.400*** 801.600*** 512.500***</td>
</tr>
<tr>
<td></td>
<td>At most 2 407.200*** 237.700*** 496.000*** 297.900*** 421.700*** 254.700*** 421.800*** 248.400***</td>
</tr>
<tr>
<td></td>
<td>At most 3 218.200*** 136.500*** 260.200*** 171.400*** 223.100*** 154.300*** 231.100*** 155.400***</td>
</tr>
<tr>
<td></td>
<td>At most 4 134.100*** 105.700*** 148.100*** 110.200*** 119.900*** 111.500*** 132.500*** 104.600***</td>
</tr>
<tr>
<td></td>
<td>At most 5 110.400*** 110.400*** 128.000*** 128.000*** 76.580** 76.580** 104.500*** 104.500***</td>
</tr>
</tbody>
</table>

CAP = capital, EC = energy consumption, EO = economic output, FI = financial inclusion, FIA = financial institutions access, FID = depth of financial institutions, FIE = efficiency of financial institutions, LBF = labor force, TO = trade openness.

Note: *** and ** imply the rejection of the null hypothesis at the 1% and 5% significance levels, respectively.

Source: Authors’ calculation.

Our previous estimations established a significant long-run cointegration relationship among the variables; however, those estimates do not reveal the degree and nature of the impact of the independent variables on the dependent variable in the model. To understand their long-run association during the study period, we employ the grouped-mean approach of the FMOLS method. This
approach uses semi-parametric corrections to the regression model to address the issue of endogeneity and serial correlation, which is an important issue when dealing with a set of macro fundamentals in the model. The results of this framework on all four models are displayed in Table 26.6. The empirical findings are consistent in terms of the nature of their impact on economic output across the four models, but their degree of impact changes. Specifically, a 1% rise in access to financial institutions increases economic output by 0.079%. Likewise, the depth of the financial institutions and overall financial development also have a considerable positive impact on economic growth. A similar impact is observed from capital, energy consumption, labor, and trade openness across the models.

Again, to understand the impact of financial inclusion variables on economic output, we further classify our full sample of EU countries into old-EU and new-EU member countries. The results illustrate that the impact from financial inclusion indicators on economic output is much stronger and more significant in new-EU member countries than in old-EU countries. Further, the results show that none of the financial indicators are significant in old-EU countries. The impact from the remaining variables on output is the same.

Again, we classify our sample countries into high-income EU and low-income EU economies. The purpose is to dig further into the nature and degree of the association among these variables. The results reveal that the financial indicators have a greater positive impact on economic output in low-income EU economies than in high-income EU countries. The nature of the impact from capital, energy, labor, and trade openness on economic output remains positive and statistically significant.

For the robustness check, we replace the economic output (GDP) variable with GDP per capita (PI) to see whether the financial inclusion indicators have a similar or dissimilar impact. The results are presented in Table 26.7. The estimated outcomes on the full sample reveal that the financial inclusion indicators have a positive influence on per capita income. Similarly, the effects from capital, energy, labor, and trade openness on per capita income are positive and statistically significant across the models. The results from old-EU, new-EU, high-income EU, and low-income EU economies also show that the financial inclusion indicators have a positive and significant impact on per capita income. It is important to note that the effect of financial indicators is much more significant in new-EU and low-income EU economies than in those of the old-EU and high-income EU countries. The findings on control factors confirm that the nature of their impact on per capita income remains the same across the groups and models.
Table 26.6: Long-Run Elasticities of Economic Output (GDP) Using Grouped-Mean Approach

<table>
<thead>
<tr>
<th>Variable</th>
<th>Full sample (EU)</th>
<th>Old-EU members</th>
<th>New-EU members</th>
<th>High-income EU members</th>
<th>Low-income EU members</th>
</tr>
</thead>
<tbody>
<tr>
<td>CAP</td>
<td>0.277*** 0.000</td>
<td>0.286*** 0.000</td>
<td>0.265*** 0.000</td>
<td>0.271*** 0.000</td>
<td>0.287*** 0.000</td>
</tr>
<tr>
<td>EC</td>
<td>0.142*** 0.000</td>
<td>0.099*** 0.000</td>
<td>0.197*** 0.000</td>
<td>0.076*** 0.004</td>
<td>0.254*** 0.000</td>
</tr>
<tr>
<td>LBF</td>
<td>0.866*** 0.000</td>
<td>1.203*** 0.000</td>
<td>0.445*** 0.001</td>
<td>1.149*** 0.000</td>
<td>0.386** 0.011</td>
</tr>
<tr>
<td>TO</td>
<td>0.138*** 0.000</td>
<td>0.148*** 0.000</td>
<td>0.124*** 0.000</td>
<td>0.156** 0.004</td>
<td>0.107*** 0.000</td>
</tr>
<tr>
<td>FIA</td>
<td>0.079*** 0.000</td>
<td>-0.045 0.193</td>
<td>0.236*** 0.000</td>
<td>-0.013 0.685</td>
<td>0.236*** 0.000</td>
</tr>
<tr>
<td>FID</td>
<td>0.049*** 0.001</td>
<td>0.026 0.194</td>
<td>0.077*** 0.001</td>
<td>0.075** 0.023</td>
<td>0.039** 0.032</td>
</tr>
<tr>
<td>FIE</td>
<td>0.022 0.348</td>
<td>-0.020 0.558</td>
<td>0.075** 0.023</td>
<td>0.009 0.778</td>
<td>0.009 0.778</td>
</tr>
<tr>
<td>FI</td>
<td>0.114*** 0.000</td>
<td>-0.043 0.151</td>
<td>0.310*** 0.000</td>
<td>0.012 0.661</td>
<td>0.028 0.609</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

CAP = capital, EC = energy consumption, EO = economic output, EU = European Union, FI = financial inclusion, FIA = financial institutions access, FID = depth of financial institutions, FIE = efficiency of financial institutions, GDP = gross domestic product, LBF = labor force, TO = trade openness.

Note: *** and ** imply significance levels at 1% and 5%, respectively.

