Overview. Economic Integration amid Diversity and Peer Reviews in Southeast Asia – Where Do We Stand?*

O.1. Introduction

The Southeast Asian region has experienced remarkable economic dynamism. While this strong growth path, often characterised as an "economic miracle", was interrupted by the Asian crisis of 1997, ten years later several indicators show signs of a sound recovery. Although the fallout from the crisis has not been fully eliminated, economic growth has been robust and trade and investment flows have been escalating due to increasing international division of labour. Southeast Asia has made significant progress in integrating into the global economy; at the same time integration within the region has also strengthened. An examination of recent developments in the region shows that despite regional diversity, several initiatives have been launched towards integration.

The purpose of the present chapter is to provide an overview of the key issues in the Southeast Asian region based on recent economic debates, focusing on the two issues of *diversity* and *integration* – these issues will reappear throughout the publication. It will also discuss the major challenges

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in the process of integration as well as how peer reviews can contribute to addressing these challenges.

The remainder of this chapter is organised as follows: the next session looks at some features of the recent dynamism and integration in the region; the following section provides an insight into regional disparities both among and within Association of Southeast Asian Nations (ASEAN) countries mainly from the viewpoint of income inequality; the penultimate section examines how peer review mechanism can contribute to addressing regional challenges using the examples of the OECD, Asian Development Bank (ADB), Asia-Pacific Economic Co-operation (APEC) and European Union (EU). The final section summarises the major issues of this chapter.

O.2. Southeast Asia – dynamism and integration[1]

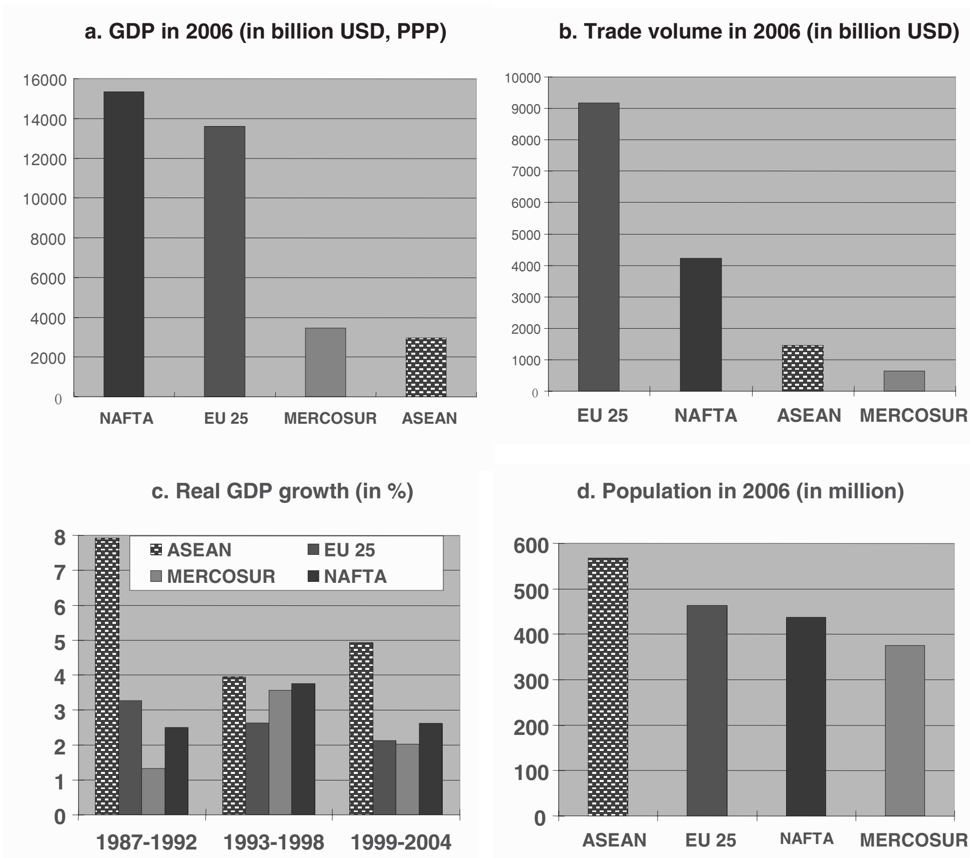
Coupling a market-driven mechanism with an institutional framework

Southeast Asia is one of the most dynamic regions in the world. It is experiencing deepening intra-regional integration as it further strengthens its integration into the global economy. Compared with other regions, its present gross domestic product (GDP) level and trade flows may be relatively small (Figure O.1), but it has a high real GDP growth and large population, indicative of the region's strong potential.

The integration of international goods and services markets has significantly advanced from the second half of the 1980s and Southeast Asian countries have been fully reaping the benefits of globalisation. Since the late 1990s, official initiatives to strengthen this market-driven integration within the ASEAN and with neighbouring countries have intensified. Recently, several new initiatives have reinforced this market-driven integration, embarking the region on a distinct path towards integration. The best blend of institution building is now under consideration, as evident by the important recent initiative to move toward a single economy via the creation of an ASEAN charter.

This section provides an overview of the main features of the market-driven integration in the 1980s-1990s and recent official initiatives since the 1990s.

Figure O.1. **Economic scale comparison among ASEAN, EU, MERCOSUR and NAFTA**



Note: ASEAN real gross domestic product (GDP) growth figures exclude Myanmar. EU 25 real GDP growth figures include the Czech Republic, Lithuania and Poland from 1990.

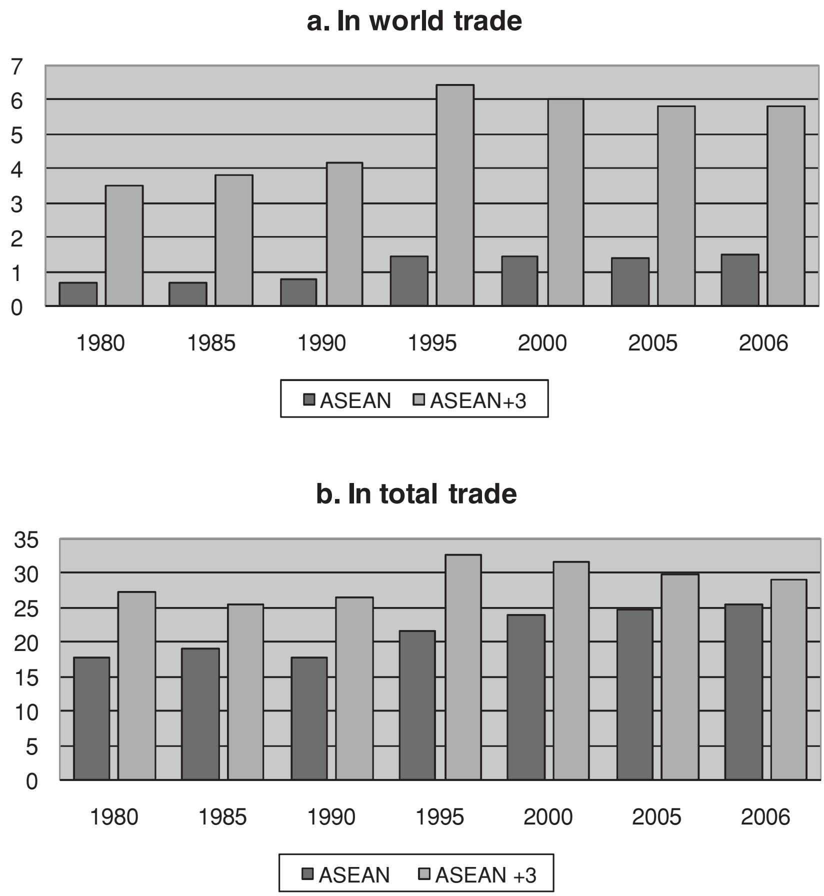
Source: GDP: *World Economic Outlook*, International Monetary Fund (IMF). Trade: World Trade Organization (WTO). Real GDP growth: *World Development Indicators*, World Bank. Population: *World Economic Outlook*, IMF.

Sources of dynamism and market-driven integration. Industrial development and its effect on strengthening production networks has been the main driver of economic dynamism and integration in the region. Since the second half of the 1980s, integration of national economies into expanding international markets in both goods and services has increased. Underlying this globalisation phenomenon is the formation of international production networks across national boundaries in which multinational enterprises play a key role in adding value to different segments of the production process spanning across countries. Southeast Asian countries have become organic parts of global production networks through vertical intra-industry division of labour and trade in parts, components and semi-finished goods. Several Southeast Asian countries have been among the most favourable destinations for industrial location among developing regions and have therefore been able to benefit from considerable business opportunities arising from ever-increasing fragmentation of the production process.[2]

Market integration in trade, investment and finance. Industrial network building has generated strong trade and investment flows. Southeast Asian countries are becoming ever more interdependent due to soaring regional trade. Although intra-ASEAN trade is still a small fraction of world trade (1.5% in 2006 as shown in Figure O.2a), this share has almost doubled in the past 15 years. ASEAN's trade interdependence has been largely driven by integration of these economies into global production networks. The ASEAN+3 (China, Japan and Korea) group's share has also been rapidly increasing, reaching 5.8% in 2006. Although intra-ASEAN trade may represent a small fraction of world trade, it constitutes a quarter of the region's total trade, with the share of ASEAN+3 region trade hovering at over 29%, reflecting strong interdependence (Figure O.2b). The pace of integration through foreign direct investment (FDI) in the region has been somewhat more modest than that of trade. According to Urata (2006), although the share of intra-ASEAN FDI has increased by over 50% as a share of global FDI over 1980-1994, relative to FDI in the entire region it has risen to a lesser extent. An interesting feature of the integration of Southeast Asian countries is the strong trade-investment nexus or mutual reinforcement between trade and FDI (Urata, 2001; Kawai and Urata, 2004). Financial integration has been progressing at a relatively slow pace, lagging behind interdependence in trade and investment. The literature on measuring financial integration (see Box O.1) unequivocally rejected the interest parity condition among some of ASEAN members.[3] Intra-regional portfolio investment flows have been steadily increasing, but their share in total inflows has only increased slightly over the past few years (Figure O.3).

Figure O.2. **Share of intra-regional trade**

Percentage



Note: Panel a shows the shares of ASEAN-10's and the ASEAN+3 region's trade as a percentage of world trade, while Panel b shows the percentage of their total trade.

Source: Author's calculation from Direction of Trade Statistics, IMF.

