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Enlargement to include Formerly Centrally Planned Economies:  
ASEAN and the EU Compared.

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During the 1990s both the Association of Southeast Asian Nations (ASEAN) and the European Union (EU) have been preparing for enlargement to include formerly centrally planned economies. This paper analyses the economic consequences from a comparative perspective, and concludes with an assessment of the implications of enlargement for ASEAN-EU economic relations.

In both cases the new members are significantly poorer than the pre-existing members, with a more rural economy, run-down infrastructure and often with less well established institutional and political regimes. Integration questions are generally more pressing for the EU with its more tightly knit economic and political structure, and the budgetary implications of enlargement are substantial. The income gap is not so large in Southeast Asia, and ASEAN is a much looser organization than the EU. Integration considerations are, however, not absent from ASEAN whose tradition of consensus could be threatened by enlargement to include members with differing political histories, institutions and aspirations - a point underlined by the last minute failure of Cambodia to be admitted after the July 1997 coup.<sup>1</sup>

The main parts of the paper will focus on two differences between the EU and ASEAN cases. First, East Asian economies in transition from central planning have been more dynamic than East European transition economies and did not suffer the major income losses experienced by eastern European countries during the first half of the 1990s. The second section discusses differences between Asian and European models of transition, and analyses the implications for ASEAN.

The second difference to be analysed is the contrast between the eastern European countries joining their main market and the Indochina countries joining a group of competing producers. Although the eastern European economies are industrialized they are potentially complementary to the existing EU countries, with the opportunity for them to specialize in agricultural products, textiles and some standardized industrial goods if they become fully integrated into the EU. In contrast, the Indochina countries and Myanmar are actual or potential competitors of the original ASEAN members, supplying food, raw materials and labour-intensive manufactures to markets outside Southeast Asia.

The speed and nature of enlargement of the two regional organizations will be determined by how the above issues are settled. The final section of the paper draws some conclusions,

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<sup>1</sup> ASEAN was founded in 1967 by Indonesia, Malaysia, the Philippines, Singapore and Thailand. Brunei joined in 1984, but with a population of only a third of a million and high per capita income its accession required little adjustment. Vietnam joined in July 1995, and Laos and Myanmar in July 1997, when Cambodia was also scheduled to become a member but its accession was postponed. SEA-10 refers to all of the above countries, and is widely believed to represent ASEAN's geographical limits as a southeast Asian organization. Pomfret (1996) reviews ASEAN's evolution and prospects.

and relates the outcomes to prospects for the future development of ASEAN-EU economic relations. A key issue is the uncertainty about where exactly comparative advantage lies in economies which were characterized by gross resource misallocation until recently. The shift to world prices implied by full membership of the EU or ASEAN could lead to trade surges as demand for previously repressed imports booms or previously unidentified areas of comparative advantage are exploited.

## **1. Enlarging ASEAN and the EU**

The evolution of the EU and of ASEAN up to the end of the 1980s is well-known. The EU had developed a much deeper economic integration with a customs union and a high degree of factor mobility, plus common policies towards areas such as agriculture.

ASEAN meanwhile was a much looser organization, whose initiatives towards establishing internal free trade or common policies had hardly progressed, but which had been a force for the regional stability underpinning its members' rapid growth. The EU had expanded from six to nine members in the 1970s and then to twelve in the 1980s (and to fifteen in 1995), reaching close to its natural limit of European market-oriented economies.<sup>2</sup> ASEAN had expanded from five to six members, but it too represented the natural limit of market-oriented economies in southeast Asia in the 1980s.

The unexpectedly sudden collapse of Communism in Europe and transition from central planning to market-based economies ushered in a new set of applicants for EU membership in the 1990s. The Central and East European economies saw the EU as an attractive partner for political as well as economic reasons, reaffirming their historic role as Europeans and providing a seal of approval for the adoption of democratic political systems. A similar change happened in southeast Asia, as Vietnam, Cambodia, Laos and Myanmar shifted from earlier antagonism towards ASEAN to a desire for membership. As in Europe, political considerations played a role as Vietnam no longer saw the ASEAN countries as members of a foreign-led anti-Communist alliance, but rather as natural allies against a resurgent China, and as long-isolated regimes in Cambodia and Myanmar sought international respectability. Although the political dimensions are important, this paper will focus on the economic consequences of enlarging the EU and ASEAN to include economies in transition from central planning.