Source: Authors’ calculation.
Table 26.7: Robustness Check – Long-Run Elasticities of Economic Output (GDP per Capita)

<table>
<thead>
<tr>
<th>Variable</th>
<th>Full sample (EU)</th>
<th>Old-EU members</th>
<th>New-EU members</th>
<th>High-income EU members</th>
<th>Low-income EU members</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$\pi = f (\text{CAP, EC, LBF, TO, FIA})$</td>
<td>$\pi = f (\text{CAP, EC, LBF, TO, FID})$</td>
<td>$\pi = f (\text{CAP, EC, LBF, TO, FIE})$</td>
<td>$\pi = f (\text{CAP, EC, LBF, TO, FI})$</td>
<td></td>
</tr>
<tr>
<td>CAP</td>
<td>0.281*** 0.000</td>
<td>0.329*** 0.000</td>
<td>0.327*** 0.000</td>
<td>0.287*** 0.000</td>
<td></td>
</tr>
<tr>
<td>EC</td>
<td>0.208*** 0.000</td>
<td>0.133*** 0.000</td>
<td>0.169*** 0.000</td>
<td>0.197*** 0.000</td>
<td></td>
</tr>
<tr>
<td>LBF</td>
<td>0.432*** 0.000</td>
<td>0.407*** 0.000</td>
<td>0.402*** 0.000</td>
<td>0.355*** 0.000</td>
<td></td>
</tr>
<tr>
<td>TO</td>
<td>0.139*** 0.000</td>
<td>0.165*** 0.000</td>
<td>0.191*** 0.000</td>
<td>0.139*** 0.000</td>
<td></td>
</tr>
<tr>
<td>FIA</td>
<td>0.067*** 0.003</td>
<td>0.059*** 0.000</td>
<td>0.016 0.504</td>
<td>0.116*** 0.000</td>
<td></td>
</tr>
<tr>
<td>FID</td>
<td></td>
<td></td>
<td>-0.026 0.423</td>
<td>-0.036 0.227</td>
<td></td>
</tr>
<tr>
<td>FIE</td>
<td></td>
<td></td>
<td>0.070* 0.058</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FI</td>
<td></td>
<td></td>
<td>0.307*** 0.000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CAP</td>
<td>0.296*** 0.000</td>
<td>0.330*** 0.000</td>
<td>0.338*** 0.000</td>
<td>0.255*** 0.000</td>
<td></td>
</tr>
<tr>
<td>EC</td>
<td>0.151*** 0.000</td>
<td>0.107*** 0.048</td>
<td>0.161*** 0.002</td>
<td>0.208*** 0.000</td>
<td></td>
</tr>
<tr>
<td>LBF</td>
<td>0.653*** 0.000</td>
<td>0.295* 0.056</td>
<td>0.134 0.382</td>
<td>0.145 0.287</td>
<td></td>
</tr>
<tr>
<td>TO</td>
<td>0.136*** 0.000</td>
<td>0.205*** 0.000</td>
<td>0.250*** 0.000</td>
<td>0.175*** 0.000</td>
<td></td>
</tr>
<tr>
<td>FIA</td>
<td>-0.057 0.101</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FID</td>
<td>0.045** 0.027</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FIE</td>
<td>-0.026 0.423</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FI</td>
<td>0.077*** 0.001</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CAP</td>
<td>0.262*** 0.000</td>
<td>0.307*** 0.000</td>
<td>0.296*** 0.000</td>
<td>0.292*** 0.000</td>
<td></td>
</tr>
<tr>
<td>EC</td>
<td>0.280*** 0.000</td>
<td>0.107*** 0.048</td>
<td>0.161*** 0.002</td>
<td>0.208*** 0.000</td>
<td></td>
</tr>
<tr>
<td>LBF</td>
<td>0.156 0.268</td>
<td>0.295* 0.056</td>
<td>0.134 0.382</td>
<td>0.145 0.287</td>
<td></td>
</tr>
<tr>
<td>TO</td>
<td>0.144*** 0.000</td>
<td>0.205*** 0.000</td>
<td>0.250*** 0.000</td>
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CAP = capital, EC = energy consumption, EO = economic output, EU = European Union, FI = financial inclusion, FIA = financial institutions access, FID = depth of financial institutions, FIE = efficiency of financial institutions, GDP = gross domestic product, LBF = labor force, TO = trade openness.

Note: ***, **, and * imply significance levels at 1%, 5%, and 10%, respectively.

Source: Authors' calculation.
26.4.1 Policy Discussion

Our results on the impact of financial inclusion on economic output demonstrate that financial inclusion has a great positive impact on the economic performance of EU nations. Further, our estimates reveal that the effect of financial inclusion on economic growth is much stronger in new-EU and low-income EU nations than in old-EU and high-income EU nations. In light of these outcomes, the relevant policy and practical inferences are discussed in what follows. We argue that financial inclusion has a significant positive impact on economic performance in a sample of EU economies. This outcome has important policy relevance. For instance, an increasing financial inclusion in any economy is a sign of low credit constraints. It further implies that higher financial inclusion helps individuals and firms to access credit from financial institutions much more easily. Here, we argue that the financial inclusion is an indication that both individuals and firms are well connected to the financial system for their borrowings and savings. Therefore, higher financial inclusion plays an important role in promoting economic development and prosperity. In light of these arguments, we point out to policy makers that in order to achieve targeted growth rates in economic performance, they must give significant priority to financial inclusion as it plays a decisive role in any economy. If the policy makers fail to give attention to the financial inclusion in their policy design, then they may end up developing policies that may not help them to achieve their targeted economic growth rates.

Our results also show that financial inclusion has played a much bigger role in economic growth in new-EU and low-income EU economies. In light of this evidence, we argue that both of the subsamples’ (new-EU and low-income EU) economies are relatively smaller and more underdeveloped than those of other members of the EU. Hence, we argue that financial inclusion has a greater role to play in economic performance in countries where there is a considerable scope for the economies to expand their economic activities. This is significantly relevant for the low-income or underdeveloped EU economies. Specifically, the policy makers should understand the role of financial inclusion in achieving targeted economic growth rates. In light of these discussions, we suggest that financial inclusion must be given significant priority while designing policies aimed at achieving higher economic growth rates, particularly in low-income and new-EU economies.
26.5 Concluding Remarks

The debate on the role of financial inclusion in economic development has become a topic of interest not only in academic circles but also in policy discussions. Given the rising interest in the topic of financial inclusion in the last few years, this chapter is designed in such a way as to examine the effect of financial inclusion on economic output in a sample of 27 EU member countries. To once again cross-check the results, we classify full-sample countries into old-EU, new-EU, high-income EU, and low-income EU economies. Further, we also measure economic development through two indicators: GDP and per capita GDP. The study accounted for a number of control factors in the model, such as capital, energy use, labor, and trade openness, and used yearly data from 1995 to 2015 and panel econometric techniques to accomplish the study objectives.

Our findings show that financial inclusion has played a significant positive role in promoting economic performance among EU nations. The results also indicate that the impact of financial inclusion on economic growth is much stronger in new-EU and low-income EU countries. This evidence suggests that financial inclusion has played a much needed role in countries where there is a significant scope for market expansion, particularly in low-income EU and relatively underdeveloped EU economies.