Box O.1. **Multi-facetedness of measuring regional integration**

Measuring regional integration is not straightforward. Although there are several ways to measure regional interdependence, in general they can be grouped into two approaches.[1] The first considers the outcome of economic activity, which can be measured either by *(i)* quantity[2] – for example the volume of trade or capital flows, etc. within a region or *(ii)* price – for example the degree to which the law of one price and the interest parity condition hold in equilibrium. The other approach is based on regulatory and institutional measures that may hinder interdependence, *i.e.* barriers to movement of goods, services, capital, people, etc. across national boundaries (for example, legal restrictions on capital accounts and tariff barriers). The latter are more difficult to measure but are probably better indicators since similar economic conditions may lead to "apparent " integration even when barriers to trade and investment are quite high.

The approach selected depends on the purpose and the area. Roughly speaking, quantity-based measures are widely used to measure interdependence in product, labour and financial markets, while price-based measures are mainly used to analyse financial linkages. Some areas use more specific approaches. Broader categories may comprise several levels of sub-categories and the results of any analysis may well depend on the choice of method. In turn, the choice of method is largely determined by the availability of data.

As pointed out by De Brower (1999), in the case of international financial integration, the extent to which domestic financial integration has occurred is crucial. This can be measured by the integration of domestic deposit and loan interest rates with domestic money market rates. The extent of such integration is related to the regulatory and competitive structure of domestic financial markets. Given that financial markets of ASEAN countries are at different stages of development, intra-regional integration needs to be assessed with care.

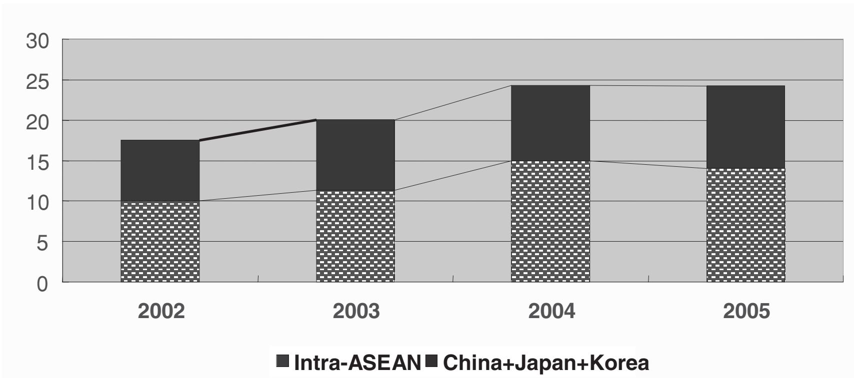
Notes:

1. There are many other classifications of the methods for measuring regional interdependence. In particular, on measuring financial/monetary linkages, see Rajan (2005).

2. The quantity-based measurement further includes the savings-investment correlation and consumption correlations, etc.

Figure O.3. **Share of total portfolio investment inflows into ASEAN 2002-2005**

Percentage



Note: ASEAN includes Indonesia, Malaysia, Philippines, Singapore and Thailand.

Source: CPIS, IMF.

From market-driven integration to the creation of institutional frameworks

Toward a single market. Regional integration in Southeast Asia has been strengthening both within ASEAN and in co-operation with neighbouring countries under different guises such as ASEAN, ASEAN+3 and ASEAN+ 6 (Australia, China, India, Japan, Korea and New Zealand). ASEAN, one of the major engines of regional integration in Southeast Asia, was created in 1967, originally as a rather political entity. During the past 40 years, ASEAN has experienced ups and downs in economic cycles and political changes (*e.g.* end of the Cold War in 1980s) while doubling the number of its member countries. For a long time, economic co-operation among members was relatively limited and attempts in the 1970s-1980s to strengthen economic co-operation were in general not very successful.[4]

Starting in the 1990s, owing to accelerating industrial development and the strengthening of production networks, the market-driven economic integration among ASEAN members was reinforced through official initiatives such as the ASEAN Free Trade Area (AFTA) in 1992 using the Common Effective Preferential Tariff (CEPT) scheme, the ASEAN Framework Agreement on Services (AFAS) in 1995 and the ASEAN Industrial Co-operation (AICO) in 1996 (see Table O.1). In addition, ASEAN as a group is engaged in bilateral FTA negotiations with neighbouring countries, which may help institutionalise the *de facto* integration.

Table O.1. **Major steps towards ASEAN regional integration**

Year	Event	Key agreements and decisions
1967	Ministerial Meeting	ASEAN established (Bangkok Declaration)
1976	1st Summit	ASEAN secretariat established
1977	2nd Summit	ASEAN Preferential Trading Arrangements (PTA)
1992	4th Summit	ASEAN Free Trade Area (AFTA) adopted using CEPT scheme
1995	5th Summit	ASEAN Framework Agreement on Services (AFAS)
1996	28th AEM Meeting	ASEAN Industrial Co-operation (AICO)
1997	2nd Informal Summit	ASEAN Vision 2020 presented
1998	30th AEM Meeting	ASEAN Investment Area (AIA)
	6th Summit	Hanoi Plan of Action (HPA)
	6th Summit	ASEAN Framework Agreement on Mutual Recognition Arrangement (MRAs)
1999	3rd Informal Summit	e-ASEAN Framework Agreement
2000	4th Informal Summit	Initiative for ASEAN Integration (IAI)
2003	9th Summit	Declaration of ASEAN Concord II (Bali Concord II)
2004	10th Summit	Vientiane Action Programme (VAP)
2005	11th Summit	Declaration on the Establishment of the ASEAN Charter (Kuala Lumpur Declaration)
2006	38th AEM Meeting*	Agreement to bring forward the goal of ASEAN Economic Community to 2015 from 2020
2007	12th Summit	Agreement to bring forward the goal of ASEAN Socio-Cultural Community and Security Community to 2015 from 2020

Note: AEM meeting stands for ASEAN Economic Ministers Meeting.

Source: Author's compilation from ASEAN secretariat materials.

In accordance with deepening economic integration in the 1990s, the concept of an ASEAN community was proposed in 1997 with the end goal of economic integration – a single market and production base – as outlined in the "ASEAN Vision 2020" statement. Toward this goal, ASEAN is implementing a series of economic integration measures, laid down in the Bali Concord II in 2003, and which rests on three pillars: the ASEAN Economic Community, the ASEAN Socio-Cultural Community and the ASEAN Security Community. Recently, ASEAN countries agreed to accelerate the schedule to achieve these goals by 2015. ASEAN has endorsed 11 priority sectors for integration including agriculture, electronics, healthcare, ICT, tourism, etc. Mid-term action plans to achieve the goal of an ASEAN community were agreed; the Vientiane Action Programme (VAP) covers the period 2004-2010 following the Hanoi Plan of Action for 1999-2004 (ASEAN, 2004; ASEAN, 2006). More recently, the discussion of an ASEAN charter has been put on the agenda and the building of rules-based regional institutions has become a key challenge.[5]

Major official initiatives in selected areas. The extent of co-operation differs according to the sphere of activity. For instance, in the area of trade, as a step towards establishing a full-fledged ASEAN Free Trade Area, the CEPT scheme was established in 1992 and ASEAN member countries have made progress ahead of schedule in lowering intra-regional tariffs. As a result, intra-regional tariffs – except for certain commodities – have been reduced to between 0% and 5%. The average AFTA tariff rate of the ASEAN countries has been reduced from approximately 11% in 1993 to approximately 3% in 2007 (see Figure O.4). The ASEAN-6 aims at a complete elimination of tariffs by 2010, and in the four new members (Cambodia, Laos, Myanmar and Viet Nam, or shortly CLMV) have until 2015. Since 2005, the Temporary Exclusive List (TEL) has been empty and as of 2007, 99% of items to be liberalised by the ASEAN-6 (Inclusive List, IL) have a tariff rate of 0-5%.

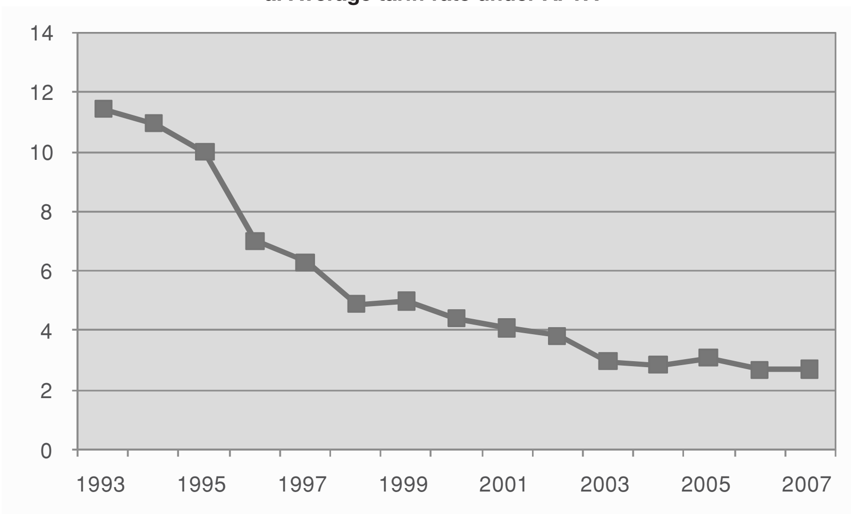
As a complementary scheme to AFTA, ASEAN Industrial Co-operation (AICO) aims to promote joint manufacturing activities between ASEAN-based companies. AICO products, upon their approval, enjoy a preferential tariff rate between 0-5%. At the moment, more than 150 projects have been approved for this scheme and involve a number of countries: Indonesia, Malaysia, Philippines, Singapore, Thailand and Viet Nam.

The Asian crisis in the late 1990s acted as a trigger for enhanced financial co-operation in the region. Mutual trust and information sharing are prerequisites for co-operation in this area. With the aim of ensuring adequate liquidity levels to reduce the risk of another crisis, the Chiang Mai Initiative (CMI), a framework of bilateral swap agreements has been established. The CMI is composed of two elements: the expansion of the existing ASEAN Swap Arrangement (ASA) and the creation of a new network of bilateral swap arrangements (BSAs). The development of an Asian bond market (Asian Bond Market Initiative, ABMI) has also been encouraged in order to secure longer-term financing. Co-operation has strengthened in the area of regional economic surveillance. Economic surveillance involves not only analyses of economic policies but also identification of vulnerable aspects of economy. The EBRD process is one of the mechanisms for information sharing and policy dialogue and the first surveillance meeting was held in April 2002. In particular, such co-operation has progressed in the framework of ASEAN+3.

