

Chapter 2

A Framework: Theories of Regional Integration

2.1 Introduction

In this chapter, major international relations theories and economic integration theories will be reviewed before assessing their applications in the case of Southeast Asia. The first section reviews political science approaches and several economic integration theories. The last section of this chapter examines the theoretical approach to regional cooperation and integration in Southeast Asia.

There has been a rapid development of regional agreements since the 1990s. Of the 194 regional agreements notified to the General Agreement on Trade and Tariffs and the WTO in early 1999, 87 were notified since 1990s.¹ Almost all WTO members (South Korea has been an exceptional case until its recent agreement with Chile in 2002) signed at least one such agreement. These agreements range from customs union (MERCOSUR in 1991) to free trade areas (NAFTA in 1994) to single market (the European Union in 1993).

With quantitative development, there have been major characteristic changes to regional agreements. First, a deepening of the scope has been recognized. The traditional focuses of Regional Trade Agreements (RTA) on the trade tariffs and quotas are extended to various other issues such as health and environment, service industries and

¹ The World Bank, *Trade Blocs*, Oxford: Oxford University, 2000, pp.1-5.

intellectual property or to issues like investment and capital mobility and even working environment.² The EU might be the best example for so called deep integration that allows the free flow of goods, services, investment, and ideas and wide ranging policy measures. The second is the emergence of open regionalism. While previous regional trade agreements in the 1960s and 1970s were aptly fell within the ambit of closed regionalism based on the import substituting development policy between developing countries, regional agreements in recent years have been more open and outward looking. Third, regional agreements between developed countries and developing countries have been witnessed during the second period.³ For example, Mexico joined the Canada-America Free Trade Area with the creation of the North America Free Trade Area (NAFTA). Most of the regional cooperation or integration efforts among developing countries are mainly linked to the decolonization process and have failed except in a few cases such as ASEAN.

The history of regional integration goes back to the nineteenth century in Europe. In 1828, Prussia established a customs union with Hesse-Darmstadt. This was followed successively by a series of integration. In the last decade of the nineteenth century numerous projects for European integration were concocted i.e., Count Paul de Leusse's in France, Middle European Zollverein in Austria, and the idea of a united Europe of Count Goluchowski in Austrian-Hungary.⁴ Many other politicians, economists, and journalists made proposals for European union, which circulated through the European

² The agreement between the U.S. and Jordan authorized the use of sanctions to enforce commitment on labor and environmental standards. *The Asian Wall Street Journal*, 20 December 2000.

³ The World Bank, 2000, pp.1-3.

⁴ Walter Mattli, *The Logic of Regional Integration*, Cambridge: Cambridge University Press, 1999, pp.68-74.

capitals during that decade. Ultimately, all the projects did not succeed. Half a century later, the idea of European integration was re-invented and the process of merging European nation-states into one prosperous economy and stable polity began. The first step was taken with the creation of the European Coal and Steel Community (ECSC) in 1952. In 1957, Germany, France, Italy, Belgium, Luxemburg, and the Netherlands signed the Treaty of Rome establishing the European Community. In the process of enlargement of the European Community, European integration had moved beyond trade. The establishment of the European Monetary System in 1979 and the adoption of the Maastricht Treaty on European Monetary and Political Union and its new name, the European Union (EU) marked a deep level of integration.⁵

Integration in other parts of the world have taken place. In the 1960s the Latin American Free Trade Association, the Andean Pact, and the Central America Common Market were initiated. In the early 1990s, more than half a dozen new integration schemes were started in Latin America, the most notable being the Mercado Comun del Sur or Southern Cone Common Market (MERCOSUR) comprising Argentina, Brazil, Paraguay, and Uruguay. In North America, a Free Trade Agreement between the United States and Canada was signed in 1989. This agreement expanded into the North American Free Trade Agreement (NAFTA) when Mexico joined in 1994.

The major studies on regional integration have focused on the search for conceptual paradigms and interpretations either on specific policy actors and processes or

⁵ Pascal Fontaine, *Europe in 10 points*, European Commission, 1998.

on the dynamic institutional configuration of the larger management system⁶. In the study of politics, one of the main tasks has been to analyze the forces that cause the formation and integration of political communities. Especially in the process of European integration, various perspectives and theories on regional integration have been developed. In general, the studies of regionalism or regional integration use international political economy (IPE) since the phenomenon of regionalism has been caused and developed not only in an economic sense but more importantly by the willingness of political actors.

2.2 Regional Integration and Theory

2.2.1 Political Approaches to Regional Integration

Realism and Regional Integration

Realism has been the dominant paradigm in IPE in explaining world peace and war especially because of and since the Second World War. It has been based on the assumption that states, the principal actors in world politics without common government, act rationally to seek self-interest.⁷ The realist perspective defines international politics as a struggle for power which consists of not only military factors but also levels of technology, population, natural resources, geographical factors, form of government,

⁶ Dimitris N. Chrysochoou, Michael J. Tsinisizelis, Stelios Starvridis & Kostas Ifantis, *Theory and reform in the European Union*, Manchester: Manchester University Press 1999, p.x111.

⁷ James E. Dougherty and Robert L. Pfaltzgraff, Jr. eds., *Contending Theories of International Relations*, New York: Harper & Row, 1990. p.81.

political leadership, strategy and ideology.⁸ However, in the tradition of realism, ideology and historical experience have not been important factors as states are considered as actors with similar interests in terms of power regardless of time and space. Thus, realist theory focuses more on describing the world as it actually is rather than how it should be. Realist theorists assume that the possibility of war or conflict is constant as human nature is essentially not easy to improve or at least not easily altered.⁹

Neorealism based on the tradition of realism stresses the structural factor. Thus, the neorealist approach contains an emphasis on the hierarchical relationship among actors in the anarchical system. According to Waltz, the constant anarchic nature of world order is the cause for war, while structure is defined by the distribution of capabilities among the units. While individuals in a state can be protected by law and force, states have no such guarantee for their survival. States are considered as unitary actors who seek their own preservation at a minimum, and at a maximum, drive for universal domination.¹⁰ In this context the emergence of a balance of power is necessary. Peace can be achieved when a balanced distribution of power among states is maintained. Robert Gilpin argues that distribution of power is the principal means for controlling the

⁸ Ibid., pp.82-84.

