

# PERSPECTIVE

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## **ASEAN's Regional Integration will be Determined by Better Connectivity in the Future**

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### **EXECUTIVE SUMMARY**

- Regional integration has witnessed an evolution in focus from merely trade liberalisation to Comprehensive Economic Partnership Agreements (CEPAs) and lately to Connectivity. This goes beyond ASEAN's own regional integration plans, and is importantly noted in initiatives recently taken by China, Japan and the US.
- In the case of ASEAN, this journey began with the ASEAN Free Trade Area (AFTA) in 1992, followed by the ASEAN Economic Community (AEC) in 2003 and then the shift to ASEAN Connectivity in 2010.
- While tariff elimination has been achieved and many AEC issues have come to be recognized as necessarily long-term work-in-progress processes, better connectivity has become the next phase of regional integration.
- Developments in ASEAN in this direction are now accompanied in the larger scheme of things by China's 'One Belt, One Road' (OBOR) and the Asian Infrastructure Investment Bank (AIIB).
- Japan and the US are also responding to this conceptual shift in the region. Japan, while continuing with its earlier approach of infrastructure funding, announced new and improved ways of financing in 2015. And more recently, the US signed the Trans-Pacific Partnership (TPP) agreement with a subset of ASEAN countries and has also quickly announced the US-ASEAN Connect.
- While trade liberalisation and other forms of economic cooperation has become the 'software' of regional integration, infrastructure connectivity is now accepted as its 'hardware'.

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## INTRODUCTION

Regional integration in the last two decades witnessed a change in focus from trade liberalisation to Comprehensive Economic Partnership Agreements (CEPAs) and more recently to Connectivity. While trade liberalisation mainly pertained to the goods sector, CEPAs encompassed services and investment liberalization, and facilitation measures like standards, safeguard provisions, and customs administration and are seen to comply with World Trade Organisation (WTO) rules<sup>2</sup>. They also covered WTO-plus issues such as competition policy, government procurement, environmental and labour standards, and education. More recently, with the publication of the Asian Development Bank's (ADB) 2009 study, *Infrastructure for a Seamless Asia*, followed by the Masterplan of ASEAN Connectivity in 2010 and the APEC Connectivity Blueprint 2015-2025 in 2014, Connectivity has become a fashionable measure of regional integration. This simple word became a buzzword when China announced its 'One Belt, One Road' (OBOR) initiative as well as its Asian Infrastructure Investment Bank (AIIB) in 2013-2014.

But why has connectivity become such a focal point for regional integration? What is happening concurrently in the ASEAN countries, China, Japan and the US to make it a key determinant for the next phase of regional integration? To answer these questions and more, this paper looks at the path travelled by the ASEAN countries from the early 1990s to the present and provides a rationale for the rising importance of connectivity in the region. The paper also discusses China's drive for regional connectivity, with Japan following closely behind. Lately, the US has also joined the 'connectivity' bandwagon, though its action-plans remain relatively imprecise.

## FROM TRADE LIBERALISATION TO CEPA TO CONNECTIVITY

For ASEAN, the journey of regional integration started with the ASEAN Free Trade Area (AFTA) in 1992, when the member countries decided to lower their intra-regional tariffs to 0-5 per cent. This was soon followed by the decision to embark on the ASEAN Framework Agreement on Services (AFAS) in 1995 and the ASEAN Investment Area (AIA) in 1998.

However, instead of trade and investment liberalisation through piecemeal efforts, the ASEAN members decided to follow a more comprehensive approach of economic integration, and this became the ASEAN Economic Community (AEC) in 2003. The AEC not only included trade and investment liberalisation commitments, but also covered issues of movement of professionals, competition policy, intellectual property rights, infrastructure development, narrowing development divide and several others. It included ASEAN+1 free trade agreements (FTAs) to indicate that ASEAN integration is a form of

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<sup>2</sup> Sen. R. (2006). 'New Regionalism' in Asia: A Comparative Analysis of Emerging Regional and Bilateral Trading Agreements involving ASEAN, China and India. *Journal of World Trade* 40(4): 553-596.

‘open regionalism’<sup>3</sup>. The two other concurrent pillars of AEC, ASEAN Political-Security Community (APSC) and ASEAN Socio-cultural Community (ASCC), talked about peace and stability and cooperation in education, natural disaster, pandemics, social security, thereby encompassing measures and features important for the general growth and sustainable development of these countries.