The outcomes of this study have significant policy implications for the EU economies, Asia, and the rest of the world. Specifically, the policy makers need to realize the role that financial inclusion plays in promoting economic growth. Therefore, it is important that policy think tank officials include financial inclusion in their discussions while designing or recommending policies aimed at achieving higher economic growth rates. Ignoring financial inclusion in their policy discussions can underestimate the determinants of economic growth and hence may result in achieving lower growth rates. This study is the first of its kind to explore the impact of financial inclusion on economic growth in the EU nations. In view of the above, the study offers considerable new knowledge to the literature and policy.
References


### Appendix A26: Sample Countries and Their Classification

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EU = European Union.
Source: Compiled by the authors.
Comparative Study on the Legal Framework on General Differentiated Integration Mechanisms in the European Union, Asia-Pacific Economic Cooperation, and Association of Southeast Asian Nations

Usanee Aimsiranun

27.1 Introduction

Unity is undeniably the ideal situation for regional integration. Progressing as a whole has nonetheless become a challenge in the context of heterogeneity of the members, especially after the enlargement as well as the widening and the deepening of the organizations’ competence. The European Union (EU), which now comprises 28 member states, has achieved the highest level of economic integration by establishing an economic union, characterized by the use of a common currency among 19 member states as well as a common economic and financial policy. The EU faces the challenge of moving beyond its core integration in the economic sphere to become a political union, as well as the challenge of membership and de-integration with Brexit.

The Asia-Pacific Economic Cooperation (APEC), comprising 21 member economies, is the world’s largest transregional economic forum, gathering industrialized, industrializing, and developing economies in the Pacific Rim. With the 1994 Bogor Declaration, APEC member economies have committed themselves to the goal of free and
open trade and investment in Asia and the Pacific no later than 2020. As for the Association of Southeast Asian Nations (ASEAN), which consists of 10 member states that differ economically, politically, socially, and geographically, the establishment of the ASEAN Economic Community has become the goal of regional economic integration. The challenge for these two regional groupings lies principally in achieving the regional liberalization goals despite the significant differences in size and the level of economic development among the member countries.

Differentiated integration refers to a “process that allows some […] member states to go further in the integration process while allowing others to opt not to do so” (Chopin and Lequesne 2016). According to the classification proposed by Stubb in 1996, there are three forms of differentiated integration based on time, space, and matter, namely “multispeed,” “variable geometry,” and “à la carte.”

“Multispeed integration” refers to a subintegration that occurs inside the institutional framework and in which the members pursue common objectives at a different pace. The core group of member states, which are willing and able, proceed first, and the others will follow later. The differentiation among the member states is temporary since the other member states have to implement the commitment, agreement, or policy when they are able. “Variable geometry” admits a subintegration among some member states, which constitutes an integrative unit. Variable geometry does not imply a fixed composition of member states, nor specific subject matters, but different participants, cooperating on different issues, on a case-by-case basis. Other members may opt in to an existing integrative unit that has commenced a deeper integration in a specific policy area (Stubb 2002; Thym 2005). For “à la carte” beyond a minimum of common policies, member states are allowed to choose, at their discretion, the policy areas in which they want to participate. Under the à la carte model, some member states can opt out from a specific policy area, in principle, permanently (Stubb 1996).

In order to accelerate the progress toward the integration goal, the European Union, APEC, and ASEAN have all experimented with various forms of differentiated integration. Multispeed integration takes the form of a transition period, in principle limited in time, granted to new member states as well as a two-tier timeline in the realization of the common goal. In recognition of the different levels of economic development as well as the different levels of preparedness of the members to open up their markets, ASEAN’s four new member states (Viet Nam, Myanmar, the Lao People’s Democratic Republic, and Cambodia) were given a more extended period to meet the requirement of the ASEAN Free Trade Area for the elimination of tariff barriers in intra-ASEAN trading of goods. The principle of the different timetables
for developed and developing member economies is also recognized in APEC for the realization of the Bogor objective. The “industrialized economies” were supposed to achieve the goal by 2010, while the “developing economies” were given until 2020.

The à la carte model takes the form of permanent derogation based on policy areas. Starting from the 1992 Treaty of Maastricht, the EU has allowed individual member states to opt out from predetermined policies, such as the single currency (United Kingdom and Denmark), the social policy, free movement of people, and the immigration and asylum law, as well as police cooperation and criminal justice (United Kingdom). The opt-out regime has created closer cooperation among member states that are not opting out. All decisions taken in these policy areas are EU decisions, and they become part of the EU acquis, which is binding on the new member states. The only difference with other EU decisions is that they are not applicable in the member states that have opted out (Piris 2012; de Witte 2018).

This chapter will not consider these two specific modes of differentiation, in which the time, the participants, and the policy areas have already been predetermined. It will focus on the general mechanism to allow subintegration, within the organizational framework, on a case-by-case basis, among some member states that are willing or ready to move forward, while the others that are not yet ready may join later.

Using the functional method in comparative law (Zweigert and Kötz 1998), the chapter compares the legal framework of three differentiated integration mechanisms, namely the EU’s enhanced cooperation, APEC’s pathfinder initiatives, and ASEAN minus X, to draw lessons as well as policy and legal development suggestions.

27.2 Development of a General Differentiated Integration Mechanism in the EU, APEC, and ASEAN

27.2.1 The EU’s Enhanced Cooperation

In its early years, European integration had been characterized by the “dogma of unity” (Piris 2014). The construction of the common market justified every member state being subject to the same rules and being expected to implement the same policy at the same pace. However, the successive enlargements starting from the mid-1980s as well as the widening of the competences of the EU beyond the internal market have created the need for differentiation among the member states (Piris 2014).
The idea of a case-by-case differentiation in the EU was put forward by France and Germany. A joint letter dated 6 December 1995, from the French President Jacques Chirac and the German Federal Chancellor Helmut Kohl to the President of the European Council, proposed that “where one of the partners faces temporary difficulties in keeping up with the pace of progress in the Union, it would be desirable and feasible to introduce a general clause in the Treaties enabling those member states that have the will and the capacity to do so to develop closer cooperation among themselves within the single institutional framework of the European Union” (EU 1996).

This proposal was institutionalized by the 1997 Amsterdam Treaty under the name “closer cooperation,” later renamed “enhanced cooperation” by the Treaty of Lisbon. This enhanced cooperation went beyond the temporary derogation granted to new member states to catch up with the older member states (multispeed) or the permanent derogation on the basis of policy area that allows a predetermined policy to be dealt with on a different basis (à la carte) (Piris 2012). With the enhanced cooperation, the Treaty of Lisbon provides for general rules to allow, on a case-by-case basis and using the EU framework and institutions, a group of member states to proceed to further their integration without the need for any time limits and without the requirement that other members have to follow (Philippart and Edwards 1999).