⁹ Hans J. Morgenthau set six principles of the realist theory. First he suggested that political relationships are governed by the objective rules based on human nature. Second, national interests defined as power is the major concept to understand political action and thinking. Third, the meaning of interest defined as power is an unstable one. Forth, he distinguished the morality of nation-state from individual ones. Universal moral principles cannot be applied to the action of states in their abstract, universal formation and it can be judged by the political consequence of a particular policy. Fifth, political realism does not identify the moral aspiration of a particular nation with the moral laws that govern the universe. Sixth, and finally, Morgenthau stressed the autonomy of the political sphere. Political actions should be judged by political criteria. Ibid., pp.94-100.

¹⁰ Ibid., pp.119-121.

behaviour of states that engage in cost-benefit calculations about possible choices.¹¹ In this realist framework, however, international cooperation can hardly be achieved mainly due to the security dilemma¹² as well as state concerns about relative gains.¹³ Realist or neorealist approaches which deny the possibility of strong cooperation through international institutions claim that the presence of a hegemonic state could foster it by forcing small states to be members of the institution against major powers. Thus, the possibility of betrayal or violence among small states could be lower as they fear punishment or lack capability. On the other hand, Waltz argues that a shared threats may stimulate states to cooperate in alliance. High risk of betrayal and shared threat oblige states to seek cooperation. However, such cooperation can last only as long as there is shared fear and balance of power.

To explain regional phenomenon, realism and neorealism focus on the distribution of power. They attempt to explain regionalism by focusing on external or internal changes of power distribution. Thus, the international system and environmental changes are important factors when investigating regionalism. For instance, the initiative for regional cooperation in Europe can be seen as a result of the shared threat from the Soviet Union and active aid from a hegemonic state such as the U.S. during the Cold War. From the viewpoints of realism or neorealism, NAFTA also can be considered as a strategic measure of the U.S. to liberalize Japan. Indeed, the formation of APEC was led

¹¹ Ibid., pp.121-123.

¹² In order to seek own security and survival, states will attempt to increase their power, but since power is a relative measure it is impossible for them all to increase their power simultaneously. Ibid.

¹³ Actors cooperate in order to achieve gains jointly not singly. However, gains are not always in absolute terms and more often may be viewed in relative terms that are inherently non-zero sum. Thus, cooperation needs a strategic behavior. Ibid.

by the U.S. in order to pressure European partners at the last phase of the Uruguay Round. Reinforcement of European integration in the mid-1980s also can be comprehended as a strategy of European countries to counter Japanese competitiveness in the world market.

Liberalism and Cooperation

In contrast to realism, liberalism stresses the importance of the non-state actors such as individuals, multinational companies, and international organizations and focuses on the possibility of the establishment of world order through cooperation among them in the economic and cultural fields. Liberalism is based on the idea that the nature of international relations is not characterized by constant conflicts, but can be changed at least progressively.¹⁴

Under the liberalist tradition, several types of characteristics have been identified, which may lead to mutual confidence, increased cooperation, institution building, and peace among states that share these values. Commercial liberalism mainly advocated by Mill argues that increased wealth, trade, and economic interdependence among states promote peace. Democratic liberalism argues that cooperation and peace among liberal democracies are relatively easy to achieve when compared to other regime types. However, these liberalist approaches have been challenged by major events. World War I falsified the liberalist prediction that complicated commercial links among the major powers can hardly lead to war. The institutional approach advocated by Wilson also was shattered by World War II. Furthermore, the economic hardships in the 1970s raised

¹⁴ Ibid., pp.81-83.

doubts about the liberalist belief that economic development can lead to peace among states.¹⁵

Neoliberalism as enunciated by Keohane, is based on the following assumptions: unlike the realist tradition, in which military issues dominate, there is no hierarchy of issues. Power is less fungible; multiple channels of contact characterize the unit-level interactions.¹⁶ However, the state-centric nature of international politics remains. In the view of neoliberalism, international institutions are the best mechanism to improve cooperation through three ways, namely, through providing information and opportunity for cooperation, strengthening the capability of monitoring on commitment, and increasing expectation for the consolidation of international institutions. To achieve those targets, there must be shared mutual interests and notable effects of institutionalization on the behaviour of states. In this sense, a group of states with interactions and issue-areas requiring simultaneous solution- for example, multiple bilateral trade relations- will need to cooperate in an institutional framework- thus the high demand for institutions will result in their formation. Despite high demand, the creation of institutions cannot be achieved if the cost is too high. However, once institutions are established, the cost is too great to discard them.

In the tradition of liberalism, federalism precludes regional integration theory. The basic idea of federalism is that wars or serious conflicts among sovereign European states

¹⁵ Ibid., pp.4-7.

¹⁶ Robert O. Keohane and Joseph Nye, *Power: World Politics in Transition*, Boston: Little, Brown, 1997, Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy*, Princeton: Princeton University Press, 1984

would be less likely if they unify under a federal government.¹⁷ While federalists adopt the ideal approach that threatens the sovereignty of nation-states, functionalists propose the gradual creation of a whole series of separate international functional agencies.

Functionalism assumes that peace can be achieved through prosperity.¹⁸ Political divisions, which are a source of conflict among nations, can be transcended only by establishing international institutions through a gradual process toward peace and prosperity. Functionalists are concerned with the process by which loyalty is shifted from one centre to another. Governments would surrender control because they would not feel threatened by the loss of authority over such a matter as health care, and they would appreciate the value of such tasks being performed at a regional or world level. However, as more and more areas of control are surrendered, states would become less and less capable of independent action. Another functionalist, Jean Monnet, suggested that instead of handing authority over specific functional areas to separate international agencies, these authorities should be handed to a single executive.¹⁹

Neofunctionalism²⁰ based on the concepts of functionalism seeks the logic of integration using concepts such as functional spillover, political spillover, updating of common interest, etc. To explain the phenomena of regional integration since the late

¹⁷ Stephen George, *Politics and Policy in the European Community*, Oxford: Clarendon Press, 1985, pp.17-18.