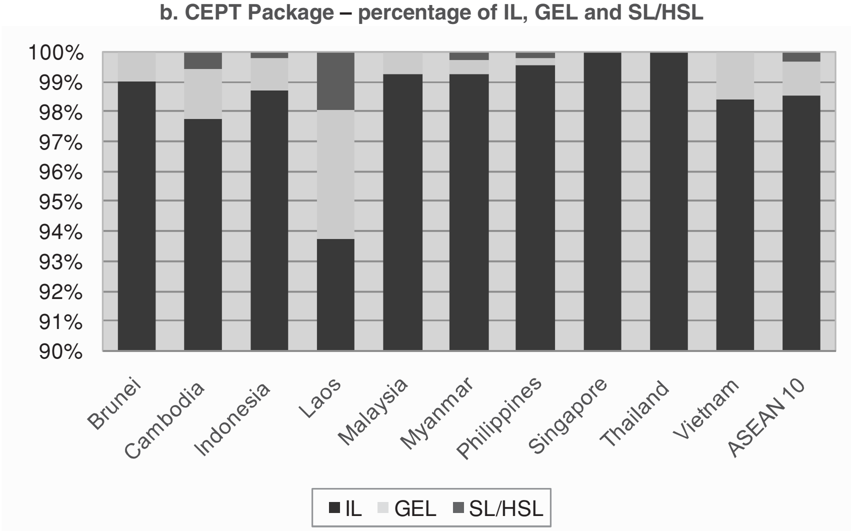
Figure O.4. **Progress in tariffs reduction**

Percentage

a. Average tariff rate under AFTA



b. CEPT Package – percentage of IL, GEL and SL/HSL



Note: The average tariff rate for 1993-96 is for ASEAN-6 and for 1997-2007 ASEAN-10. Data for 2007 is as of July 2007. IL stands or Inclusion List, GEL for General Exceptions List and SL/HSL for Sensitive List/Highly Sensitive List.

Source: CEPT Package, ASEAN secretariat.

The Asian crisis gave rise to enhanced co-operation not only in the area of finance but also with regard to FDI. Creating a favourable investment climate is important to attract FDI. With the ultimate aim of making investment barrier-free, ASEAN embarked on a process of investment liberalisation, facilitation and promotion in 1998. The main intention was to improve the investment environment in the entire region and to maintain competitiveness by removing investment barriers and liberalising investment rules and policies in sectors covered by the agreement. Compared with trade, the progress of this initiative is relatively slow. Under the ASEAN Investment Area (AIA), investment will be liberalised in all industries for intra-regional investors by 2010 and for investors from outside the region by 2020 with some exceptions.

ASEAN countries are also facing a number of regional challenges in other areas such as intellectual property rights, science and technology, information and communication technology (ICT), energy, food, agriculture and environmental issues.

Challenges ahead: towards more competitive and attractive markets

With the changing landscape of the global economy – marked in particular since the late 1990s by the integration of global markets, the Asian crisis and the emergence of China – Southeast Asian countries are now facing the challenges of how to remain competitive, move up the value chain and attract investors.

A more competitive and investor-attractive region can be achieved by *(i) further strengthening integration and co-operation* and *(ii) creating a favourable economic environment/institutional framework* in different fields. These two aspects will be examined in the following subsections.

Strengthening regional integration and co-operation

Strengthening regional integration is one means of enhancing competitiveness and attracting investors. Larger markets – a consumer market of 560 million – that produce economies of scale are more attractive for investors. An important benefit of regional integration is the reduction of transaction costs (for instance, due to the dismantling of tariffs and other barriers) that leads to higher efficiency of resource allocation and welfare gains through enhanced competition in the domestic market. The benefits of integration should be measured not only by the degree of integration itself (for instance, increase of investment/trade flows) but also by whether that integration brings about stability and competitiveness in the region. In addition to such economic benefits, integration is likely to bring about political benefits.

The current integration process in Southeast Asia faces three major challenges:

- Institutional framework building to implement existing initiatives is essential. Having a clear vision of the future direction will be a challenge for the region.
- Macroeconomic and monetary co-ordination lags behind other forms of co-operation and needs to be strengthened to enhance stability in the region.
- Regional integration and domestic reforms are closely interrelated. Domestic reforms to adapt to a more open economy are crucial.

Institutional framework building to enhance integration. Southeast Asia has witnessed *de facto* economic integration for some time. Decision making in ASEAN is pragmatic, and the case-by-case approach typically represents the spirit of the "ASEAN way" (Goh, 2003; Severino, 2006). Stronger integration and the growing number of initiatives imply deeper interdependence and a spill-over effect. There is a growing need to create an institutional framework to co-ordinate views between countries and more effectively implement/monitor the existing economic initiatives. A well-structured framework will minimise co-ordination costs and help harmonise standards and procedures. Recent developments to establish a *charter* show that ASEAN is in transition to a more rule-based organisation and is now trying to develop a *new* "ASEAN way" (Soesastro, 2005).

From a long-term perspective, a clear image of the direction of institutional building is important. One approach, similar to that taken by the EU, is the creation of a sort of judicial authority to enforce ASEAN Economic Community (AEC) rules; another way is to develop a more soft-type institutional building.

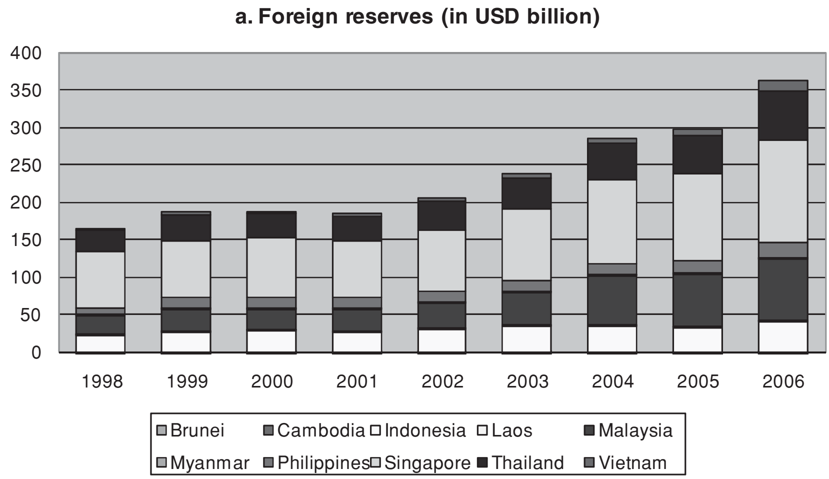
Macroeconomics and monetary co-ordination. Significant increases in capital inflows, coupled with the Asian crisis, raised region-wide awareness of financial risk. However, regional co-operation in these areas is limited compared with co-operation in other fields. The three particular issues of capital management, exchange rate regime and foreign reserve management should be on the agenda for discussion at the regional level in order to enhance the economic stability of the region.

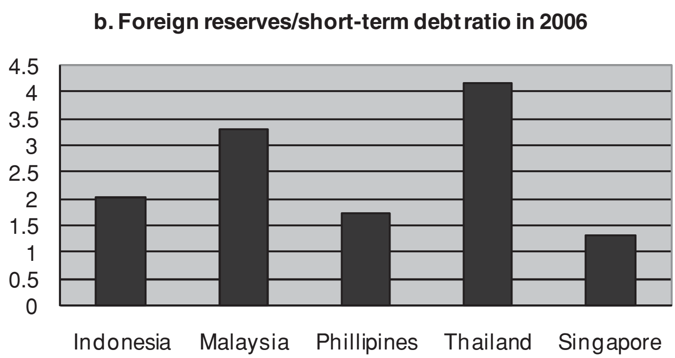
The management of capital flows has elicited an animated debate in Southeast Asia, and countries have adopted capital controls to varying degrees (Mineane, 2004). Malaysia has long had stringent capital controls, while Thailand re-introduced restrictions after the crisis. The liberalisation of capital movements, on the one hand, reduces transaction costs and leads to more efficient resource allocation based on market principles. On the other hand, large and sudden capital flows may lead to volatility of the effective exchange rate and thereby cause disruption in industries heavily relying on tradable goods. If the domestic financial system is not adequately developed, capital account liberalisation should be pursued with caution. There is also a controversial debate on which currency regime should be adopted. The post-crisis experience in Southeast Asia shows that immediately after the crisis most affected countries made their exchange rates more flexible: nevertheless, there is a sort of "fear of floating", as Calvo and Reinhart (2002) pointed out, which subsequently prompted some countries to opt for a managed float or *de facto* pegs rather than freely floating regimes.[6]

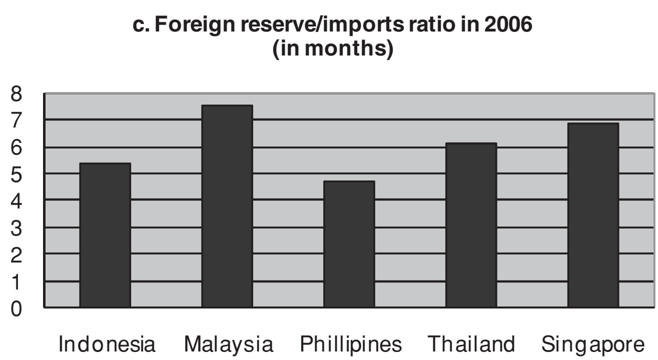
Although substantially lagging behind the debate on the exchange rate regime, a lively discussion has started regarding the amount of foreign reserves that should be held. After the crisis, many countries began to accumulate large foreign exchange reserves (Figure O.5a) to levels well above the amount of the short-term external debt they held (Figure O.5b), or the equivalent of three months' imports (Figure O.5c), measures often used as a "rule of thumb" for prudent reserve holdings. Given the opportunity costs of holding reserves, the question concerning the optimal amount of reserves has arisen.[7] Another issue is the use of foreign exchange reserves, with some suggesting that these funds be invested in regional infrastructure.

Domestic reforms to adapt to a more open economy. The removal of cross-border restrictions lies at the heart of regional integration in Southeast Asia. The major challenge for the future is the choice of domestic structural policies to adopt to fit this ever more open environment. This would include, for example, building a regulatory/institutional framework conducive to the increase of productivity and the maintenance of competitiveness in the region. Domestic regulatory/institutional frameworks may be crucial in order to reap the benefits of regional integration while inappropriate regulations may hinder the integration process. The removal of cross-border restrictions and consistent domestic regulatory reforms are mutually reinforcing. Effective implementation of policies is crucial in Southeast Asia. When designing domestic policies it is important to consider incentive compatibility, whereby policy makers are fully aware of the benefits of introducing reforms despite the fact that these reforms may entail more than negligible adjustment costs.

Figure O.5. **Foreign reserves in selected ASEAN countries**







Note: Foreign reserves exclude gold in Viet Nam.

Source: Joint BIS-IMF-OECD-World Bank statistics on external debt.