### 27.2.2 APEC’s Pathfinder Initiatives

To achieve the Bogor goal of free and open trade and investment in Asia and the Pacific no later than the year 2020 (APEC 1994), three pillars of APEC’s work agenda include trade and investment liberalization, business facilitation, and economic and technical cooperation (ECOTECH) (APEC 2018a). APEC is based on cooperation and consensus decision-making. APEC relies on voluntary, nonbinding commitments and the logic of “open regionalism,” which treats members and nonmembers in a nondiscriminatory manner under the assumption that trade liberalization primarily benefits the country that undertakes it (Beeson 2008). The concerted unilateral liberalization approach allows member economies to liberalize economic sectors at their own comfortable pace. The individual action plans require members to periodically report on the liberalization of 15 policy areas, while the collective action plans provide the participating countries with best practice and databases (Hsieh 2013).

Beyond the different timelines among developed and developing economies, APEC first initiated the Early Voluntary Sectoral
Comparative Study on the Legal Framework on General Differentiated Integration Mechanisms in the European Union, Asia-Pacific Economic Cooperation, and Association of Southeast Asian Nations

Liberalization (EVSL) scheme in 1997 to remediate the slow progress toward the realization of the Bogor goal. According to the EVSL scheme, developed member economies would voluntarily lower tariff and nontariff barriers for 15 sectors. However, this experience was not successful due to its voluntary nature, as well as the opposition from Japan and the skepticism toward the liberalization proposal of other Asian countries after the financial crisis. After the failure of the EVSL, APEC shifted its focus toward trade and investment facilitation to lower transaction costs, while continuing the removal of trade barriers through bilateral or multilateral free trade agreements outside APEC’s framework (Su 2007; Hsieh 2013).

The 2001 Shanghai Accord marked an important stage of APEC’s reform after the Asian financial crisis. APEC’s leaders strongly endorsed the “pathfinder initiative” concept as one of the ways to invigorate progress toward the Bogor goal of free and open trade and investment, by providing “a framework to encourage broader participation through enhanced capacity building programmes” (APEC 2001). The pathfinder approach allows “economies that are ready to initiate and implement the cooperative arrangements to proceed to do so, while those who are not yet ready may join at a later date” (APEC 2014). The pathfinder has become the main approach in advancing business facilitation in APEC.

27.2.3 ASEAN Minus X

As for ASEAN, after the end of the Cold War, the organization shifted its focus from ensuring regional peace and security to strengthening economic cooperation. In response to the Asian financial crisis in 1997/98, as well as to the new global economic system with the rise of the People’s Republic of China and India as economic powers, the ASEAN leaders agreed to deepen regional economic integration by establishing the ASEAN Economic Community (AEC), which aims, among other things, to transform ASEAN into a single market and production base (Yue 2013).

ASEAN’s approach to cooperation, known as the “ASEAN Way,” is characterized by “a high degree of discreetness, informality, pragmatism, expediency, consensus building, and nonconfrontational bargaining styles,” which is “often contrasted with the adversarial posturing and legalistic decision-making procedures in Western multilateral negotiations” (Archarya 1997). The principle of consultation and consensus has been the principle of decision-making in ASEAN. This loose and flexible method of cooperation allows ASEAN member states to
be comfortable in terms of approach, scope, and pace of implementation (Stubbs 2000).

For the establishment of the ASEAN Free Trade Area, ASEAN agreed on the gradual reduction and elimination of tariff barriers in intra-ASEAN trading of goods. The member states’ obligation was temporarily asymmetrical since the ASEAN-6 were obliged to reduce their tariffs for the benefit of all 10 member states, while the four new member states were exempted from this obligation for a certain period. The differentiation was agreed upon in recognition of the development gap as well as the different levels of preparedness and comfort of the member states in opening up their markets.

The concept of the subregional arrangement, later known as “10 minus X” or “ASEAN minus X,” as a way to accommodate the different economic interests of the member states appeared even before the accession of the four newest member states. The concept was sanctioned for the first time in the 1992 Framework Agreement on Enhancing ASEAN Economic Cooperation, as a mode of implementation of economic arrangements. Article 1(3) of the framework lays down the principle that “all member states shall participate in intra-ASEAN economic arrangements. However, in the implementation of these economic arrangements, two or more member states may proceed first if other member states are not ready to implement these arrangements” (ASEAN 1992).

ASEAN minus X was recognized in the ASEAN Framework Agreement on Services (AFAS) as amended by a protocol in 2003 as a new approach to service sector liberalization beyond the GATS framework (ASEAN 1995, 2003). As an exception to Article 4(1) of AFAS, the ASEAN minus X formula allows two or more member states to liberalize a set of agreed service sectors without having to extend the concessions to nonparticipating member states on a most-favored-nation basis. Others may join at a later stage or whenever ready (ASEAN 2017).

With the 2007 ASEAN Charter, ASEAN minus X was recognized as a mode of flexible participation for the implementation of economic commitments (ASEAN 2007). The insertion of Article 21(2) in the ASEAN Charter created the potential to extend the scope of ASEAN minus X, beyond service liberalization, to other areas of economic integration. The 2007 ASEAN Economic Community Blueprint provides for the application of the ASEAN minus X formula regarding the liberalization of professional service subsectors (AEC Blueprint 2007, Art. 21), and the liberalization of financial service subsectors (AEC Blueprint 2007, Art. 22), as well as in order to accelerate the implementation of agreed economic initiatives (AEC Blueprint 2007, Art. 72 V).
27.3 Conditions of Establishment and Functioning

27.3.1 Enhanced Cooperation

The conditions of the establishment and functioning of the mechanisms reflect primarily the perception toward differentiated integration inside the organization. In the EU, due to the fear of a “two-tier Europe” expressed by some member states, the initial conditions for applying the enhanced cooperation were so restrictive that it was impossible to implement the mechanism. For instance, at least a majority of member states was required to set up an enhanced cooperation, the authorization was subject to unanimity, and further cooperation among some needed authorization by all (de Witte 2004). With France and Germany threatening to cooperate outside the EU framework if a more flexible mechanism of enhanced cooperation inside the treaties framework was not in place (de Witte 2004), the Nice Treaty and then the Lisbon Treaty further relaxed the conditions.

Article 20 of the Treaty on European Union (TEU) and Title III of Part VI of the Treaty on the Functioning of the European Union (TFEU) currently regulate the enhanced cooperation mechanism. Enhanced cooperation is only possible in the areas where the EU does not have exclusive competence. It does not, however, allow for an extension of EU competence beyond the areas defined by the treaties. The enhanced cooperation must aim to further the objectives of the EU, protect its interests, and reinforce its integration process (Article 20, para. 1 TEU). It must not undermine the internal market or economic, social, and territorial cohesion. It shall not constitute a barrier to, or discrimination in, trade between member states, nor shall it distort competition between them (Article 326 TFEU). At least nine member states must participate in the enhanced cooperation.