¹⁸ Walter Mattli, 1999, p.21.

¹⁹ Stephen George, 1985, P.20

²⁰ Neofunctionalism writings include works by Ernst Hass, Philippe Schmitter, Leon Lindberg, Joseph Nye See, Ernst B. Hass, *The Uniting of Europe*, Stanford: Stanford University Press, 1968, Phillippe C. Schmitter, 'a Revised Theory of Regional Integration', *International Organization*, 24. No.4, 1970, Leon N. Linberg and Stuart A. Sheingold, eds., 'Regional Integration; Theory and Research', *Special Issues International Organization*, CCIV, No.4, Autumn 1970, Joseph S. Nye, 'Comparative Regional Integration: Concept and Measurement', *Ibid.*, 22, Autumn 1968.

1980s, neofunctionalists unlike realists, have focused on the internal dynamics. They stress the significant role of Non-governmental Organizations (NGOs) or the leadership of a supranational organization and regional institutions. The European Commission encourages development of interest groups. So the creation of the ECSC led to the representatives of the coal and steel industries in all the participant states switching at least part of their political lobbying from national governments to the high authority. Relevant trade unions and consumer groups followed suit. However, the governments still play an important role in the convergence of supranational and subnational interests.²¹ According to neofunctionalism, egoism is the main engine behind regional integration. Haas argued that national groups with their own specific interests and aims encourage the process of community formation. The supranational actors expand the mandate of their own institutions to have more influence in community affairs.²²

Functional spillover, one of the main concepts of neofunctionalism, is the idea that if states integrate one sector of their economies, technical pressure will push for the integration of other sectors. Because modern industrial economies are made up of interdependent parts, it is not impossible to isolate one part from the rest. Political spillover is another process that involves the build-up of political pressure in favour of further integration within the states involved.²³ Once an area of the economy is integrated, the interest groups operating in that sector exert pressure at the community level, on the organization charged with running their sector. Upgrading common interests is the third element in neofunctionalism. It is an institutionalized swapping mechanism to resolve the

²¹ Ibid., pp. 21-28.

²² Ernst B. Haas, *The Uniting of Europe*, Stanford: Stanford University Press, 1968, p.xxxiv.

²³ Ibid., pp. 291-313.

deadlock caused by member states facing significant difficulties in arriving at a common policy.

The 1965 crisis²⁴ revealed the limitations of neofunctionalism. Neofunctionalists, however, accepted most of the criticism and reassessed their framework rather than abandon it. Haas and Lindeberg argued that they had neglected the role of leadership, a strange conclusion when the emphasis on the role of the Commission is borne in mind.²⁵ They underestimated the strength of nationalism. Stuart Holland also found misidentification of the nature of the economic interests. According to him, different governments will face different combinations of pressure because of differences in the structures of their economies. They were criticized for failing to take account of cyclical changes of economic conditions and other international factors. These limitations cause neofunctionalism to fail to explain the linkage between welfare maximization and regional integration, to examine economic transaction and to specify conditions under which subnational demands for integration become accepted at the national level.²⁶

Among the alleged deficiencies of functionalism and neofunctionalism are that it is difficult to separate the economic and social tasks from the political tasks and the road to political integration lies in political will, rather than functional integration in the economic social sectors.²⁷

²⁴ It is also called De Gaulle phenomenon, see Stephen George, 1985, pp.9-11.

²⁵ Ibid., pp. 28-34.

²⁶ Ibid.

²⁷ Walter Mattli, 1999, pp.21-28.

Intergovernmentalism is an alternative approach to these theories; it argues that integration is mainly the result of a series of bargaining among political leaders.²⁸ Intergovernmentalism assigns a central role to heads of states. In the view of intergovernmentalism, regional integration represents a series of bargains among political leaders of the major nations in a region.²⁹ The emphasis on power-related variables does enable intergovernmentalists to explain important features of regional agreements that elude neofunctionalists. According to this view, bargaining tends to converge towards the lowest common denominator of large state interests, because big states exercise a veto over fundamental changes in the rules of integration.

However, by focusing solely on episodes of interstate bargains, the theory cuts into on-going economic, legal, and social processes and presents a picture of integration that ignores or discounts defining events that precede or follow interstate bargains. As a theory that explains the varying course of integration in terms of shifting preferences, it offers little to assess the theory's validity.³⁰

Constructivism

Constructivism has been given more attention since the 1980s. Constructivism stresses the importance of culture, ideas, ideology and socialization. Constructivism rests on the basic assumption that the international system is socially constructed. Ideology, history and socialization are important matters to define policy preferences.

²⁸ For other theoretical approaches such as liberal intergovernmentalism, new institutionalism, and multilevel governance, see Stephen George, 1985, pp.46-51.

²⁹ Walter Mattli, 1999, p.28.

³⁰ Ibid.

Constructivists contend that not only are identities and interests of actors socially constructed, but also that they must share the stage with a whole host of other ideational factors emanating from people as cultural beings. Constructivism rests on an irreducible inter-subjective dimension of human action. No general theory of the social construction of reality is available to be borrowed from other fields and international relations constructivists have not as yet managed to formulate a full-fledged theory of their own. As a result, constructivism remains more of a philosophically and theoretically informed perspective on, and approach to the empirical study of international relations.³¹ However, the constructivist approach has at least provided fruitful insights ignored by traditional approaches.³² The constructivist approach has tried to draw upon these insights by introducing new concepts to international relations theory. Constructivism is a structural theory of the international system that makes the following core claims: (1) states are the principal units of analysis for international political theory; (2) the key structures in the state system are intersubjective, rather than material; (3) state identities and interests are an important part constructed by these social structures, rather than given exogenously to the system by human nature or domestic politics.³³ States have a corporate identity and social identity. While the former is the intrinsic, self-organizing qualities that constitute actor individuality, the latter can be found in relation to other states in international society. Upon the fact that states may have different identities and interests, relations among states can be cooperative or conflictive. States define their interests in the process

³¹ Ruggie, J. 'What Makes the World Hang Together? Neo-utilitarianism and the Social Constructivist Challenge', *International Organization*, Vol. 52, No.4, Autumn 1998.