Creating a favourable economic environment/institutional framework in the region

Enhancing competitiveness and creating attractive markets are complex issues and require comprehensive approaches. Reflecting the distinct features in the region, the following areas need special attention:

- enhance competitiveness by creating an economic environment that promotes industrial co-operation/enterprise development and by strengthening production networks;
- maintain the synergy effect between trade and investment through further liberalisation and harmonisation across countries;
- strengthen the financial system and access to credit in order to support enterprise development;
- consider upgrading the infrastructure so as to benefit from a possible multiplicative effect on other policies;
- improve environmental and natural resource management for sustainable development;
- enhance innovative capacity and reinforce the quality of human capital.

Creation of an economic environment conducive to strengthening industrial co-operation and production networks. Multinational production networks have largely driven economic growth in Southeast Asia. Amid the changing economic environment and restructuring of global production networks, Southeast Asian enterprises need to find new strategies that reflect their comparative advantages. It is crucial to create an economic environment that allows firms to make decisions about the production process and costs in a flexible way and that enables firms to exploit their potential. An integrated regional production base would provide greater scope for industrial efficiency and cost competitiveness in a wide array of products as well as some services. CLMV countries would also benefit from being a part of the regional production network.

Many Southeast Asian countries have adopted new strategies. Viet Nam has emerged as a low-cost manufacturing platform, exploiting its advantage of having a large pool of skilled manpower. The Philippines has managed to carve out a niche in electronics, software programming, back-office and call-centre operations owing largely to its English-speaking population. Thailand has continued to be a key automobile assembly hub, while

Malaysia's electronics and semi-conductor industries have thrived. Singapore has further advanced on the value chain, developing new industries such as biotechnology and strengthening its position as Southeast Asia's financial hub. In Indonesia, FDI is recovering gradually from the crisis and the government is creating a new attractive environment. It is crucial for the region to adapt to the changing global environment and participate in new production networks to enhance its attractiveness for investors.

In addition, to promote local firms, it is essential to enhance small and medium-sized enterprises' (SMEs') capacity to penetrate into vertical production chains. Inviting foreign SMEs would aid in the formation of industrial clusters and gradually strengthen local SMEs.

Trade and investment policies. Maintaining competitiveness in external trade and promoting intra-regional trade are important. Trade openness and deregulation of FDI results in new technologies, management know-how and links to global networks. FDI and trade are mutually reinforcing in Asia, therefore maintaining this synergy effect between trade and investment is crucial.

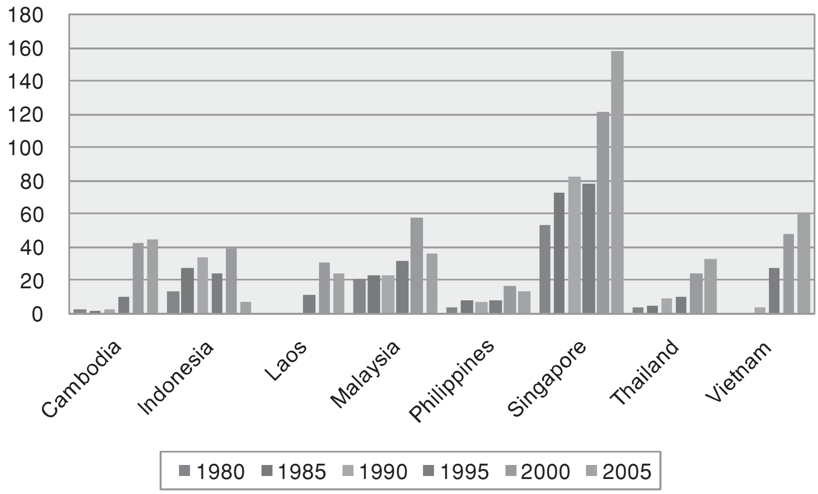
Attracting FDI is a major challenge for the region. Some ASEAN members, such as Singapore, Thailand, Viet Nam and Cambodia, have been accumulating an ever increasing share of FDI relative to their GDP, while other countries, such as Indonesia, Laos, Malaysia and the Philippines saw a falling share in the past few years (Figure O.6a). Looking at flows, although the decreasing trend in FDI inflows after the Asian crisis has reversed in the last few years, its growth in Southeast Asia lags behind that enjoyed by China (Figure O.6b).

Reducing transaction costs may enhance the attractiveness of the region for investors. Efficiency could be raised by reducing unnecessary costs related to different product standards, customs procedures and unpredictable policy implementation. An important issue related to the proliferation of FTA/EPA (Economic Partnership Agreement) initiatives in the region, the so-called spaghetti bowl phenomenon (Baldwin, 2006), is how to ensure coherence across different trade arrangements. In particular, different treatment of rules of origin, product standards and exclusion lists can be counter-productive. With the increasing importance of trade in services for the region, the ASEAN framework agreement on services (AFAS) is an important step forward to create an integrated market.

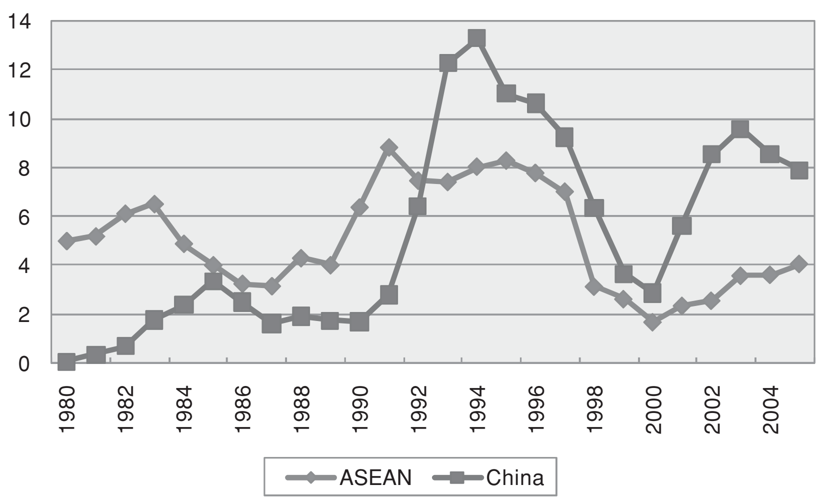
Figure O.6. **FDI indicators in ASEAN in 1980-2005**

Percentage

a. FDI stock as percentage of GDP



b. The share of global FDI flows to ASEAN and China



Source: United Nations Conference on Trade and Development (UNCTAD).

Stable financial system and access to credit. Stable access to credit provided by an efficient financial system is also pivotal in enhancing competitiveness, as financing constraints are one of the most serious obstacles to a firm's activity. Given that Southeast Asian economies have mostly bank-based financial systems, the strengthening of prudential regulations after the financial crisis has largely contributed to improve the stability and efficiency of banking systems. Access to credit is a particular issue for small firms in Southeast Asia and is alleviated by micro-financing and informal financing. For some of the ASEAN members, rural poverty exacerbates access to credit.

Infrastructure development. Infrastructure investment has so far mainly been undertaken at the sub-regional or country level and although there are numerous successful projects, in general there is a shortage of regional infrastructure in Southeast Asia. Upgrading infrastructure, in particular in transport and telecommunications, will better link countries and regions into the artery of economic activities and reduce the transaction costs of trade, investment, etc. From a long-term perspective, infrastructure development needs to be examined on the basis of risk sharing and transparency. In parallel with purely public and private initiatives, blending the two in the form of public-private partnerships, for instance, can be a promising avenue to explore. Upgrading infrastructure can be a powerful tool to reduce acute regional income disparities in Southeast Asia. In general, there is a synergy effect between different types of infrastructures; therefore consistent overall planning is crucial.

Environmental and natural resource management for sustainable development. ASEAN is one of the richest regions in natural resources. Natural resource management in this region is thus crucial not only for the region but also at the global level. Issues to tackle include global reduction of greenhouse gases and climate change. Regional co-operation should be strengthened in forest conservation, including preventing illegal logging and deforestation, and building a safety net for natural disasters. Environmental management policies need to take into account possible urban population growth in the ASEAN.

Improving the environment is strongly connected to energy efficiency. Encouraging cost-effective clean technologies and using energy-efficient fuel including clean coal technology are inevitable in the region.

Innovation and development of human capital and technological capacity. Promoting innovation not only strengthens enterprise competitiveness but also facilitates the formation of new production networks and hence benefits the entire region. As theoretical and empirical evidence shows, innovation is a major source of competitiveness for which the appropriate formation of human capital is central. A key issue is human capital development as countries move from agricultural production to manufacturing and service-based economies and in the face of the growing complexity of technology. In addition to adapting to a new business environment, it is vital to increase access to education, particularly in the rural areas. Innovation policy needs to be tailored to the specific circumstances of individual countries and there is ample room to improve R&D policies (government *vs.* private, etc.) in Southeast Asia.[8] Venture capital is at an early stage of development, and therefore needs to be fostered in order to introduce innovative ideas. The enforcement of intellectual property rights needs to be considered to stimulate innovation in the region.

Distinct features of regional integration in Southeast Asia: a comparative view

Compared to the unfolding of the European Economic integration (see Table O.2), an example of implemented large-scale and multi-domain integration, the integration process in Southeast Asia has several distinct features, and the institutional structures and the international environments differ substantially. A comparison with the EU highlights these features and provides insight into the ASEAN integration process.

A major characteristic shared by the two is that an historical event precipitated integration and that prospective members in both regions had desired closer ties within each region. For Europe, following World War II, a union helped, *inter alia*, to create an environment in which political conflicts were less likely to occur. In Asia, one of the major triggers for co-operation was the Asian crisis, whose consequences in particular called for closer financial co-operation in the region. Notwithstanding some common features however, there are large differences.

Southeast Asia is characterised by the following features:

- Both the EU and Southeast Asia show diversity, but it is more evident in Southeast Asia. The huge diversity among Southeast Asian countries in terms of economic development, institutional framework, political situation, culture, etc. will produce a distinct path of integration in the region.
- Southeast Asia has experienced market-driven integration based on enterprise development, while in the EU, the institutional framework led the integration process.
- Integration among countries in Southeast Asia has advanced in parallel with the region’s deepening global ties, while EU

integration proceeded in a relatively closed economy. This difference will influence the discussion of sequencing the integration process.

- Political momentum was very strong from the beginning of the integration process in EU, while political will in Southeast Asia is relatively weak, although it has recently committed to a faster pace of integration.