The main EU institutions are closely involved in the authorization procedure. The European Commission has the competence to evaluate the member states’ request with the conditions and limitations laid down by the treaty. The European Parliament consents to the enhanced cooperation as proposed by the European Commission. The European Council gives authorization with a formal decision adopted through its ordinary decision-making procedure. The authorization can be subject to judicial review by the Court of Justice of the European Union (Fabbrini 2012).
The authorization procedure is adopted by the European Council based on a qualified majority voting. One exception is the Common Foreign and Security Policy where unanimity is required. However, the condition of last resort limits the use of the enhanced cooperation only to cases where the European Council has established that the objective of such cooperation cannot be attained within a reasonable period by the EU as a whole (Article 20, para. 2 TEU). This condition requires enhanced cooperation to be preceded by genuine attempts to adopt the legislation applicable to all the member states (de Witte 2004).

With regard to the implementation of the enhanced cooperation, the participating member states make use of the institutions of the EU. The European Parliament and the European Commission exercise normal power and in the standard composition (Article 20, para. 1 TEU). As for the European Council, however, all member states participate in its deliberations, but only the members representing the participating states take part in the vote (Article 20, para. 3 TEU). Acts adopted in the framework of enhanced cooperation are regular European laws with the same legal effect as any other European laws, but with a geographically limited applicability scope since they bind only the participating members (Thym 2005). Such acts are not part of the acquis and will not bind the new member states (Article 20, para. 4 TEU). Once established, the cooperation shall be open at any time to all member states (Article 328, para. 1 TFEU). Moreover, the European Commission and the participants who form an avant-garde must ensure the promotion of the participation to include as many members as possible (Article 328, para. 2 TFEU).

### 27.3.2 Pathfinder Initiatives

The 2001 APEC Shanghai Accord states that pathfinder initiatives have to be consistent with the Bogor goals and contribute to advancing APEC initiatives. They have to observe the APEC principles of voluntarism, comprehensiveness, consensus-based decision-making, flexibility, transparency, and open regionalism. They also have to be transparent and open to encourage the broadest participation (APEC 2001).

The conditions for establishing the pathfinder initiatives were specified by the APEC Committee on Trade and Investment (CTI), in 2007 and recently updated in 2017. The pathfinder initiative guidelines aim to address two major preoccupations, namely low participation in, and stalled implementation of, some pathfinder initiatives (APEC 2014). Before the adoption of a pathfinder initiative, interested member economies (at least three) need first to establish an “interim pathfinder” to allow a discussion and an exploration of likely participation (APEC
The interim pathfinder will be subject to a review by the CTI, and it can obtain pathfinder status, with the approval of the Senior Officials' Meeting, if, after 1 year, more than 25% of the member economies (currently six members) participate and the rest support the launch of the initiative, including through participation in capacity-building activities. If at least 50% of the members (currently 12 members) participate in the initiative, such an interim pathfinder can be fast-tracked to become a pathfinder immediately. In both cases, the lead economies have to elaborate a proposal document detailing the objectives, implementation, and outcomes of the initiative. The proposal needs to include, among other things, detail on how to reach the objective of full participation by APEC members as well as a detailed plan for capacity building to secure wide participation (APEC 2014, 2017a).

The pathfinder initiatives are reviewed on an annual basis in accordance with the proposal document. Given that limited membership and implementation may undermine the credibility of the initiatives and of APEC, and to optimize the resources, the Senior Officials' Meeting, on the basis of the CTI's recommendation, can decide to terminate the pathfinder or invite the lead economy to revise the initiative if, after 4 consecutive years, the rate of participation is below 50% or if there appears to be little prospect of increasing participation or of achieving concrete progress (APEC 2017a).

### 27.3.3 ASEAN Minus X

The conditions for the establishment and implementation of the ASEAN minus X formula are defined by the 2003 protocol to amend the AFAS, as well as the ASEAN Charter (Article 21 [2]). In terms of its scope, the use of the ASEAN minus X formula pertains to the implementation of the arrangements that have been previously agreed upon by all the member states. In contrast to the EU and APEC, ASEAN has not defined a high threshold as two member states suffice to launch the cooperation. Nevertheless, the establishment of ASEAN minus X is subject to the consensus of all the member states. This condition implies that some members can proceed first toward the liberalization goal only when there is consensus among all the member states to do so (Woon 2016).

Once established, the benefit of concession is limited to the participants. The extension of the preferential treatment to the remaining member states on a most-favored-nation basis is only voluntary. In order to facilitate the expansion of the cooperation, the participating member states have an obligation to inform the other member states, through the ASEAN Secretariat, about the progress of negotiations (including
the scheduling of commitments for the specific sectors or subsectors concerned) and the agreements reached (ASEAN 2003).

The nonparticipating states may join any ongoing negotiations among the participating member states, in consultation with the participating member states. The remaining member states may “in due course become a party to such an agreement upon making offers at similar or acceptable levels to the participating member states” (ASEAN 2003). The admission of the other member states requires the unanimous consent of the participating member states. In determining the acceptability of the offer, the participating member states shall nonetheless take into account “developmental differences, both in terms of economic and stage of development of the particular sector” and cannot “require a higher level of commitments from the remaining member states than their respective commitments under the agreement” (ASEAN 2012).

Table 27.1 compares the conditions of the establishment and functioning of the enhanced cooperation, the pathfinder initiatives, and the ASEAN minus X mechanisms.