What is difficult to ignore in any comparison is the future limits of the EU, or just how many of the transition economies will join, and when. In the remainder of the paper it will be assumed that the likely pool of potential members contains Poland, Hungary and the Czech and Slovak Republics, as well as Bulgaria, Romania and Slovenia, and the three Baltic republics (Estonia, Latvia and Lithuania) so that quantitative comparisons are between the current EU15 and a putative EU25; this assumption makes no prediction about what will happen but the argument is little affected by whether the smaller economies, in particular

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<sup>2</sup> Norway, Switzerland, Iceland, Malta and Cyprus remained outside, although they were linked to the EU by varying arrangements.

the last four listed are in or out. The before and after comparison is more straightforward for ASEAN, since of the SEA-10 only Cambodia is not yet an ASEAN member and its accession would not have a major economic impact.

Langhammer (1997b, 4) illustrates some similarities and differences. EU enlargement from 15 to 25 increases population and land area by 28% and 34%, while expanding ASEAN from 6 to 10 increases population by 37% and land area by 47%, ie. about a third larger impact. For current dollar GNP, the comparison is 4% versus 6%; the new members are much poorer than existing members, although the gap is smaller for ASEAN than for the EU. Another interesting comparison is the percentage increase in the agricultural labour force, which would be 55% for the EU and 50% for ASEAN; in both cases the newcomers are more agrarian than the existing members, but the percentage increase is more pronounced for the EU. That is especially important given that agricultural and regional policies account for four-fifths of the EU's budget, so that the eastern expansion is likely to require substantial EU policy reforms.<sup>3</sup>

In sum, the enlargement of the EU is more problematic than ASEAN enlargement. The EU's deeper integration, especially the cost of bringing poor rural countries inside the common agricultural policy, is the major reason for slower progress. Also, the larger economic distance from Brussels to eastern Europe than from ASEAN to Indochina (Fischer et al., 1997; Langhammer, 1997a) may add to the EU's caution.

## **2. Transition in Asia and in Europe**

The contrasts between Asian and European transition economies are often perceived to be strong, although there is less agreement as to which differences are significant. All of the centrally planned economies were strongly influenced by the Soviet model, even though significant differences had emerged in China and Yugoslavia by the time Mao and Tito died. Major reforms were introduced earlier in China than in any of the Central and Eastern European countries (other than Yugoslavia). But the most striking difference between Asian and European transition economies is in post-reform performance. Whereas all the European transition economies suffered a substantial drop in output and almost all of them experienced severe hyperinflation, both China and Vietnam enjoyed accelerated output growth after introducing reforms and China avoided high inflation.

How to explain these differences? The initial response of China specialists was to claim a superior transition strategy based on gradual change rather than the Big Bang adopted in Eastern European countries such as Poland (Chen, Jefferson and Singh, 1992). Although this claim had some superficial plausibility, it did not stand up to wider comparative analysis.

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<sup>3</sup> Tangerman (1997) reports EU Commission lower-bound estimates that expenditure under an unchanged CAP would rise by 12 billion ecu (a 28% increase) if the ten eastern European countries joined. That is well above internal EU limits on spending growth, and any raising of the limits would be unpopular among western European taxpayers and contrary to the EU's WTO commitments for phasing out agricultural subsidies.

China's 1978/9 reforms were in fact dramatic: fundamentally reforming agriculture where over four fifths of the population worked and permitting foreign investment for the first time since 1949. On the other hand, some of the Eastern European countries were cautious about the speed of reforms, and yet all of them experienced the same initial output loss (Blanchard, 1997). Vietnam is difficult to classify, in that it followed a similar agriculture-plus-open-door strategy to China's when it began reforms in 1986, but also adopted a Polish-type strict macro policy when the reform process was revitalized in 1989.

The response of supporters of rapid transition was to explain the differing Asian performance by different initial conditions (Sachs and Woo, 1994). The main advantage of the Asian reformers was their large agricultural sector and readily identifiable comparative advantage in labour-intensive activities. As a general explanation the "initial conditions" view is unconvincing, because some initial conditions (eg. bigger stock of human capital) favoured the European transition economies. On the other hand, central planning was especially flawed in agriculture with its large number of producers operating in varying natural conditions (soil, climate, etc.), and a *fortiori* in rice farming where there were not even major economies of scale to be reaped from collectivization. In industry, it was easier to release rural labour into new manufacturing activities than to change the distorted output mix of an inefficient industrial sector. Both China and Vietnam, and the smaller Indochina countries, benefited from having relatively few state enterprises to deal with; privatization and restructuring were major issues in Eastern Europe and the former USSR because state-owned industrial enterprises accounted for the majority of economic activity, while in China they employed less than a sixth of the workforce.