Table O.2. **Major steps towards EU integration**

Year	Key agreements and decisions
1951	European Coal and Steel Community (ECSC) established (Belgium, the Federal Republic of Germany, France, Italy, Luxembourg and the Netherlands)
1957	European Economic Community (EEC) and Euratom
1965	Executives of the three European Communities (ECSC, EEC, Euratom) merged
1967	Merger Treaty of 8 April 1965 enters into force (the three European Communities are hereafter called EC)
1968	Customs union completed and common external tariff established
1970	Werner Plan on phased attainment of economic and monetary union, named after Luxembourg's Prime Minister, is presented to the Council and Commission
1972	Currency "snake" set-up
1973	EC formally enlarged to nine members (Ireland, Denmark and United Kingdom join). EC granted sole responsibility for common trade policy
1979	European Monetary System (EMS) takes effect
1981	Greece becomes the 10th member state
1986	Spain and Portugal join the Community, bringing membership to 12
1987	Single European Act enters into force
1988	Commission presents Cecchini report ("The Cost of non-Europe") quantifying the advantages of a single market
1992	Maastricht Treaty on European Union signed
1993	Treaty on European Union enters into force
1995	Austria, Finland and Sweden join EU
1996	The European Council in Dublin agrees to a stability and growth pact for the economic and monetary union and the future euro notes are presented to the public
1999	Stage III of the Economic and Monetary Union begins and the euro becomes the currency of the participating EU member states

Source: Author's compilation from European Commission materials.

Market-driven integration and weak institutional base. Southeast Asian economies have spontaneously formed an economic block as a result of enhanced trade, investment and financial transactions under a relatively soft institutional framework. Consequently, and in contrast to the EU, regional integration is being driven essentially by the market rather than by official initiatives.[9] The institutionalisation of the integration process also differs between ASEAN and the EU, and as such, the issue of regional sovereignty may also differ.

Intra-regional integration advances in parallel with strengthening global ties. Southeast Asia is advancing its integration process in a globally open market environment. For instance, ASEAN strengthened its integration process through reductions in trade barriers due to General Agreement on Tariffs and Trade (GATT) / World Trade Organization (WTO) rounds and huge capital inflows, while the EU was able to push economic integration behind relatively closed markets. Initially limited integration in the form of ECSC was widened toward a process of complete integration of the industrial goods market.

Such differences would lead to different sequencing of the integration process. Europe began with trade integration starting in 1958 and financial integration was ongoing but accelerated significantly in the 1980s. In the EU integration process, trade preceded monetary integration, while in Asia, the order is not so clear (see Box O.2). In addition, in Asia, monetary co-operation started with co-operation in liquidity provision and bond market development after the Asian crisis.

Weak political momentum. European integration started with the post-war political reconciliation, although this political momentum was far greater than the ensuing implementation of economic initiatives. There were both strong trade ties between original members of EEC and strong political motivation. European economic integration was successful especially from the point of view of economic gains. In contrast, in Southeast Asia, political momentum is weak but the economic driving force is strong. The recent crisis created some momentum to strengthen official commitment to co-operate. In fact, the initiative to achieve a single economy originally planned by 2020 was brought forward to 2015.

Box O.2. **Money or trade – which comes first? Sequencing of regional integration**

One interesting controversy that arises when designing the process of regional integration is its sequencing: should integration start with trade, financial markets or a common currency? Furthermore, is there a prescribed order to follow or should it vary case by case? The growth in integration initiatives in the Southeast Asian region has brought this debate to the forefront.

With regard to sequencing, the theoretical and empirical literature developed along distinct tracks in the two areas of trade and monetary integration, but recently a new stream of literature has emerged analysing the connection between the two (Alesina and Barro, 2002; Klein and Shambaugh, 2006). To provide sound policy guidance, however, still more theoretical and empirical research needs to be done.

On the trade side, the criteria for judging whether countries would be good partners within a custom union have focused on the degree of production networks and cost differentials between prospective partners, the price elasticities of demand and supply for traded goods and services, the scope of economic gains from a dynamic perspective, etc. Analogous to the theory of economic liberalisation, the applied international economics literature would suggest that trade should come first as it needs the fewest prerequisites, followed by financial markets as it requires, *inter alia*, efforts to strengthen prudential supervision, adoption of international auditing and accounting principles and increase in market liquidity. Monetary integration should come last as it presupposes large scale harmonisation across participating countries including in the field of financial structures and economic policies (McKinnon, 1991). The five levels of integration – preferential trading arrangements, free trade area, customs union, common market and economic union – used by Balassa (1961) are often interpreted as a sequencing pattern of regional integration, thereby suggesting that integration in trade should precede that in finance.

On the monetary side, the modern theory of monetary integration, dating from the seminal papers by Mundell and McKinnon on optimal currency areas, has focused on the trade off between efficiency and macroeconomic flexibility, the degree of factor mobility between partners, macroeconomic trends, the synchronisation of business cycles, the strength of the financial sectors of potential members, etc. Some studies emphasise that Asia is unique; countries seem to be reluctant to give up their currencies but at the same time find it inevitable to liberalise their financial markets. Amid such constraints, flexible exchange rates are a natural choice and under such regimes regional financial integration should concentrate on equity rather than debt markets, given that the former are less vulnerable to exchange rate volatility (Eichengreen, 2006). Plummer and Wignaraja (2006) conclude from their macroeconomic and demand supply symmetry analyses that although East Asia may not yet be an optimal currency area, it is moving in that direction, and moreover, with the EU as the benchmark, it may already be there. Furthermore, monetary integration would reinforce convergence across countries in the Asian region (Pomfret, 2005).

Reflecting on the recent development in globalisation, a new stream of literature analysing the connections between trade and monetary integration has emerged and shows increasing evidence that trade and monetary integration are closely connected. In analysing the relationship between the two, it is important to note the "two way" causality. For instance, if exchange rate stability encourages trade, the formation of an exchange rate union will help establish the conditions for a trade agreement. By reducing transaction costs, a single currency may encourage further trade among partners in the region. By the same token, regional trade agreements (RTA) may be undermined by exchange rate instability among members. Frankel and Rose (1998) suggest that intra union trade is encouraged by reducing the risk of exchange rate changes and that this in turn increases the degree of synchronisation between business cycles of countries. Forbes and Chinn (2003) found bilateral trade flows to be an important determinant of cross country financial linkages. In Europe, an initial trade agreement tended to be followed by increasingly binding constraints on exchange rate policy.

In other regional settings, discussion is taking place on the optimal way of sequencing the integration process. Cross fertilisation between theoretical/empirical studies and policy making will eventually prove to be useful.

While such differences would warrant a different pattern of integration in Southeast Asia, the experience of the EU could nevertheless offer some lessons.

O.3. Economic diversity in Southeast Asia

Regional diversity is manifest in a myriad of ways including economic capacity, economic institutions and policies as well as social, political and cultural environments. This section focuses on a major challenge for regional integration – income disparities *among* countries and *within* countries. The former widened after the new members (Viet Nam, Laos, Myanmar and Cambodia) joined ASEAN in the 1990s. Disparity among countries can also be observed based on several economic indicators. To narrow disparities among ASEAN members, the obvious way is to encourage growth in the less developed members. The latter – disparities within countries – is similarly a serious challenge, as it can be observed in many Southeast Asian countries. After describing the major features of these disparities, some ways to proceed with integration amid disparities will be presented.

Income disparities "among" and "within" ASEAN countries – growth cum equity?

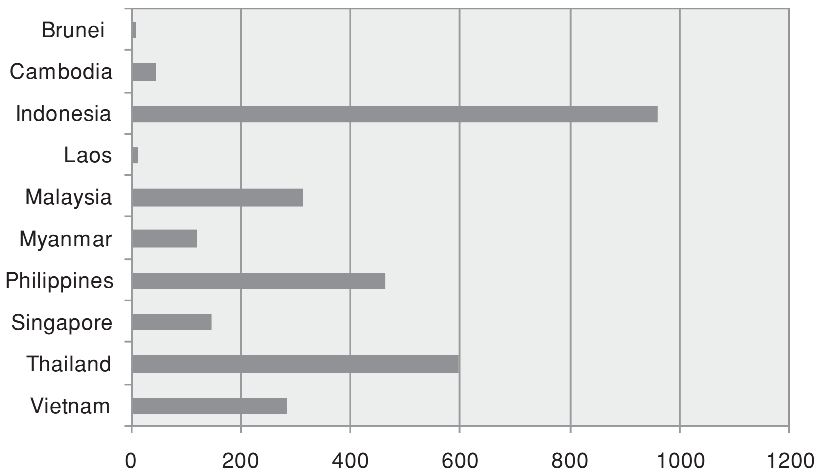
Income disparities "among" ASEAN countries

Reducing income disparities among Southeast Asian countries have long been recognised as a policy priority and the income gap might be an obstacle to integrate economies. Looking at GDP per capita, for instance, there is an over 100-fold difference between the wealthiest and the poorest member (Figure O.7b). Similarly, there are large disparities among ASEAN members in terms of GDP (Figure O.7a) as well as attributes of well-being, such as adult literacy (Figure O.7c), life expectancy (Figure O.7d) and unemployment (Figure O.7e) (see Box O.3). Several attempts have been made to narrow the income gap among ASEAN member countries.[10] These attempts show a large variation in terms of their initiators; some were launched by ASEAN, some outside of ASEAN, and some jointly by neighbouring ASEAN countries. One of the earlier attempts initiated by ASEAN to reduce the income gap between members was the ASEAN-Mekong Basin Development Cooperation (AMBDC), launched at the 5th ASEAN Summit in 1995. The purpose of the AMBDC was to stimulate economic development of member countries located in the Mekong Basin and its major project was the Singapore-Kunming Rail Link. A few years later, the 2001 informal ASEAN summit launched the Initiative for ASEAN Integration (IAI) with the particular aim of reducing disparities within the region (and agreed on its six-year work plan over 2002-2008). The four priority areas of this plan include infrastructure development, human development, information technology and regional integration. The Hanoi Declaration echoed the importance of these four areas.

In addition to the ASEAN initiatives, there have been other bodies attempting to reduce inequalities in the region. One major initiative was the Greater Mekong Sub-region (GMS) programme of the ADB proposed in 1992. It was initially envisaged to focus on transport and energy infrastructure, but was eventually enlarged to include human development, trade, investment and other areas. The GMS comprises several projects such as the Phnom Penh-Ho Chi Minh Asia Highway, the Phnom Penh human development plan and the Greater Mekong Sub-region Business Forum (GMS-BF).