Table 27.1: Conditions of the Establishment and Functioning of the Mechanisms

<table>
<thead>
<tr>
<th></th>
<th>Enhanced cooperation</th>
<th>Pathfinder initiatives</th>
<th>ASEAN minus X</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal basis</td>
<td>Art. 20 TEU and 326–334 TFEU</td>
<td>Shanghai Accord 2001 Pathfinder initiative guidelines 2017</td>
<td>Art. 21(2) ASEAN Charter Protocol to amend AFAS 2003</td>
</tr>
<tr>
<td>Minimum participants</td>
<td>9 (from 28)</td>
<td>Interim pathfinder: 3 (lead economy + 2 others) Pathfinder: • 1st year 25% (6) • 4th year 50% (11)</td>
<td>2</td>
</tr>
<tr>
<td>Scope</td>
<td>Areas of nonexclusive competence of the EU</td>
<td>Initiation and implementation of cooperative arrangements</td>
<td>Implementation of economic arrangements Service liberalization</td>
</tr>
<tr>
<td>Conditions</td>
<td>Not undermine the internal market or economic, social, and territorial cohesion Prohibition of barrier or discrimination in trade or distortion of competition between member states</td>
<td>Consistency with the Bogor goals Principles of voluntarism, consensus-based decision-making, flexibility, transparency, and open regionalism</td>
<td>continued on next page</td>
</tr>
<tr>
<td>Authorization</td>
<td>Enhanced cooperation</td>
<td>Pathfinder initiatives</td>
<td>ASEAN minus X</td>
</tr>
<tr>
<td>---------------------------------------------------</td>
<td>----------------------------------------------------------------</td>
<td>-------------------------------------------------------------</td>
<td>---------------------------------------------------</td>
</tr>
<tr>
<td>Condition of “last resort”</td>
<td>Qualified majority vote in the Council (Unanimity for Common Foreign and Security Policy)</td>
<td>Consensus of all member economies</td>
<td>Consensus of all member states</td>
</tr>
<tr>
<td>Effect of acts or decisions adopted under the framework</td>
<td>Regular EU law but applicable only to the participating member states</td>
<td>In principle, no requirement for reciprocity (except some)</td>
<td>Concession limited to the participating member states</td>
</tr>
<tr>
<td>Relationship with nonparticipating member states</td>
<td>All member states may participate in the deliberation of the Council in the area of enhanced cooperation. Only participating member states can vote.</td>
<td>Capacity-building program to ensure broad participation</td>
<td>Information, through the ASEAN Secretariat, on the progress or result of the negotiations (ex. the scheduling of commitments)</td>
</tr>
<tr>
<td>Admission of new participants</td>
<td>Accession open to all member states</td>
<td>Accession open to all member economies</td>
<td>Accession open to all member states</td>
</tr>
<tr>
<td>Conditions set in the authorization decision</td>
<td>Adoption of policies compatible with the arrangements</td>
<td>Offer of same or acceptable level of commitments</td>
<td></td>
</tr>
</tbody>
</table>

AFAS = ASEAN Framework Agreement on Services, ASEAN = Association of Southeast Asian Nations, EU = European Union, TEU = Treaty on European Union, TFEU = Treaty on the Functioning of the European Union.
Source: Author’s compilation.
27.4 Organizations’ Implementation of the Mechanisms

In the EU, the enhanced cooperation was implemented for the first time more than 10 years after its introduction. Prior to its application, it was suggested, however, that the possibility of other member states initiating enhanced cooperation had contributed to softening Italian opposition to the adoption of the framework decision on the European Arrest Warrant in 2001 (Thym 2005).

The relaxation of the conditions, especially since the Lisbon Treaty, has enabled the application of the mechanism. As shown in Table 27.2, the enhanced cooperation was first implemented in 2010 in the field of transnational divorce and legal separation. It was then implemented in 2011 for the creation of the unity patent system, in 2016 for the marital property regime in transnational situations, and last in 2017 for the establishment of the European public prosecutor. The adoption of enhanced cooperation for the financial transaction tax and for the project of European supercomputer infrastructure is an ongoing process (EU 2019b). The four experiences of the enhanced cooperation in the EU since 2010 have been encouraging. As of March 2019, the enhanced cooperation in place includes the majority of the member states.

<table>
<thead>
<tr>
<th>Enhanced Cooperation</th>
<th>Year Adopted</th>
<th>Participating Member States (as of March 2019)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Law applicable to divorce and legal separation</td>
<td>2010</td>
<td>17 (Belgium, Bulgaria, Germany, Estonia, Greece, Spain, France, Italy, Latvia, Lithuania, Luxembourg, Hungary, Malta, Austria, Portugal, Romania, Slovenia)</td>
</tr>
<tr>
<td>European unitary patent</td>
<td>2011</td>
<td>26 (Belgium, Bulgaria, the Czech Republic, Denmark, Germany, Estonia, Ireland, Greece, France, Italy, Cyprus, Latvia, Lithuania, Luxembourg, Hungary, Malta, the Netherlands, Austria, Poland, Portugal, Romania, Slovenia, Slovakia, Finland, Sweden, the United Kingdom)</td>
</tr>
<tr>
<td>Property regime rules</td>
<td>2016</td>
<td>18 (Belgium, Bulgaria, the Czech Republic, Germany, Greece, Spain, France, Croatia, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Finland, Sweden)</td>
</tr>
<tr>
<td>European public prosecutor</td>
<td>2017</td>
<td>22 (Belgium, Bulgaria, the Czech Republic, Germany, Estonia, Greece, Spain, France, Croatia, Italy, Cyprus, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Austria, Portugal, Romania, Slovenia, Slovakia, Finland)</td>
</tr>
</tbody>
</table>

Source: EU (2019b).
As for APEC, the pathfinder approach has allowed the advancement of diverse APEC initiatives principally concerning business facilitation. After the endorsement of the concept by the leaders in the 2001 Shanghai Accord, eight pathfinder initiatives were endorsed between 2002 and 2003 (Su 2007; APEC 2014). Successive initiatives were launched afterward, and the number increased to 12 in the period 2015–2017. After the recent review in accordance with the 2017 updated guidelines, some initiatives were terminated due to the absence of further development. As of August 2018, seven initiatives retain the status of pathfinder initiatives with participation from 11 to 20 member economies (APEC 2018b) (Table 27.3).

The initiatives include the use of electronic certificates of origin (11 APEC members), adherence to International Electrotechnical Commission standards (16 APEC members), mutual recognition arrangements for conformity assessment (18 APEC members), and exemption of customs duties for shipments under the de minimis value of $100 (11 APEC members) (Hsieh 2013; APEC 2018b). The most recent one concerns an “Inclusive Trade Initiative,” which aims “to better communicate the benefits and challenges of trade and to explore policy assistance to widely distribute the benefits of trade” (APEC 2017a).

It has been suggested that the pathfinder initiatives, along with the collective actions on trade facilitation, contributed to reducing transaction costs among the APEC member economies by 5% between 2007 and 2010 (APEC 2012; Hsieh 2013).