³² The constructivist's critique of neorealists and neoliberalists concerns not what these scholars do and say but what they ignore. Jeffrey T. Checkel, 'The Constructivist Turn in International Relations Theory', *World Politics* Vol. 50, January 1998, p.324.

³³ Alexander Wendt, 'Collective Identity Formation and the International State,' *American Political Science Review*, Vol.88, June 1994, p.385.

of defining the social situations in which they participate. For example, the Cold War constructed a social structure wherein the two principals identified each other as enemies and defined their national interests regarding each other in antagonistic terms. International structure consists of social relationships which give meaning to material capabilities. Institutions and states are based on mutual relationships. Institutions embody the constitutive and regulative norms and rules of international interaction. However, institutions exist because states produce and reproduce them through practice. Constructivism suggests that state identities, interests and relationships with other states can be altered at the systemic level through institutionally mediated interactions.³⁴ Constructivists pay attention to institutions that exist at the fundamental level of international society, such as international law, diplomacy, and sovereignty. Organizations such as ASEAN are superficial indications of these deeper institutional structures. Constructivist analysis of international relations focuses on understanding the social structures governing state relationships.

³⁴ Ibid., pp.398-399.

2.2.2 Economic Approaches to Integration

Globalism, Regionalism and Bilateralism

Traditional economic theories have mentioned two main trends in the world. One is about multilateralism that have been pursued through GATT, a series of trade rounds, and more recently WTO. Another concern is about regional integration or preferential trading arrangements. There are still contending perspectives on the relationship between multilateralism and regionalism. The advocates of multilateralism argue that a multilateral process such as the World Trade Organization (WTO) is essential to achieve free international trade. Despite anticipating mutual benefits among members through less or no trade barriers, FTAs are based on discrimination against nonmembers. Due to the inherent discriminatory elements, proponents of the WTO consider FTAs as stumbling blocks towards multilateral trade negotiation in the context of the WTO. Meanwhile, the proponents of regionalism argue that regional arrangements through free trade agreements (FTAs) promote freer trade, which will eventually culminate in multilateralism. For this reason, FTAs or regionalism can be seen as a stepping stone towards world free trade. Indeed, considering the faster and easier process of FTAs (either bilateral or regional), FTAs can be generalized in the multilateral system and could create incentives for other regions and individual countries to catch up with the global process.

Article 24 of the GATT/WTO basically sanctions the formation of regional agreements with some limitations. According to the article, Regional Integration

Agreements should not on the whole raise protection against excluded countries; should reduce internal tariffs to zero and remove other restrictive regulations of commerce other than those justified by other GATT articles; and cover substantially all trade.³⁵ Even though the GATT and WTO have not effectively monitored the implementation of regional and bilateral trade agreements, it is widely agreed that major regional pacts such as the European Union and North American Free Trade Agreements meet those criteria. However, given the nature of trade diversion of the RTAs it often leads to the formation of new interest groups that are ultimately against multilateralism and intra-regional protectionism. The World Bank said that preferences that are inherent in any RTA tend to divert trade away from poorer countries.³⁶

In the same context, the relationship between bilateralism and regional integration has not been clearly tested. In Southeast Asia, Singapore actively pursued the bilateral trade agreements with non-ASEAN countries such as Japan, the US, and New Zealand. The most recent Free Trade Agreement between Singapore and the US include not only traditional trade issues but also the protection of intellectual property, the inclusion of e-commerce and information and communication technology services, advanced rules of origin and customs cooperation. While Singapore is willing and ready to accept a number of conditions in the context of bilateral pacts, other ASEAN members especially less developed members still are not ready and not willing to accept such bilateral accords. Given the diversity of levels of development with slow implementation of AFTA, the move by Singapore may create hurdles for regional trade pacts.

³⁵ See Appendix 4. The Article XXIV of the GATT/WTO.

³⁶ The World Bank, *Global Economic Prospects*, 2003

The classic model of economic integration was developed by Bela Balassa. For Balassa, economic integration refers to the creation of formal cooperation between states and the progressive movement towards a free trade area, a customs union, a common market, monetary union and finally total economic integration.³⁷ In the staged model of Balassa, the integration of economies at a certain level i.e. a free trade area would create functional pressure toward forming the next step of integration – the customs union. A customs union could then generate the deepening of integration such as creating a common market.³⁸ However, not surprisingly, this model is empirically relevant only to the European case. Based on the model of Balassa, the main types of economic integration schemes are summarized in Figure 2.1.

³⁷ Walter Mattli, 1999, pp.32-34.

³⁸ Free Trade Area refers to the status that eliminates tariff and nontariff trade barriers but do not harmonize external barriers. Customs unions remove internal barriers with a common external tariff among member countries. Common market can be defined as customs unions in which barriers to the mobility of labour and capital are eliminated. Members of group also may look for to establish a common currency and common economic policies, which form an economic and monetary union, finally states can form single state in a confederation. Robert Z. Lawrence, *Regionalism, Multilateralism, and Deeper Integration*, Washington, D.C.; The Brookings Institution, 1996, pp.21-22.