A third view of the difference between post-reform performance of Asian and European centrally planned economies is that motives varied. In Eastern Europe transition to a market-oriented economy was undertaken by new governments, often with a commitment to the market mechanism and private ownership as the underpinnings of a new political system. In brief, transition was a goal in itself, or at a minimum an important symbol of a new era. In East Asian centrally planned economies, the Communist Party remained in power and was reluctant to even refer to "transition" to a more market-oriented economy, instead preferring convoluted images of renewal or new economic policies or a social market economy. In brief, the emphasis was on continuity. This was also true of some former Soviet republics, but the difference between, say, Turkmenistan or Belarus, which tried to preserve the economic status quo and China or Vietnam is that the leadership in China and Vietnam recognized the necessity of promoting economic growth in order to bolster their own survival chances. A growth strategy may involve a greater role for market mechanisms, but the leadership typically saw this as a price to be paid rather than a benefit in itself.

The recipe for accelerating growth in China or Vietnam was well-known from the experience of the East Asian newly industrialized economies next door. The key component was exporting labour-intensive manufactures, which involved opening up the economy to international trade and also to the transfer of skills needed to produce and sell such products in the high

income countries. Improved agricultural productivity would allow resources (especially labour) to be transferred from agriculture into labour-intensive manufacturing without pressure on food supplies.<sup>4</sup> The entire history of Chinese economic policy since 1978 can be interpreted as working to support this growth strategy (Pomfret, 1997b). To be sure, this led to a more market-oriented economy, but measures necessary to a market economy whose worth in promoting growth was unclear were not undertaken; in the financial sector, for example, the foreign exchange market was gradually opened up but domestic asset markets remained tightly regulated and inefficient in allocating capital.

What are the implications of this analysis for southeast Asia? The five original ASEAN members and the four seeking membership in the 1990s were really not so different thirty years ago (Table 1). Apart from Singapore and Brunei, all of the SEA-10 were low to middle income countries which had been drawn into the global division of labour as primary product exporters and which had not developed substantial manufacturing sectors. In the 1970s and 1980s, with centrally planned economies insulated from world markets, Vietnam, Laos, Cambodia and Myanmar all suffered increasingly from resource misallocation and economic stagnation. The rapid growth of Malaysia, Thailand and Indonesia, especially in the decade up to 1996, opened up a substantial income gap. The gap is, however, less wide than the one opened up between western and eastern Europe during forty years of central planning in the east, and it is more readily bridgeable because the southeast Asian transition economies can follow the growth path of the ASEAN countries.

### **3. Competing and Complementing Countries**

The EU15 are more industrial than the ten eastern European countries wishing to join the EU. Shouldn't this complementarity increase the potential gains from freer trade within an EU25, as the east trades food, raw materials and basic industrial goods in return for more skill-intensive manufactures and services from western Europe? On the other hand, if the new ASEAN members produce identical goods to the old members, will there be no gains from intra-ASEAN trade and increased friction as they compete in overseas export markets?

The complementarity of the EU15 and the European transition countries could lead to considerable trade creation as grains, coal, steel and other eastern European exports gain market share in the enlarged EU at the expense of the EU15's most protected economic activities. If that were the end of the story there would be considerable gains from trade, and little trade diversion as there are few third country supplies to EU "sensitive product" markets that could be diverted. The problem arises from the endogeneity of policy. The highly protected activities are in this situation because they are politically influential and the threat of competition from new EU members will lead them to use their political influence to prevent the

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<sup>4</sup> Agriculture also played other important roles in providing markets, capital and exports. By sharing the benefits with the rural population an agriculture-led strategy coopted a large part of the population in support of the reform process.

trade creation outcome, which benefits consumers and exporters in the EU15 at the expense of specific factors in the protected activities.

What is the likely outcome? In agriculture, the EU is constrained by international commitments entered into under the Uruguay Round. CAP reform will have to precede the accession of major actual or potential food exporters such as Poland or Hungary. That is why the EU's eastern enlargement is turning into a protracted exercise. In other sectors, subsidies or market-sharing arrangements could be made, if the EU were willing to accept further deviations from market-based resource allocation. Past evidence is that the EU has usually been willing to accept such deviations, even if substantial net-welfare-reducing trade diversion is incurred, in order to protect the "sensitive sectors", but it has a cost and may be less acceptable in the future.