### Table 27.3: Status of APEC’s TILF-Related Pathfinder Initiatives

<table>
<thead>
<tr>
<th>Pathfinder Initiatives</th>
<th>Lead Economies</th>
<th>Year Launched</th>
<th>Participation Status (as of August 2018)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advance Passenger Information</td>
<td>Australia</td>
<td>2002</td>
<td>Terminated</td>
</tr>
<tr>
<td>Electronic SPS Certificates</td>
<td>Australia and New Zealand</td>
<td>2002</td>
<td>Terminated</td>
</tr>
<tr>
<td>Kyoto Pathfinder (participation in the revised Kyoto Convention on the Simplification and Harmonization of Customs Procedures)</td>
<td>Australia</td>
<td>2002</td>
<td>Has become a collective action plan under the Sub-Committee on Customs Procedure</td>
</tr>
<tr>
<td>Food MRA</td>
<td>Thailand</td>
<td>2003</td>
<td>Terminated</td>
</tr>
<tr>
<td>Data Privacy</td>
<td>Australia, Canada, and United States</td>
<td>2007</td>
<td>Terminated</td>
</tr>
</tbody>
</table>

*continued on next page*
Table 27.3 continued

<table>
<thead>
<tr>
<th>Pathfinder Initiatives</th>
<th>Lead Economies</th>
<th>Year Launched</th>
<th>Participation Status (as of August 2018)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mutual Recognition</td>
<td>Joint Regulatory Advisory Committee</td>
<td>1999</td>
<td>8 (part I) 4 (part II) 3 (part III)</td>
</tr>
<tr>
<td>Assessment of Conformity</td>
<td>United States</td>
<td>2002</td>
<td>20</td>
</tr>
<tr>
<td>Joint Regulatory</td>
<td>Australia, New Zealand, Singapore, and United States</td>
<td>2009</td>
<td>11</td>
</tr>
<tr>
<td>Advisory Committe</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Joint Regulatory</td>
<td>Japan and United States</td>
<td>2011</td>
<td>12</td>
</tr>
<tr>
<td>Technology Choice Principles</td>
<td>United States</td>
<td>2016</td>
<td>12</td>
</tr>
<tr>
<td>Self-Certification of Origin</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(participants agreeing to practice self-certification with free trade agreement partners based on a set of common operating guidelines)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Facilitating Trade in Remanufactured Goods</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Temporary De Minimis Value</td>
<td>United States</td>
<td>2011</td>
<td>11</td>
</tr>
<tr>
<td>Permanent Customs Duty Moratorium on Electronic Transmissions, Including Content Transmitted Electronically</td>
<td>United States</td>
<td>2011</td>
<td>11</td>
</tr>
<tr>
<td>Inclusive Trade Initiative</td>
<td>Rep. of Korea and Chile</td>
<td>2017</td>
<td>11</td>
</tr>
</tbody>
</table>

APEC = Asia-Pacific Economic Cooperation, MRA = mutual recognition arrangement, SPS = sanitary and phytosanitary, TILF = Trade and Investment Liberalization and Facilitation.
Source: APEC (2017a, 2018b).

In ASEAN, only two ASEAN minus X agreements have been concluded under the ASEAN minus X formula, in accordance with Article IV bis of AFAS. Singapore is party to both agreements. The first one is the agreement between Singapore and the Lao People’s Democratic Republic on education services concluded in 2005, which provides for preferential treatment between the parties on trading of education services. The other one is the 2014 agreement between Brunei Darussalam and Singapore to further liberalize trade in telecommunication services and to reduce the international roaming rates between Singapore and Brunei Darussalam (ASEAN 2015).

Nevertheless, the possibility of implementing the economic agreements under the ASEAN minus X formula has facilitated the
adoption of the agreements; member states are more inclined to give their
consensus to the adoption of the agreements despite not being ready,
knowing that they can delay the implementation of the commitments
they have agreed to. Members that are ready and willing may implement
such arrangements first and others may implement them later
(Tevini 2018). For instance, the ASEAN Tourism Agreement requires
ratification by all the member states to enter into force. Nonetheless,
under the ASEAN minus X formula, the implementing agreements
may be concluded by just two member states (ASEAN 2002; Severino
2006). In recent ASEAN economic agreements, ASEAN minus X has
been expressly recognized as the formula for implementing the agreed
commitments, as demonstrated, for instance, by the Implementation
Framework of the ASEAN Single Aviation Market (ASEAN 2011).

27.5 Assessing the Mechanisms: Challenges
and Some Policy and Legal Development
Suggestions

This part comparatively summarizes the conditions and analyzes
the strengths and limitations of each mechanism with regard to the
advancement of regional cooperation and integration. It suggests some
possible legal and policy developments to improve the effectiveness of
the mechanisms.

27.5.1 Development of the Differentiated
Integration Mechanisms

The EU has chosen the supranational approach to achieve the economic
union, while ASEAN and APEC have opted for the intergovernmental
approach to, respectively, establish a common market in Southeast Asia
and to liberalize trade and investment in Asia and the Pacific. Despite
the different modes of cooperation, all three regional groupings have
embraced the differentiated integration concept to accommodate the
heterogeneity of levels of economic development and of the diverse
interests of the member states.

The introduction of the enhanced cooperation mechanism in
the EU has been the most challenging due to the predominance of
the concept of uniformity. Nonetheless, the differentiation inside the
regional framework is preferable to international agreements, since
it allows the involvement and control of the EU institutions. It is also
caracterized by the principle of openness and nondiscrimination,
thereby preventing the participating member states from discriminating
against, or rejecting the admission of, remaining members who satisfy the conditions (de Witte 2004).

In APEC and ASEAN, cooperation among the members has been characterized by a certain degree of flexibility to accommodate diverse national interests. The concept of flexibility is not unfamiliar and is viewed as allowing the safeguarding of the sovereignty and autonomy of their members. The cooperation among some member states has been accepted as far as such cooperation respects the principle of consensus decision-making and is not perceived as prejudicing the interests of the other member states.

27.5.2 Establishment of the Mechanisms

The organizations’ experience has demonstrated that the conditions for the establishment of differentiated integration have to find the right balance: While adequate substantial and procedural conditions are necessary to protect the interest of the organizations as well as of the nonparticipating member states, too restrictive conditions will render the mechanism impracticable.

In the EU, the application of enhanced cooperation was possible after the relaxation of its requirements, especially the reduction of the minimum threshold of participants from a majority to nine as well as the abandonment of the right to veto. At present, a qualified majority vote in the European Council suffices to authorize the enhanced cooperation among some member states, provided that other conditions laid down by the treaties are respected. Moreover, the relaxation of the conditions is counterbalanced by the condition of last resort. To be precise, such a requirement ensures that an enhanced cooperation among some is only possible after genuine attempts to adopt the legislation applicable to all the member states have failed. In APEC and ASEAN, a consensus among the member states is required to establish a pathfinder initiative or an ASEAN minus X.

In the EU, the safeguarding of the union’s as well as the nonparticipating member states’ interest is ensured through a precise set of conditions laid down in the TEU and TFEU, as well as through control of the EU institutions, especially the European Commission, the Council, and the European Court of Justice. In APEC and ASEAN, with their loose institutionalization, the members’ interests are primarily safeguarded through the consensus decision-making. The requirement for consensus implies the right to veto of the potential nonparticipating members when they consider that cooperation among other members may undermine their national interest. Such a requirement implies thus that the organizations cannot “advance without all [member states]
being satisfied that their interests [are] being safeguarded” (Stubbs 2000).