Figure O.7. **Economic diversity in ASEAN**

a. GDP in 2006 (in billion USD, PPP)



b. GDP per capita in 2006 (in USD, PPP)

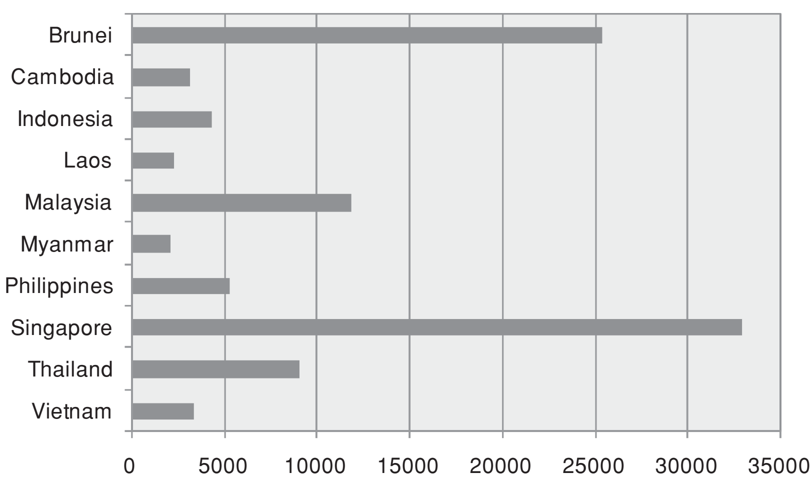
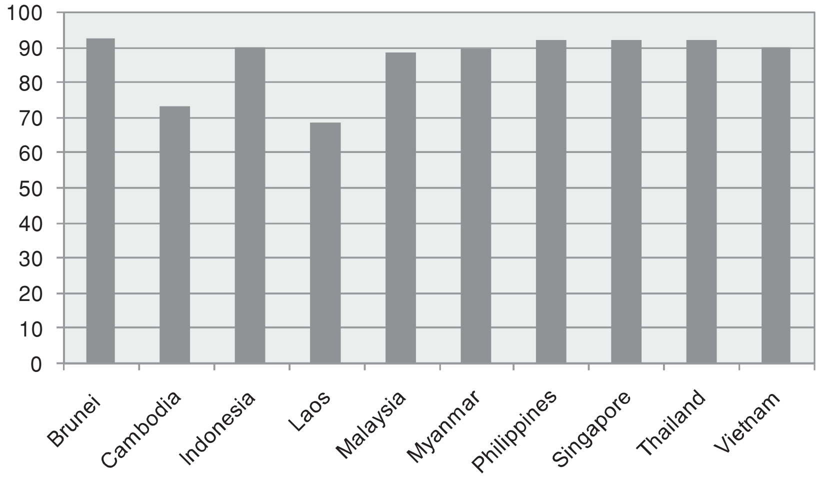


Figure O.7. **Economic diversity in ASEAN (continued)**

c. Adult literacy rate in 2004 (in %)



d. Life expectancy in 2004 (in years)

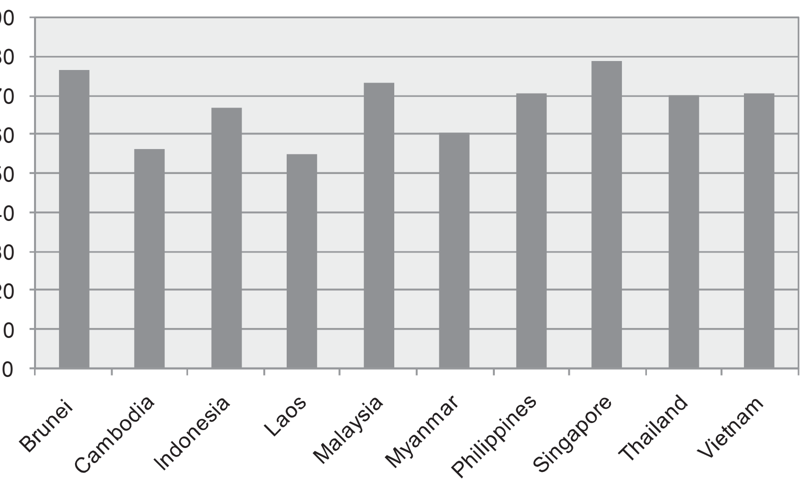
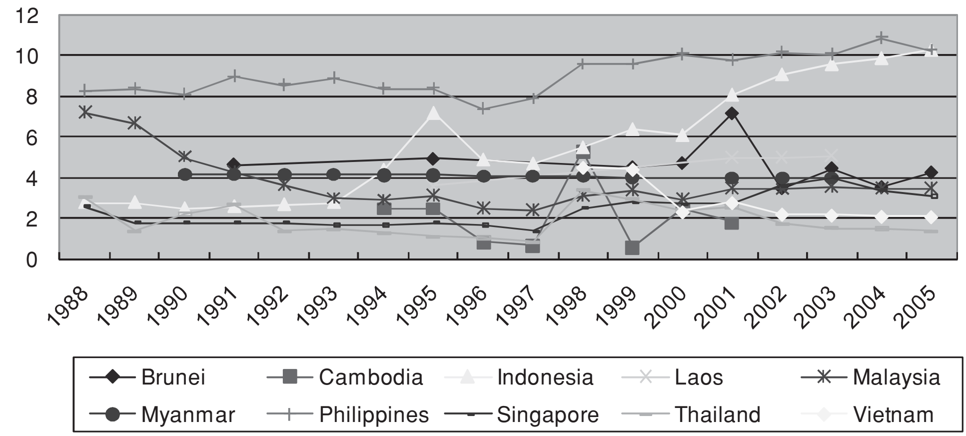


Figure O.7. **Economic diversity in ASEAN (continued)**

e. Unemployment rate (in %)



Source: GDP and GDP per capita: *World Economic Outlook* (WEO), IMF. Adult literacy rate and life expectancy: UNDP. Unemployment rate: ADB.

There are also multilateral initiatives. Such initiatives create "sub-regional economic zones" based on geographical proximity. Proximity and the sharing of existing infrastructure economise on costs and thereby support the expansion of economic activities. The formation of "growth triangles" including the Indonesia-Malaysia-Singapore Growth Triangle (IMS-GT), the Indonesia-Malaysia-Thailand Growth Triangle (IMT-GT) and the Brunei-Indonesia-Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA) played an important role in boosting growth in the respective regions: The IMS-GT, the largest of the three, was initiated in the late 1980s with the purpose of creating an investment area including Riau province of Indonesia, Johor of Malaysia and Singapore. The development of Batam Island was at the heart of this initiative. As a result of the dismantling of investment barriers, in particular on Batam Island, the number of investing firms increased 50% and the population doubled in a couple of years. This is considered one of the most successful projects. The IMT-GT was launched in the early 1990s and includes six north-eastern Indonesian provinces, five northern Malaysian provinces and five southern Thai provinces (for more details see Vimolsiri, Chapter 11). The BIMP-EAGA was proposed in 1994 and covers Brunei, the Indonesian provinces of North Sulawesi, East Kalimantan, West Kalimantan, the Malaysian provinces of Sabah, Sarawak, Labuan and the Philippine islands of Mindanao and Palawan. The Philippines has long attempted to eradicate poverty in its poorest region of Mindanao, and the initiative was designed to contribute to this.

Box O.3. **Converging or diverging in ASEAN?**

Are ASEAN countries experiencing a convergence of economic growth among them while becoming ever more integrated with the world economy? Most studies looking at convergence check the existence of either β or σ convergence or of a common deterministic/stochastic trend. The concepts of β and σ capture different convergence processes: β convergence examines whether developing countries will catch up with developed ones and this type of convergence can be unconditional or conditional, depending on whether additional control variables are absent or present in the cross section regression. σ convergence examines income inequalities among countries and it means that the variance of per capita income for a group of economies is decreasing over time. The two concepts of β and σ convergence are related: a necessary condition for σ convergence is the existence of β convergence.

β convergence is commonly used in growth empirics. This measure, based on Barro and Sala I Martin (1992) and Mankiw *et al.* (1992), makes a distinction between conditional β convergence (the convergence of countries after controlling for differences in steady states) and absolute β convergence (where poor economies simply grow faster than wealthy ones). Concerning this regression framework, Quah (1993) and Friedman (1992) pointed out "Galton's fallacy problem" and both suggest that σ convergence should be of interest as it directly answers the question of whether the distribution of income across economies is becoming more equitable.

In parallel with these methodological debates, there have emerged a number of empirical studies checking the convergence process in Southeast Asia. Evans and Kim (2005) estimate the Solow growth model for 17 Asian countries, including most ASEAN members, with the random coefficients technique and find that there is a convergence of 2% per annum among the sample countries. Lim and McAleer (2004) show that several time series tests for convergence don't support income convergence between pairs of ASEAN-5 countries (Indonesia, Malaysia, Philippines, Thailand and Singapore) and Chowdhury (2005) arrives at the same result after examining nine ASEAN countries during 1960-2001. As an example of another stream of literature, a study by Park (2003) looks at σ convergence using the simple Theil index. It shows that incomes since the mid-1970s have been converging in Asia.

These attempts are distinct in that neighbouring countries are jointly undertaking regional development. These schemes may prove to be effective, particularly when countries face cross-border problems that are difficult to solve by an individual country. Moreover, joint efforts may bring about efficiency gains through the scale effect. There is a large variation between sub-regional growth areas in terms of success, but it is expected that an appropriate blend with domestic policies would bring positive results.

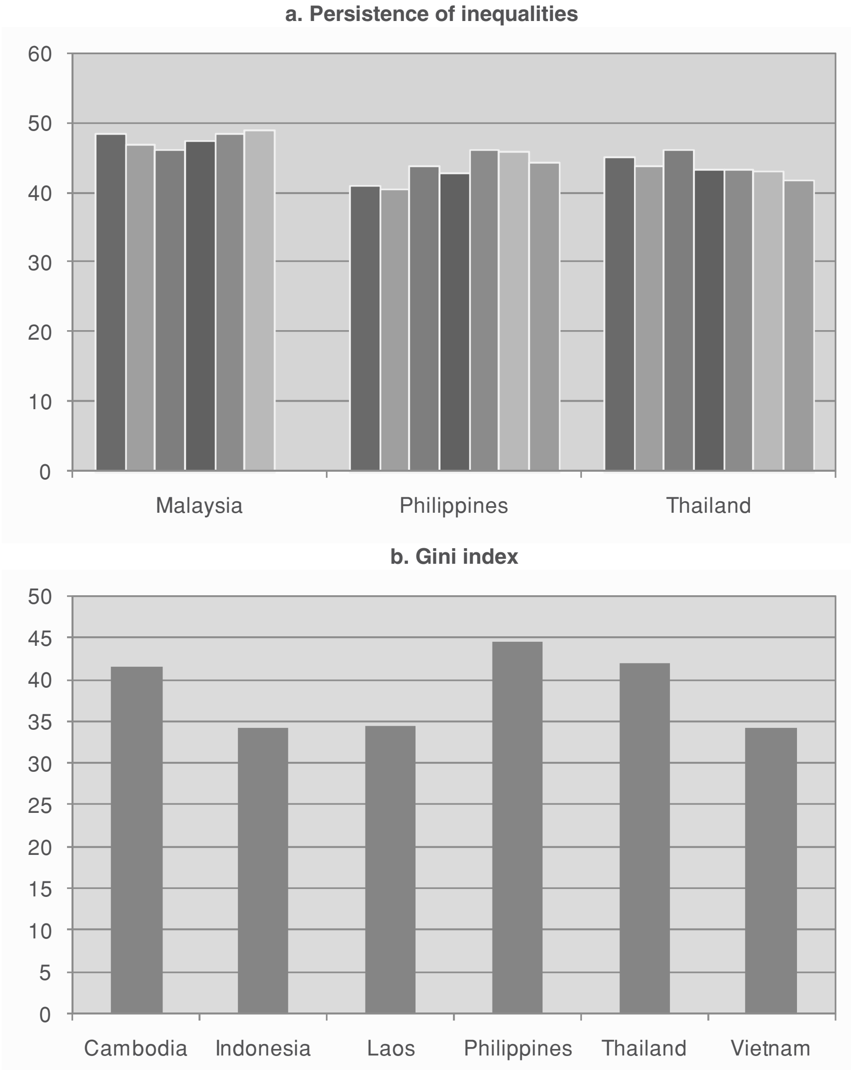
Income disparities "within" ASEAN countries