Bringing competing countries into ASEAN was much easier. Within southeast Asia, intra-ASEAN trade has always been a small share of ASEAN members' total trade. Apart from flows between Singapore and Malaysia, and to a lesser extent Singapore and Indonesia, intra-ASEAN trade has been of minor importance (Pomfret, 1996). The ASEAN exporters of labour-intensive manufactures compete in Japanese, North American and European markets, but each has a small total market share so rivalry is muted. One important element of ASEAN's evolution has been the recognition that there are benefits from negotiating as a group for market access. Although both effects are limited, enlargement added more to ASEAN's negotiating strength than to competition among ASEAN members for overseas markets.

The ASEAN countries also compete for inward direct foreign investment. Again with respect to export-oriented DFI in labour-intensive activities there is more sense of solidarity in setting conditions, than a sense of competing for limited DFI. This is less true when it comes to DFI catering for the southeast Asian market. The car industry in particular has threatened to become a battleground, but the lines are between national car projects in Malaysia and Indonesia and foreign-badged cars assembled in Thailand; none of the world's major automobile producers is likely to look to Indochina or Myanmar as a location for supplying the region. Thus, with respect to DFI as with trade, ASEAN enlargement posed no major problem, and in the economic environment after the July 1997 enlargement any competition for DFI is further limited by the decline in capital inflows into the whole region.

In sum, although competitive partners seem to have most to gain and competing partners least to gain from a regional trading arrangement, the reality of the EU and ASEAN may be different. Countries with large capacity in what the EU has until now designated as sensitive products pose a serious challenge to the whole edifice of a common market regulated by interventionist sectoral policies. Although the costs of price supports in agriculture and of subsidies and other interventionist measures in coal and steel have been shown to be large, they have so far not blown out the EU budget. A move from EU15 to EU25 with unchanged CAP would blow out the budget. Enlarging ASEAN to include the SEA-10, by contrast, has no major economic hitch. There are special time schedules for the new members to adopt the ASEAN Free Trade Area (AFTA), but AFTA is of minimal economic

significance due to the limited intra-AFTA trade.<sup>5</sup>

#### 4. Conclusions

Despite the similarity of the enlargement issues facing the EU and ASEAN during the 1990s the outcomes are likely to differ substantially. In the short-term ASEAN enlargement has proceeded smoothly (apart from a slight Cambodian hiccup) whereas EU enlargement has not proceeded at all (apart from the German adjustment). Enlargement will consume EU political attention, but will have no economic impact this century. In ASEAN there will be some disputes over intra-ASEAN trade as new members have limited experience with WTO-type obligations and seek exception status in implementing AFTA, but because intra-ASEAN trade will continue to be of minor importance internal trade disputes are unlikely to be major. ASEAN will assume slightly greater weight in international negotiating now that it consists of nine rather than six countries and its total population has increased from 328 million in 1992 to over 470 million in 1997. The larger group will, moreover, remain fairly cohesive in its negotiating aims as, with the exception of the two small states, Brunei and Singapore, the ASEAN countries all want the high income countries to have open markets for labour-intensive manufactures and food and a few other primary products.

In the longer term the outcome is less predictable. Some at least of the eastern European countries are likely to become EU members early in the next century. This will increase EU self-sufficiency in some ASEAN export items and perhaps involve some trade diversion at ASEAN countries' expense. On the other hand, the prospects for enlargement behind high external trade barriers are slim, especially now that agriculture has been reincorporated into the WTO framework for international trade.

In sum, the prospects are positive for increasing EU-ASEAN economic relations. The balance of economic power will clearly favour the EU for the foreseeable future, but the enlargement process is likely to strengthen ASEAN's relative negotiating strength. Since that strength will be used to reinforce liberal tendencies within the EU, there should be a positive outcome for all apart from some protected producers in the EU15.

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<sup>5</sup> AFTA calls for tariffs of 5% or less on intra-ASEAN trade, but does not restrict external trade policies. With free-trading Singapore as a potential entrepot a true free trade area would need to address the trade deflection problem (Pomfret, 1997a, 185-8), but even 5% tariffs which require continuation of customs procedures could be sufficient to deter transshipment.

Table 1: SEA-10 GNP per capita, 1970 and 1995

	<u>1970</u>	<u>1995</u>
Brunei		
Cambodia	130	270
Indonesia	80	980
Laos	120	350
Malaysia	380	3,890
Myanmar	80	235 <sup>b</sup>
Philippines	210	1,050
Singapore	920	26,730
Thailand	200	2,740
Vietnam	140 <sup>a</sup>	240

Note: (a) GDP-weighted average of the two Vietnams, (b) 1994, from Langhammer (1997a, 163).

Sources: World Bank *Atlas*, 1972; *World Development Indicators*, 1997.

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