It has been suggested that in APEC, the developing economies do not generally oppose the launch of a pathfinder initiative because they do not want to be seen as posing an obstacle to the progress of the group (Su 2007). In ASEAN, the requirement for the consensus of all the member states to launch an ASEAN minus X can be questioned. Taking into account the fact that the use of ASEAN minus X is currently limited to the implementation of economic arrangements to which all the member states have already agreed, the consensus requirement should be reviewed. Such a reform is necessary to ensure that ASEAN’s “progress toward regional economic integration is no longer held at the pace of the slowest” or the least willing member (Severino 2006).

27.5.3 Effect of Decisions Adopted under the Differentiated Integration Framework

In the EU, the decisions adopted under the framework of enhanced cooperation apply only to the participating member states. They are considered normal EU legislation, but with a limited geographic scope. They do not form part of the EU acquis and, as such, do not bind the new member states.

The concession established under the ASEAN minus X formula is also limited to the participating members. The participating member states can extend the benefits of the concession to the other member states on a voluntary basis. However, such an extension must be “unconditional, nondiscriminatory, and without the need for reciprocity” (ASEAN 2012).

In contrast, in APEC, “only a few initiatives are conducted on the basis of reciprocity” (Hsieh 2013). The benefit of the initiatives can be subject or not to the requirement for reciprocity. It is thus important to ensure the most extensive participation in the pathfinder initiatives through the requirement of a progressive threshold in order to maintain the initiatives.

27.5.4 Contribution to Furthering the Integration Progress

The success of a differentiated integration mechanism may be measured not only by its application but also by its nonapplication. The existence of the possibility of forming cooperation only among some members under the framework of the organization can facilitate the adoption of the decision as a whole. In the EU, since the readjustment of the
conditions, enhanced cooperation has become an effective instrument for overcoming paralysis in decision-making. It has allowed the advancement of integration among some in fields where a unanimous vote is required by overcoming the blockage by some countries not wishing to participate in the initiative. The process is nonetheless designed to allow the inclusion of nonparticipants, as observers, in the decision-making process under the framework of enhanced cooperation to avoid splitting Europe (Ondarza 2013).

Since 2001, APEC’s experience with the pathfinder approach has allowed the initiation of various cooperative arrangements to facilitate trade and investment in APEC. Among the three differentiation mechanisms, the use of APEC’s pathfinder initiative has been the most active. The reason for this may reside in the fact that the pathfinder mechanism is used in APEC for business facilitation and the experience of APEC has shown the most cooperative arrangements for facilitating trade and investment to be beneficial for the participating members (PECC 2002).

In ASEAN, the more limited use of the ASEAN minus X formula may be explained by the fact that the deepening and widening of service liberalization beyond the multilateral framework, to which ASEAN minus X is assigned, is more sensitive. Nevertheless, the existence of a form of flexibility, including ASEAN minus X, for the implementation of economic agreements has facilitated the adoption of the agreements themselves. The challenge remains to find a reasonable limit to the postponed implementation of the agreements the member states have previously agreed to. Otherwise, such agreements will remain without effect.

### 27.5.5 Suggestions on Legal Development and Policy

As the EU has widened and deepened its competences and has become centralized and rigid, it has been suggested that different forms of flexibility may have become more prominent to accommodate the growing anti-Europe sentiment of many European citizens in the post-Brexit EU (de Witte 2018). The enhanced cooperation has a role to play in accommodating greater heterogeneity inside the EU with the perspective of future enlargement to include Macedonia, Montenegro, Serbia, and Turkey (EU 2019a). As envisioned by the European Commission in its proposal, one very probable scenario of the enlarged EU is “those who want more do more” (EU 2017). The challenges remain the “recalibration of the dogma of unity” (de Witte 2018), so that the differentiated integration is no longer seen as an integration gone wrong, and turning the enhanced cooperation into EU projects that include all the member states.
In APEC, since the cooperation among the member economies is based on the principle of open regionalism and only some arrangements are subject to the reciprocity requirement, APEC’s preoccupation with ensuring the largest participation of the member economies in the established pathfinder initiatives is a necessity. The possible developments may focus on: first, ensuring the most extensive participation in the initiatives, through the requirement of a progressive threshold of participants as well as capacity-building programs; second, ensuring the effective implementation of established pathfinder initiatives, possibly through a “voluntary but binding approach” (Shaolian 2005); and third, addressing, through the pathfinder approach, the liberalization of sensitive sectors that were the object of the previous EVSL.

The ASEAN minus X formula remains an important alternative for flexible participation in the implementation of economic commitments, by allowing member states that are not yet ready or willing to delay the implementation of the commitment they have agreed to. In the context where ASEAN aspires to become a more rule-based community that functions more on binding commitments, the ASEAN minus X formula will likely be more frequently used. Further developments could consist of the following. First, the use of the mechanism should be encouraged through relaxation of its conditions. Since ASEAN minus X only pertains to the implementation of the economic arrangements to which all the member states have previously agreed by consensus, the requirement for a unanimous consensus to allow cooperation under the ASEAN minus X formula should be reviewed and replaced by a majority vote. Second, to ensure that the economic arrangements are not left without effect, the possibility of the member states delaying the implementation, under the ASEAN minus X formula, should have a reasonable limit. Third, bearing in mind the diversity of the ASEAN member states, ASEAN may explore the potential of ASEAN minus X as an alternative mode of decision-making, especially in the field of economic cooperation.
References


Comparative Study on the Legal Framework on General Differentiated Integration Mechanisms in the European Union, Asia-Pacific Economic Cooperation, and Association of Southeast Asian Nations


Economic Integration in Asia and Europe

Lessons and Policies

Asia and Europe have taken differing approaches to economic integration, with Asia choosing loose economic cooperation based on bilateral and regional economic agreements, such as on trade, investment, and financial integration, and Europe choosing to strengthen institutionalization. The Association of Southeast Asian Nations is the only regional grouping pursuing integration toward a common market in Asia, while Europe is otherwise integrated through the European Union and its single currency. Economic Integration in Asia and Europe highlights the important economic integration trends and processes in the two regions.

Covering wide-ranging perspectives on regional economic integration, this book provides extensive explanations on how integration has progressed globally and generated benefits for trade, economic growth, and regional development, drawing from the experiences, lessons learned, and best practices from Asia and Europe. The discussions are based on analytical approaches, regional comparisons, and case studies, with the goal of deepening economic integration in support of higher endogenous growth.

The book aims to derive policy implications and recommendations that readers can utilize as a reference for the design of policy frameworks and research on economic integration. It offers an essential resource for government officials, policy makers, and scholars and comprises 27 chapters in six main parts: perspectives and approaches, fiscal and monetary integration and safety nets, disintegration, regional initiatives and case studies, energy and the environment, and financial inclusion and legal approaches.

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