Sizeable income disparities exist not only across different ASEAN countries, but also across regions within countries, exacerbating the challenge of regional integration. Moreover, robust economic growth over the past decades, beside its poverty-alleviating effect, has brought about widening regional disparities in these countries. How do these inequalities affect growth and thereby countries' capacity to fully reap the benefits of regional integration?

The link between inequality and growth has been one of the most debated issues not only in policy making but also in the context of economic theory. Cordoba and Verdier (2007)[11] build a theoretical framework based on Lucas's work and conclude that the welfare costs of inequality outweigh the benefits of growth. Recent literature based on theories of incentives (Aghion *et al.*, 1999), however, does not give a clear conclusion as to whether inequality stimulates or deters economic growth, owing in large part, to different channels through which inequality and growth may interact. Similarly, the results of empirical studies are inconclusive and very much dependent on the econometric specification, the method and the sample. According to the early literature on the relationship between inequality and economic growth, inequality is inevitable at early stages of development and should diminish with growth as illustrated by the inverse U-shape Kuznets curve. Banarjee and Duflo (2000) provide a plausible explanation why estimates of the relationship between the level of inequality and growth are so different from one another. They find that changes in income inequality (in either direction) are associated with reduced growth in the following period. While this does not explain the relationship between the *level* of inequality and growth, it sheds light on the non-linear relationship between the two. The major policy implication of this finding is that large swings in the income distribution are growth-deterring.

The ASEAN experience – similar to the theoretical and empirical literature – is inconclusive on the relationship between inequality and growth: all have achieved remarkable growth amid somewhat differing levels of inequalities. Behind the different inequality levels are historical and political factors as well as different levels of tolerance towards inequality in different countries. Moreover, inequality has been persistent in countries that have the highest levels such as Philippines and Thailand (Figure O.8). Box O.4 provides some theoretical explanations for the persistence of inequality. Among ASEAN-5, Indonesia has traditionally had a low level of income inequality and this level remained more or less stable over the Suharto regime and afterwards.

Figure O.8. **Gini index of income inequality in ASEAN countries**



Note: Panel a: Years differ by country: Malaysia: 1984, 1987, 1989, 1992, 1995 and 1997, Philippines: 1985, 1988, 1991, 1994, 1997, 2000 and 2003 and Thailand: 1981, 1988, 1992, 1996, 1999, 2000 and 2002.

Panel b: Latest available year, Cambodia 2004, Indonesia 2002, Laos 2002, Philippines 2003, Thailand 2002 and Viet Nam 2004.

Source: United Nations Development Programme (UNDP).

Box O.4. **Why is income inequality persistent? – Some theoretical arguments**

The recent theoretical debate sheds some light on the challenge of persistent inequality. Many recent works emphasised the role of human capital investment under credit market imperfections. The usual common feature of the setting of these models is that human capital formation cannot be financed by issuing claims against a child's future earnings due to the lack of enforceability of such contracts. This box discusses some variations of this setting.

Banerjee and Newman (1993) argue that owing to capital market imperfections, people can borrow only limited amounts and as a result, occupations that require high levels of investment are beyond the reach of poor people, who have no choice but to work for wealthier people. Wage contracts are viewed primarily as a substitute for financial contracts. The wage rate and pattern of occupational choice are determined by an individual's wealth. Low wage rates slow down the wealth accumulation of the poor and therefore preserve the high initial supply of labour, which in turn reinforces the low equilibrium wage rate. Ghatak and Jiang (2002), however, pointed out that credit market imperfections give rise to rents in occupations involving set-up costs and these rents may motivate poor individuals to work hard and save to overcome the borrowing constraint. Galor and Zeira (1993) also examined the role of income distribution through investment in human capital and pointed out that persistence can easily arise when there is credit rationing. They show that with a fixed size investment technology, inequality can become persistent. Poor agents are unable to afford the fixed size investment that would enable them to accumulate enough wealth to pass the threshold. As a result, initial poverty persists in the long run.

In a similar vein, Mookherjee and Ray (2003) look at human capital investment as an intra-household decision. Given that it is the parents who decide how much to invest in their children's education, poor families are unable to catch up owing to their limited means to invest, while high-income families can easily afford to spend on education. This results in perpetuation of inequality. Durlauf (1996) and Das (2007) analysed the relationship between human capital investment and neighbourhood choice. Parents affect the conditional probability distribution of their children's income through the choice of a neighbourhood in which they live.

In general, the ability of such theoretical models to explain the persistence of income inequalities is limited due to their assumptions, but they provide some insight into certain aspects of the phenomenon. It should be noted, however, that given the complexity of the continuing income inequality, such inequality needs to be examined from broader aspects. The situation in Southeast Asia is in line with the theoretical model. Credit access is indeed a substantial problem in the region and several methods have been used to mitigate this constraint. For instance, the increasing use of micro-finance in the region indicates that access to credit is difficult. Improvement in credit conditions is key to the alleviation of persistent income inequality.

O.4. Peer review process: tool for regional co-operation in Southeast Asia

How can regional integration be fostered in light of the distinct features and challenges facing this region? The peer review mechanism may help answer this question.

The peer review mechanism is a tool for policy dialogue (see Annexes A and B of this publication). Its non-binding and "soft law" nature can be suitable as a co-operation tool in Southeast Asia. The challenge of how to apply the peer review in order to foster regional integration amid economic diversity in Southeast Asia is the main topic of this publication.

Peer reviews can contribute to regional co-operation in Southeast Asia. The EU peer review process shows how relevant it can be in a regional context. In the European experience, Bertoldi (see Chapter 3) mentions that peer review, peer support and peer pressure are key instruments in the governance framework of a regional economic union, even though these instruments are implemented differently depending on the context.

Moreover, peer review is not a new concept for Asian countries (see Ikhsan, Chapter 8 and Vimolsiri, Chapter 10). Indeed, following the Asian crisis, peer reviews were institutionalised in the form of the ASEAN Surveillance Process (ASP) in 1998, although admittedly this process is still in its infancy (see Beltran, Chapter 9). The aim of the ASP is to strengthen the capacity of policy making within ASEAN. Two mechanisms facilitate this: one is a monitoring mechanism that allows early detection of problems that might affect the economy in general, and the financial sector in particular; the other is a peer review mechanism that identifies policy issues arising from the monitoring exercises that need to be addressed.[12]

Different organisations conduct peer reviews in different ways. For instance, APEC has been using peer reviews as a tool to achieve the common goals of free and open trade and investment in the Asia-Pacific region (see Woodhead, Chapter 2). These goals, known as the Bogor Goals, were laid down in the Bogor Declaration in 1994. In their path towards achieving the Bogor Goals, economies prepare individual action plans (IAPs) tracking their progress. These IAPs then become the object of the peer review process, which has evolved through trial and error. At the outset, the submission of IAPs for peer review was conducted on a voluntary basis, but in the early 2000s, the process was made more rigorous. As part of the mid-term stocktaking process in 2005, a timetable was set for the review of all 21 member economies. The IAP peer review process has proved to be an effective tool to facilitate learning from each other's experiences, enhance policy-relevant interaction and encourage participants to progress towards the goals of free and open trade and investment.

In response to the Asian crisis, the ASEAN+3 adopted the ERPD process as part of their efforts towards regional financial co-operation. According to Kawai and Houser (Chapter 1), they have recently decided to integrate the ERPD with the regional liquidity support facility, the Chiang Mai Initiative. In addition, National Surveillance Units have been set up in ASEAN+3 countries for economic and financial monitoring. The ultimate aim is to strengthen the Chiang Mai Initiative as a facility independent from IMF programmes and to transform it into a multilateral arrangement. This requires a more active and effective role for the ERPD, whose major role so far has been information exchange and co-ordination. Information exchange is the first evolutionary step of the ERPD and is a prerequisite to peer review and due diligence. Information sharing is crucial in the areas of macroeconomic development and in support of institutional, legal and regulatory reforms in the areas of foreign exchange and financial markets. It is argued that for the ERPD to become a more powerful tool, both its peer review and due diligence features need to be enhanced.

The OECD peer review process has several distinct characteristics (see Box O.5, Annexes A and B and Thygesen, Chapter 6). The OECD's useful role lies in bringing together the independent analytical capacities of the secretariat and the policy experience of national government officials. As the country examples of Belgium (Van Houte, Chapter 12), Japan (Hirono, Chapter 13) and Korea (Kwon, Chapter 14) show, the secretariat helps to identify the specific issues on which to focus the review and ensures the quality of the methodological instruments. By adding a detailed discussion with the relevant national officials when the secretariat's draft is presented to the committee, the process facilitates formulations of policy recommendations that are endorsed by national governments, thereby helping to build consensus amongst participating countries on the required policy orientations. Peer reviews are implemented in a number of ways within the OECD. Subsidiary bodies of the OECD – committees or working parties dealing with a particular issue – can decide to undertake peer reviews as part of their activities, or to carry out a one-time peer review at the request of a country or a region. The various directorates in the OECD secretariat constantly adapt and improve the modalities of the peer reviews to meet the specific requirements of the policy area concerned.