Table 2.1: Main Types of International Economic Integration

| | Free Trade Area | Customs Union | Common Market | Economic Union | Total Political Union |
|--|-----------------|---------------|---------------|----------------|-----------------------|
| Removal of tariffs and quotas | √ | √ | √ | √ | √ |
| Common external tariff | | √ | √ | √ | √ |
| Factor mobility | | | √ | √ | √ |
| Harmonization of economic policies | | | | √ | √ |
| Total unification of economic policies | | | | | √ |

Customs Union Theory

A customs union can be defined as an arrangement in which members have free trade internally and a common external tariff.³⁹ This concept is related to a free trade area which has non-common tariffs against non-members. The creation of a customs union may have two effects on trade. By eliminating the internal trade barriers in a custom union, this will lead to more trade among the partners through cheaper imports from more efficient industries in a member state of the union and this trade creation should contribute to the general welfare. On the other hand, there will be a trade diversion effect. If third countries were the lowest-cost suppliers prior to the establishment of a custom union, the imposition of the common tariff puts these suppliers at a competitive

³⁹ A perfect customs union requires the following conditions: 1) the complete elimination of tariffs as between the member territories 2) the establishment of a uniform tariff on imports from outside the union, and 3) apportionment of customs revenue between the members in accordance with an agreed formula. Jacob Viner, *The Customs Union Issue*, London: Stevens & Sons Limited, 1950, p.5.

disadvantage after the creation of the union. The resulting trade diversion reduces a country's economic welfare and could misallocate global resources. The net welfare effect of a customs union is an empirical question and will depend on the amount of trade created and diverted as well as on difference in unit costs and on transportation costs. The effects of trade diversion could be small if the members of the union have extensive trade with each other and low common tariff imports from nonmember countries. Corden Warner examines these relations between trade creation and diversion and welfare using new concepts. He argues that the cost-reduction effect surpasses the trade suppression effect.⁴⁰

However, according to these explanations, only global trade can be the suitable regime to avoid all trade diversions. Some unilateral tariff elimination can bring greater trade creation without giving rise to trade diversions. To overcome such limitations, they concern two motives for the creation of customs unions. The first motive is strategic and includes considerations of the impact of integration on the terms of trade. If non-member countries produce competitive goods with high price-elasticities of demand, then the price of exports may fall after the creation of a common external tariff. It compensates the union for welfare loss due to trade diversion. The second motive concerns changed preferences. Constraints of world trade agreement on using of first best domestic policies might lead nations that have nationalist aspirations in certain fields to opt for customs

⁴⁰ The cost-reduction effect refers to a reduction in average unit production costs as domestic output expands following the creation of an economic union. The trade suppression effect refers to the replacement of cheaper imports from non-member countries by domestic production under economies of scale. Warner, M Corden, 'Economies of scale and Customs Union Theory', *Journal of Political Economy* Vol. 80, 1972, pp.465-475.

union, because customs unions comparatively are compatible with such a framework.⁴¹ However, customs union theory fails to explain customs in advanced societies with highly competitive industries.

Optimal Currency Area Theory

A currency area means an area which adopts a fixed exchanged rate regime or a single currency. Optimality is defined in terms of the ability of an area to achieve both internal balance (full employment and low inflation) and external balance (payments equilibrium) in the least costly way, that is, without interference from monetary and fiscal policies. An optimal currency area has been implicitly defined by Mundell as a currency area for which the costs of waiving the exchange rate as an internal instrument of adjustment are outweighed by the benefits of adopting a single currency or a fixed exchange rate regime.⁴² More specifically, it means a geographic area within which labour is sufficiently mobile to permit speedy adjustments to payment imbalances and regional unemployment, so that exchange rates can be fixed and a common currency can be adopted.

The concept of OCA has been strongly related to the arguments on fixed and flexible exchange rates. In traditional economic theory, a flexible exchange rate is adapted by a country afflicted with price and wage rigidities in order to mainly maintain both internal and external balances. Because under a flexible exchange rate, the induced

⁴¹ See Harry G. Johnson, 'An Economic Theory of protectionism, Tariff Bargaining, and the Formation of Customs Unions', *Ibid.*, Vol.73, 1965, pp.256-283.

⁴² Ronald I. Mckinnon, 'Optimal Currency Area', *American Economic Review* Vol.53, September, 1963, pp.717-725.

changes in the terms of trade and real wages would eliminate payment imbalances without much of the burden of real adjustments such as unemployment and inflation.⁴³ On the contrary, the optimal currency area theory assumes that fixed exchange rates (or a currency area) may reconcile internal and external balances more efficiently than a flexible rates if a country is highly integrated within a region. The creation of a currency area is efficient if a region has high mobility of its factors of production. In this context, they argue that more open economies are better candidates for a currency area. The openness of a region is measured by the ratio of tradable to non-tradable goods. The effectiveness of the exchange rate might decrease with such openness, as prices and wages will neutralize the change in the exchange rate more quickly. Independent internal monetary and fiscal policies are desirable in countries with a small external trade connection, as there is no reason to believe that they should experience the business cycle in unison.⁴⁴ In short, the optimal monetary arrangement of an internally open but externally relatively closed economy would be to peg its currency to the body of internally traded goods for price stability, and adopt externally flexible exchange rates for external balance. In such an environment, nations could save their residents from incurring foreign exchange risks and currency conversion costs by joining a monetary union with a common currency.

Not surprisingly, there are costs and benefits in adopting an optimal currency area. The main cost is the loss of monetary independence. A small and open economy may be more willing to participate in a currency union because it does not have much freedom to

⁴³ Dainels and Vanhooose (eds.), Dvid, *International Monetary and Financial Economics*, London: South-Western College Publishing, 1999, pp. 414-445.