Box O. 5. **What can OECD peer review offer?**

The peer review mechanism – the assessment of the policies and performances of a country by other countries – is at the heart of the OECD's method of work. It is a tried and tested instrument that helps member countries improve their policy making, adopt good practices and generate established standards and principles. This method of international co-operation has become increasingly popular in recent years, even beyond OECD borders. The scope of the peer review mechanism has expanded rapidly in terms of policy areas reviewed and the number of organisations involved. The success with peer reviews has encouraged other organisations, such as New Partnership for Africa's Development (NEPAD), to adopt this tool and the OECD has started to discuss peer review experiences with ASEAN.

Peer reviews can serve as an important capacity-building instrument, since it is a mutual learning process that allows best practices to be tested and emulated. In many different settings, the "soft law" nature of the peer review can prove better suited to encouraging and enhancing compliance than a traditional enforcement mechanism. Based on solid analytical evidence, the review results in a series of recommendations reflecting the collective wisdom of participants that aim to support the reform efforts of the country under review. Important prerequisites of peer reviews are the sharing of common values, mutual trust and the analytical credibility of the review process. A strong common understanding of the ultimate goals of the peer review and a high degree of shared confidence in the value and integrity of the process are keys for its success.

Peer reviews are a flexible tool in terms of the policy areas and countries to be covered. In the real operation at the OECD, different methods are used for different policy areas. Peer review can apply not only to country-by-country examinations but also to cross-country thematic reviews or to broader issues of regional co-operation. The impact of this exercise can vary according to the practical details of the implementation and the degree of mutual trust among participants.

Source: Annexes A and B to this publication.

There is no standardised peer review mechanism as such, but all peer reviews share certain structural elements: a commitment to transparency and information-sharing; an agreed set of principles, standards and criteria against which performance will be reviewed; designated actors to carry out the review; and a set of procedures leading to the final result. When regional integration projects involve deepening legal and economic commitments, Comley (Chapter 4) stated that it is important to disentangle sanction regimes from peer reviews to ensure that the free disclosure of information is incentive compatible.

Given their flexible nature, peer reviews can be tailored to foster integration, taking into consideration specific characteristics. Several

Southeast Asian countries (Part II, from Chapter 8 to Chapter 11) identified the importance of the peer review mechanism and made suggestions as to how this tool could be fitted to the region's need. Some of the aspects of peer reviews that would suit this region include information sharing and co-ordination. Both are expected to be an effective tool.

The following points should be given special attention in the application of the peer review mechanism to this region:

- **Information sharing.** The information exchange aspect of peer reviews has been recognised as a potentially useful tool for the Southeast Asian region, as it may help to bridge the information gap in policy making.
- **Co-ordination of regional policies and identification of issues**. Peer reviews can also be helpful in co-ordinating policies in order to jointly address regional challenges. They could also work as an early warning system and provide input to the government regarding policy reforms.
- **The role of facilitator**. A competent facilitator would enhance dialogue and co-ordination and encourage participants to share views on regional issues. Involvement of regional organisations (for instance, ASEAN and ADB) will be helpful in adapting peer reviews to different purposes. From a long-term perspective, capacity-building to strengthen the role of facilitator is important.

The application of the peer review mechanism to Southeast Asia is still in its infancy. This publication provides some suggestions to policy makers in Southeast Asia on how the peer review mechanism could be applied to address regional and domestic policy challenges.

O.5. Conclusion

This chapter provided an overview of the major characteristics of the Southeast Asian region from the point of view of its economic diversity and regional integration. It confirmed that the process of enhanced integration is progressing despite the diversity of participating countries. Southeast Asian countries now face several challenges: how to blend market-driven integration with an institutional framework and how to enhance competitiveness and attract investors in the region. The peer review mechanism might help to address these issues.

The following chapters address the question of how to adopt peer reviews to the Southeast Asian region in light of its specific characteristics, *i.e.* what aspects of this mechanism should be retained and what should be adjusted in order to take into account these characteristics and the area of co-operation.

Various examples of peer reviews in different institutions provide a useful reference to develop the most relevant framework for Southeast Asia. Part I of this publication is based on regional integration experiences of the ADB, APEC, the EU and the OECD, while Part II consists of views from Southeast Asia. Part III briefly introduces the experiences of OECD member countries. Annexes A and B present two papers on the OECD peer review mechanism and the example of the Economic Development and Review Committee (EDRC). The application of the peer review mechanism to the Southeast Asian region is still at an early stage and the best ways to adopt it should be explored.

Notes

1. This section is based on Tanaka and Langer (2007).
2. OECD (2005) discusses this dynamism from the point of view of policy coherence for development in the region.
3. Cheung *et al.* (2003) and Kawagoe *et al.* (2005) examined the interest parity condition between selected countries in East Asia and concluded that countries are converging towards an equilibrium point of interest parity, which implies that their interdependence is deepening.
4. Although the co-operation has advanced in several frameworks, here the focus will be on initiatives in the framework of ASEAN-10. See Kawai and Houser (Chapter 1) for the framework of ASEAN+3 and Woodhead (Chapter 2) for APEC for more details.
5. At the 12th Summit in Cebu, the Report of the Eminent Persons Group on the ASEAN Charter invited ASEAN members to “calibrate the traditional policy of non-intervention in areas where the common interest dictates closer co-operation.”

6. Some argue that most developing countries should adopt one of the "two corner solutions", *i.e.* irrevocably fixed or fully flexible exchange rate regimes, as these two extreme systems appear to be more immune to crises owing to their higher policy credibility (Fisher, 2001). According to other views, such as Corsetti *et al.* (1999) and Williamson (2000), intermediate exchange rate systems are preferable, as fluctuation bands, for instance, provide some flexibility for monetary policy while maintaining a certain degree of exchange rate stability.

7. For instance, according to the buffer stock model, the amount held in reserves should decrease with an increase in economic adjustment costs and in the opportunity cost of holding reserves. Aizenman and Marion (2003) and De Beaufort Wijnfolds and Kapteyn (2001) investigated empirically whether reserves in Southeast Asia are excessively high using the buffer stock model and both found a positive answer. Such techniques, however, are not able to project the optimal amount of reserves.

8. See Yusuf (2003) for more comprehensive discussions about innovation policy in Asia.

9. Bocquet (Chapter 5) mentioned that Asia is unlikely to embark on the same path of relatively formal institution building, as did the Europeans 50 years ago.

10. See Fukasaku, Chapter 7, for a case study of trade related assistance.

11. Lucas (2004) stresses the overwhelming importance of growth and does not attribute a role to redistribution.

12. The Manila Framework Group (MFG) is another mechanism for surveillance in Asia, with participation of IMF, World Bank, ADB and Bank of International Settlements (BIS).

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List of Abbreviations

ABAC	APEC Business Advisory Council
ABF	Asian Bond Fund
ABMI	Asian Bond Market Initiative
ADB	Asian Development Bank
ADBI	Asian Development Bank Institute
AFAS	ASEAN Framework Agreement on Services
AFTA	ASEAN Free Trade Area
AICO	ASEAN Industrial Co-operation
APEC	Asia-Pacific Economic Co-operation
APRM	African Peer Review Mechanism
ASEAN	Association of Southeast Asian Nations
ASEM	Asia-Europe Meeting
ASEAN+3	ASEAN+ China, Japan and Korea
ASEAN+6	ASEAN+ Australia, China, India, Japan, Korea and New Zealand
ASEAN-6	Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore and Thailand
BI	Bank of Indonesia
BIAC	Business and Industry Advisory Committee
BIMP-EAGA	Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Triangle
BIS	Bank of International Settlements
BOT	Bank of Thailand
BSAs	Bilateral Swap Arrangements
BSP	Central Bank of the Philippines (*Bangko Sentral ng Pilipinas*)
BPS	Statistics Indonesia (*Badan Pusat Statistik*)
CEPT	Common Effective Preferential Tariff
CGI	Consultative Group for Indonesia
CLMV	Cambodia, Lao PDR, Myanmar and Viet Nam
CMEA	Council for Mutual Economic Assistance (Viet Nam)
CMI	Chiang Mai Initiative
EAS	East Asia Summit
EC	European Commission
ECB	European Central Bank

ECSS	Executive Committee in Special Session (OECD)
EDRC	Economic Development and Review Committee (OECD)
EMBI	Emerging Markets Bond Index (JP Morgan)
EMEAP	Executive Meeting of Asia-Pacific Central Banks
EMS	European Monetary System
EMU	Economic and Monetary Union
EPA	Economic Partnership Agreement
ERPD	Economic Review and Policy Dialogue
ESAC	Economic and Social Advisory Council
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GATT	General Agreement on Tariffs and Trade
GDDS	General Data Dissemination Standards (IMF)
IAI	Initiative for ASEAN Integration
IAP	Individual Action Plan
ICT	Information and Communication Technology
IFC	International Finance Corporation
IMF	International Monetary Fund
IMS-GT	Indonesia-Malaysia-Singapore Growth Triangle
IMT-GT	Indonesia-Malaysia-Thailand Growth Triangle
IOSCO	International Organisation of Securities Commissions
KKP	Economic Co-ordination Minister Office (*Kementerian Koordinator Perekonomian*) (Indonesia)
LPEM	Institute for Economic and Social Research Faculty of Economics University of Indonesia (*Lembaga Penyelidikan Ekonomi dan Masyaraka Fakultas Ekonom Universitas Indonesia*)
MCM	Ministerial Council Meeting (OECD)
MERCOSUR	Southern Common Market (*Mercado Comun del Cono Sur*)
MFN	Most Favoured Nation
MNEs	Multinational Enterprises
MPDF	Mekong Private Sector Development Facility
MRAs	Mutual Recognition Agreements
NAFTA	North American Free Trade Agreement
NEDA	National Economic and Development Authority (Philippines)
NEPAD	New Partnership for Africa's Development
NESDB	National Economic and Social Development Board (Thailand)
NPLs	Non-Performing Loans
NSCB	National Statistical Coordination Board (Philippines)
NTMs	Non-Tariff Measures
OEEC	Organisation for European Economic Co-operation
OMC	Open Method of Coordination
PSD	Private Sector Development

R&D	Research and Development
SCCP	Sub-Committee on Customs Procedures (APEC)
SDDS	Special Data Dissemination Standard (IMF)
SEACEN	South East Asian Central Banks
SEANZA	South East Asia, New Zealand and Australia
SEDP	Socio-Economic Development Plan (Viet Nam)
SET	Stock Exchange of Thailand
SEZ	Special Economic Zone
SGP	Stability and Growth Pact
SMEs	Small and Medium-Sized Enterprises
SOEs	State Owned Enterprises
TCB	Trade Capacity Building
UNCTAD	United Nations Conference on Trade and Development
UR	Uruguay Round
VAT	Value-Added Tax
VAP	Vientiane Action Programme
WTO	World Trade Organization

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