⁴⁴ Ibid.

choose its mix of inflation and unemployment in the first place. A continuously floating exchange rate would facilitate this independence. On the other hand, in economies which are highly integrated in commodity trade, fluctuations in their private sectors are naturally highly correlated. Therefore, there is less need for independent monetary policies within the bloc and a strong case to be made for imposing the uniform discipline that a common currency system would provide. Independent national policies are neither necessary nor desirable if exchange rates can upset carefully negotiated tariff, tax, and pricing policies. On the other hand, the great usefulness of money benefits the optimal currency area. They stress the benefits deriving from the elimination of transaction costs and a better performance of money as a medium of exchange and as a unit of account. Further it might eliminate the risks of future exchange rate fluctuations, and maximize the gains from trade specialization. However, there are some unsolved problems such as asymmetric information and unequal distribution of economic capabilities among potential members. They use game theory to refine and extend the analysis.⁴⁵

Economic studies mostly have focused on the welfare implications of regional integration but place little emphasis on the political conditions that play a significant role for its implementation. In the economic field, economists look primarily at market relationships among goods and factors of production within a region and exclude the relevance of institutional and political forces. They are interested in the welfare effects of integration. However, by a narrow focus on markets, these theories overlook a key aspect of integration, namely the provision of common rules, regulations, and policies that govern regional economic areas. The failure to consider this institutional dimension

⁴⁵ Walter Mattli, 1999, pp.34-38.

renders economic theories of integration ill equipped to tackle questions that pertain to the deepening and broadening of integration. Although there is a rational in their explanation is rational, it fails to explain the process of deepening and enlarging communities. In addition, they overlook institutional factors such as different regulatory policies.⁴⁶ What these theories miss are collective action problems, willingness of potential providers, and effects of regional integration on outsiders.

2.3 Theoretical Approach to Regional Cooperation in Southeast Asia

Some scholars of regional integration, such as Fernando⁴⁷ and Gills⁴⁸ argue that the nature of regional integration in Europe and Southeast Asia is not much different. Fernando sheds light on the historical backgrounds of both cases arguing that the security concern was the main factor for the birth of regionalism in the two regions. In the case of Europe, it was the beginning of the Cold War that followed the end of the Second World War with weak economies of West Europe and fear of the Soviet Union expansion. Similarly in Southeast Asia, relevant factors were the Sabah dispute between Malaysia and the Philippines, the confrontation between Indonesia and Malaysia, the separation of Singapore from Malaysia, the Vietnam War and the Cultural Revolution in China with its potential effects on the region. Currently ASEAN and the European Union share the common goal of regional cooperation not only to improve economic performance but

⁴⁶ Ibid.

⁴⁷ Fernando Rodrigo, 'Regional Co-operation versus Regional integration: Are ASEAN and the European Union so different?' UMESP Discussion Paper, No.3, University of Malaya European Studies Programme, 2001.

⁴⁸ Gills, B.K, East Asian Development in World Historical Perspective: Ascent and Descent, paper presented to International Political Science Association at the XVII World Congress, August 1997, Seoul

also to strengthen their regional identity. It has also been argued that the economic models in the two regions are not much different from one another. Institutional factors that are commonly described as a European characteristic can be found in the Asian model, as the network elements of the Asian model are also present in the European one.

There is little disagreement that political and security issues have been the most common focus in the studies of the region in the early 1990s. To explain regional cooperation and security in Southeast Asia, realism is the oldest perspective. Realist perspectives disagree with the liberal or neoliberal explanation that growing economic interdependence could contribute to a stable regional order. Realists argue that although the need for economic cooperation was one of the aims of ASEAN, economic cooperation has been limited and disappointing in terms of expectations.⁴⁹ Indeed, against the neoliberal institutionalism, they argue that multilateralism has failed to overtake into a superior position of state interest. Multilateral institutions could contribute to mitigate state behaviour but could hardly transform into an international system. The provisions of regional institutions have been ineffective. The emphasis on national interests has always been primary due to fear of the potential dominance of powerful states. Based on the anarchical international nature and balance of power, realists argue that ASEAN remains as an intergovernmental entity rather than a community with supranational authority and shared cultural traditions.⁵⁰ In the realists' viewpoint, political cooperation is possible only with external threats and its progress is inherently limited. Hence, the creation and achievements of ASEAN was possible because of the

⁴⁹ Michael Leifer, *ASEAN and the Security of Southeast Asia*, London: Routledge, 1989, p.141.

⁵⁰ *Ibid.*, p.153.

security interests of the states. The Vietnam War was the main cause for the creation and cooperation among ASEAN members. In response to Vietnam's invasion of Cambodia, which was seen also as a threat to the members especially Thailand, the members cooperated with each other and even with China in order to prevent Vietnam from dominating Indochina.⁵¹

Despite such cooperation, fundamentally the member states had acted based on their own national interests. The common interests had been seen as temporary rather than permanent. Domestic factors, such as independence and political weakness have also been important motivations for regional cooperation. In this view, the creation of ASEAN was based on each member's desire to remain independent.

To understand regional cooperation in Southeast Asia, more attention should be paid on other factors such as ideology, history, and culture. The failure of the Association of Southeast Asia to attract other countries, in particular Indonesia, was understood to be caused by the ideological difference arising from Indonesia's pro-communist stance. The change of regime to Suharto's anticommunist and pro-Western policies in 1966 made the creation of ASEAN possible. Historical experience also played an important role. Indonesia regarded China rather than Vietnam as the main external threat because of its colonial experience that made it more suspicious of external powers.⁵² Singapore's perception and actual relationship have not been determined solely by the geographic proximity and material factors but more often by its confrontation with its neighboring

⁵¹ Sorpong Peou, 'Realism and constructivism in Southeast Asian security studies today: a review essay', *The Pacific Review*, Vol.15, No.1, 2002, pp. 125-130.

⁵² Michael Leifer, 1989, p.91.

countries in particular with Malaysia.

Constructivism has incorporated the concept of balance of power approach but it is necessary only in the short term in which multilateralism could help it by providing norms of restraint and confidence building. In the long term, eventually multilateralism may replace the balance of power politics. Acharya has adopted and developed the concept of community.⁵³ The concept of a security community refers to member states which rule out war and the use of force by member states in settling disputes with other

⁵³ Security Communities and other frameworks of security cooperation

Security regimes:

- Principles, rules and norms that restrain the behavior states on a reciprocal basis.
- Competitive arms acquisitions and contingency planning usually continue within the regime, although specific regimes might be created to limit the spread of weapons and military capabilities.
- The absence of war within the community may be due to short-term factors and consideration such as the economic and political weakness of actors otherwise prone to violence or to the existence of a balance of power or mutual deterrence situation. In either case, the interests of the action in peace are not fundamental, unambiguous or long-term in nature.

Security community

- Strict and observed norms concerning non-use of force; no competitive arms acquisitions and contingency planning against each other within the grouping.
- Institutions and process (formal or informal) for the pacific settlement of disputes.
- Long-term prospects for war avoidance.
- Significant functional cooperation and integration.
- A sense of collective identity.

Collective defence:

- Common perception of external threat(s) among or by the members of the community; such a threat might be another state or states within the region or an extra-regional power, but not from a member.
- An exclusionary arrangement of like-minded states.
- Reciprocal obligation of assistance during military contingencies.
- Significant military interoperability and integration.
- The conditions of a security community may or may not exist among the members.

Collective security

- Prior agreement on the willingness of all parties to participate in the collective punishment of aggression against any member state.
- No prior identification of enemy or threat
- No expectation of and requirement for economic or other functional cooperation.
- A collective physical capacity to punish aggression.

Amitav Acharya, *Constructing a Security Community in Southeast Asia*, London: Routledge, 2001, pp.20-21.

members of the group based on long-term developed habits of peaceful interaction.⁵⁴ He defined ASEAN by 1990s as a nascent security community.⁵⁵ ASEAN has played a role in moderating intra-regional conflicts and significantly reducing the likelihood of war. Two factors that are norm and identity have contributed to the success of ASEAN. The first factor is ASEAN's norm that includes non-interference, non-use of force, regional autonomy, and avoidance of collective defense. The second is the practice of the ASEAN Way which is characterized by compromise, consensus building, ambiguity, avoidance of strict reciprocity, and rejection of hard legalization. The norms of non-interference and non-use of force are evident in ASEAN's response to Vietnam's invasion of Cambodia. The member states of ASEAN negotiated with Vietnam rather than formed a military alliance against it. The policy of constructive engagement that allowed full admission of Burma was also consistent with the norm of non-interference by members and by other external regional powers. Instead of punishing or isolating Burma amidst pressure from Western powers, ASEAN members looked for a peaceful solution based on the norm of non-use of force.⁵⁶ The collective identity contributed to the building of a security community in the region. There have been shared traditions and similarities that were disrupted by colonial rule. However, given the cultural and social diversity in the region, the limitation of cultural determinism was recognized as Acharya argues that ASEAN's

⁵⁴ Ibid., p.1.

⁵⁵ Three phases of in the development of security community were identified. The nascent phase contains a number of triggering mechanisms including threat perceptions, expected trade benefits, shared identity and organizational emulation. The ascendant phase is characterized by tighter military coordination, reduced fears on the potential threat, and the starting of cognitive transition towards intersubjective process and collective identities. The mature phase is marked by deeper institutionalization, supranationalism, a mutual trust, and low or no expectation of conflicts. Ibid., pp.34-35.

⁵⁶ Sorpong Peou, 2002, pp.131-132.

norm was not only created by culture, but also it created the culture.⁵⁷ The ASEAN Way refers not only to principles of agreement among members, but also the result of a long-term process of interaction and adjustment. Despite its merits, the norms and identity of the region remain elusive and the impact of these factors is difficult to assess as ASEAN expands itself.

From the viewpoint of intergovernmentalism, regional cooperation even including AFTA has been developed through a series of intergovernmental bargaining without supranational authority. Thus, national interests still take priority over the regional interest. Along with the progress of economic cooperation, there should be the mechanism to coordinate potential conflicts to promise equal benefits. However, it does not explain well the process of ASEAN's enlargement despite strong diplomatic pressure from the West and with no specific benefits to the existing members. Despite priority of national interest over the regional one, no critical conflicts erupted between members since the establishment of ASEAN.

Traditional economic theories on regional integration such as custom unions and optimal currency theory could only provide part explanation on the evolution of regional cooperation in the region. Southeast Asia has shown different patterns of regional integration. Unlike the arguments of federalist and functionalist arguments which stress the supranational transfer of powers and residual and subsidiary national competences remaining at state level, ASEAN has developed the 'ASEAN Way' which is fully

⁵⁷ Amitav Acharya, *The Quest for Identity: International Relations of Southeast Asia*, Singapore: Oxford University Press, 2000, p. 72.

compatible with national sovereignty.⁵⁸ The founding member states had recorded rapid economic development since the 1970s in which ASEAN provided the stable economic environment by reducing serious internal conflicts. It, however, should be noted that their economic growth had not been much related to efforts to enhance formal economic cooperation in the region. The founding member states adopted the anti-communist stance and market capitalism with openness to the world economy. At the state level, economic factors have been a significant consideration in foreign policy. In particular, the attraction of foreign capital through investment and credit has been the main task. The dependence theorists once criticized the region's high dependence on Western powers, especially the U.S.

Since the Bali Summit in 1976 that stressed on economic cooperation, several economic cooperation schemes were pursued such as the ASEAN industry projection plan, the ASEAN industry cooperation plan and the Preferential Trading Arrangement, which accorded tariff preferences for trade among ASEAN economies. Ten years later, an Enhanced PTA Programme was adopted at the Third ASEAN Summit in Manila further increasing intra-ASEAN trade. It, however, failed due to heavy reliance on administrative protection and opposition by industrial and agricultural vested interests.⁵⁹ Despite such cooperation, economic cooperation remained at a symbolic level so that intra-regional trade and investment were limited. Even the economic consideration in the

⁵⁸ In comparison to the EU, Asian concept of sovereignty is much more territorially contingent. Consequently, regionalism becomes a tool for the consolidation of state-power. Richard Higgott, 'The International Political Economy of Regionalism', William D. Coleman and Geoffrey R.D. Underhill eds., *Regionalism and Global Economic Integration: Europe, Asia and the Americas*, London: Routledge, 1998 pp.52-53.

⁵⁹ Richard E. Baldwin, 'The Causes of Regionalism', *The World Economy*, Vol. 20, 1999, p.873.

first ASEAN Summit was believed to be in response to events in Indochina. Given the divergences in economic policies and levels of development and priority on the political issues, from the early days of ASEAN economic cooperation had achieved little success. The relationship between members was marked by rivalry rather than complementarities in competitions for foreign direct investment. Hence, most of the research was focused on the individual state's economic growth and policies based on trade and FDI oriented approach and rather than on regional issues.

Even though economic cooperation was never neglected in the process of regional integration, it had not been the main focus of ASEAN which still has a limited degree of free trade among members. Recent developments such as the implementation of AFTA were caused by external factors such as the emergence of regional trade blocs and multilateral trade talk rather than by spillover effects.

Given the slowness of the AFTA implementation, there are pessimistic prospects for the future of AFTA. The creation of AFTA could be premature considering the low volume of intra-regional trade, which is a precondition for the success of regional integration.⁶⁰ Moreover, the neoliberalists with an assumption that growing economic interdependence between countries is a necessary pre-condition for successful cooperation predict that AFTA is unlikely to succeed. However, those perspectives ignore global and domestic factors that also are important in the process of regional integration. In contrast to trade-centered explanations, there was optimism that AFTA

⁶⁰ For instance, intra-ASEAN trade in 1985 was 18.6 per cent of the total trade of the six core ASEAN members, and then it decreased to 17.4 per cent in 1990 although it rose to about 20 per cent in 1995. Jose L. Tongzon, *The Economies of Southeast Asia*, Cheltenham: Edward Elgar, 2002, p.50.

could help members attract FDI and counter the threats of the potential emergence of trade blocs in Europe and North America due to continued economic growth and rapid liberalization despite the slowness of the AFTA. With newly emerging markets, particularly in China since the 1990s, it is expected that AFTA could play a role to attract FDI through the creation of a single regional market. On this account, AFTA is regarded as an instrument that could avoid investment diversion rather than as machinery for trade creation as in neoclassical approaches.⁶¹ However, it failed to explain the fact that AFTA is less favourable to foreign investors than domestic investors in the region. While the full market access of the latter is scheduled between 2003 and 2010, the former are to get these benefits only by 2020. Such a discrimination policy implied that ASEAN members are more concerned about domestic interests.⁶² In this sense, some scholars argue that the growing influence of reform-minded domestic business interest and the change of national elites from nationalists to liberalist who favored economic liberalization.⁶³ In fact, however, there have been gaps between member's liberal policies and they have kept the mixed policies. Moreover, this perspective is not sufficient to explain why AFTA did not engage fully in unilateral or multilateral liberalization and why AFTA favored domestic investors more.

The launching of AFTA following the change of the world political economy after the end of the Cold War stimulated the discussion of economic cooperation and even economic integration in the region. The financial and economic crisis in 1978~1988

⁶¹ Perti, P., 'AFTA and the Global Track', *ASEAN Economic Bulletin*, Vol.14, No.2, pp.190~201.

⁶² Menon, J., 'the expansion of AFTA: Widening and Deepening', *Asia Pacific Economic Literature*, Vol.12, No.2, pp.10-12.

⁶³ Richard Stubbs, 'Signing on to Liberalization: AFTA and the politics of Regional Economic Cooperation', *The Pacific Review*, Vol.13, No. 2, 2000, pp. 297~318.

hit most ASEAN member states and other countries in East Asia such as South Korea. It revealed the weakness and incapacity of ASEAN to handle regional crisis as a united regional institution. The economic crisis raised questions on the eventual role and goal of regional institutions. Indeed, the need for new regional institutions was broadly recognized. The idea of an Asia Monetary Fund aimed to enhance cooperation in the financial field. It also expanded the scope of regional cooperation to East Asia including Japan, China, and South Korea. Most significant is the Chiang Mai Initiative in 2000, which planned to establish the system of currency swaps among ASEAN and Japan, China, and South Korea. Now ASEAN has agreed to establish the FTA with China by 2010, seeking similar FTAs with Japan as well as South Korea.

2.4 Conclusion

As seen above, there have been various and numerous academic approaches to regional integration. Central to these analyses has been the search for conceptually refined paradigms and interpretations either on specific policy actors and processes, or on the dynamic institutional configuration of the larger management system. Research on regional integration is multi-dimensional and interdisciplinary work. There has been no grand theory that can provide a complete or comprehensive explanation of regional integration in Southeast Asia. Furthermore, divided fields such as political sciences, economics, and other social science disciplines make it difficult to formalize comprehensive approaches. In particular, such criticism has been directed towards research, which relies heavily upon factor analysis in the development of inductive theory. In other words, the absence of a deductive theoretical work is not likely to provide an

adequate basis for predictive theory.⁶⁴ However this thesis will also not be free from such limitations. Keeping inherent theoretical weakness in mind, it will investigate the logic of regional integration in Southeast Asia.

In this study, regarding basic questions, as referred to in Chapter 1, various theoretical concepts and perspectives will be applied to understand and explain regional cooperation and regional integration in the region. As seen above, the IPE perspective will be used to understand major developments of ASEAN. For instance, realist perspective explains the background for the creation of ASEAN and its evolution in the Cold War era in which security issues dominated. Even the realistic assumption that national interest will never be undermined by regional cooperation could give a rational explanation for the implementation of AFTA and other forms of regional economic cooperation. However, reluctance to hand over sovereignty to supranational authority could be seen as a main hurdle for further economic integration. Various economic concepts and explanations focused on FTA, Custom Unions, and Monetary Union will assess the extent of regional integration and accompanying challenges. The potential role of the ASEAN Way such as non-interference policy will be investigated while considering economic theory and the constructivist perspective. Economic integration theories mostly point out that the tradition of ASEAN Way will be contradictory to further integration, while constructivist perspectives consider it an important factor to strengthen regional identity and community. Thus, the understanding of regional

⁶⁴ Oran R. Young, "Professor Russett, Industrious Tailor to Naked Emperor." *World Politics XXI*, April 1969, pp.87-94.

cooperation, which is being pursued towards regional integration, could be reached by applying multi dimensional approaches.

In the following chapter, in order to understand the background of regional cooperation or integration in Southeast Asia, we will review the evolution of regional integration and characterize it mainly through the case of ASEAN.