Then, in 2010, ASEAN embarked on its journey towards Connectivity, launching its Master Plan of ASEAN Connectivity (MPAC) which covered three main elements – physical connectivity, institutional connectivity and people-to-people connectivity. The issue of physical connectivity became important for ASEAN after the Asian Development Bank (ADB) estimated that the ASEAN countries would require infrastructure investment of as much as US\$596 billion between 2006 and 2015<sup>4</sup>. Connectivity was felt to be necessary to reduce cross-border business transaction costs, travel and time costs and to ensure that regional integration benefited not only the elites and the poor, but the core as well as the periphery in member countries.

ASEAN has now passed its key milestone of 2015 and has already announced its plan for the next phase of regional integration, namely AEC 2025. Not much is new there though. Most of the earlier commitments have been retained, with new headings and ideas like ‘people-oriented’ and ‘good governance’. However, the group of countries has promised under Laotian chairmanship, to deliver in September 2016 a new ASEAN Connectivity document that is expected to be far-reaching, covering issues of both hard and soft infrastructure needed to strengthen and sustain the process of regional economic integration.

### **WHY IS CONNECTIVITY THE NEW BUZZWORD IN ASEAN?**

Why connectivity is the new guiding concept lies in what has already been achieved and what will mostly remain a ‘work in progress’. For any further benefit to be gained from regional integration, each individual ASEAN members needs to be adorned with the necessary infrastructure. Building infrastructure is broadly termed as trade and investment facilitation measures, barring which it is difficult for ASEAN to attract Foreign Direct Investment (FDI) or to limit the development gap between the member countries.

- a. Tariffs may have been reduced but eliminating non-tariff barriers will remain a long-term priority. ASEAN countries have had great success in eliminating or reducing border tariffs for intra-regional trade. But benefits from this are often offset by the prevalence of non-tariff barriers (NTBs) in the region. These NTBs are in the form of additional

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<sup>3</sup> Hill, Hal and Menon, J. (2010) ASEAN Economic Integration: Features, Fulfilments, Failures and the Future, ADB Working Paper Series on Regional Economic Integration, No. 69.

<sup>4</sup> Basu Das, Sanchita (2013) ‘Conclusion and Policy Recommendations’, in Sanchita Basu Das (ed). Enhancing ASEAN’s Connectivity, Singapore: ISEAS

taxes and charges, non-automatic licenses, varied standards and technical regulations<sup>5</sup>. It is reported that these forms of NTBs have replaced tariffs as measures to influence trade or to protect domestic industries; and are frequently found for products and in industries where tariffs have been reduced<sup>6</sup>. While some of the NTBs are part of a country's culture and domestic political economy, others emerged in response to increased global economic uncertainties<sup>7</sup>. Consequently, the former are sticky and are hard to remove while the latter will be dynamic in nature.

b. Initiatives like robust competition policy, intellectual property rights, narrowing development divide will remain 'work in progress'. For example, with regard to the competition policy, several ASEAN-wide activities were initiated: ASEAN Expert Group on Competition was set up, and the ASEAN Regional Guidelines on Competition Policy and the Handbook on Competition Policy and Laws in ASEAN for Businesses were written. While the Guidelines provide a reference point for countries' current experience and international best practices, the Handbook provides ideas about basic competition law as applicable to some ASEAN countries<sup>8</sup>. However, none of these talks of a region-wide standardized competition policy and leaves it as a national subject. Similarly, narrowing the development gap will always remain part of the agenda for ASEAN integration as no two countries can be similar and gap in the quality of human resource and infrastructure will always remain. Harmonising standards, technical regulations and conformity assessments are trade facilitation initiatives that are important for ASEAN countries' deeper integration. But the initiatives, for now, are for selected ASEAN industries<sup>9</sup> and progress in implementation is slow due to domestic political-economy factors<sup>10</sup>. Hence, benefits from these issues are likely to be incremental.

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<sup>5</sup> Austria, M. (2013). 'Non-tariff Barriers: A Challenge to Achieving the ASEAN Economic Community' in Sanchita Basu Das, Jayant Menon, Omkar L. Shrestha and Rodolfo Severino (Eds.), *The ASEAN Economic Community: A Work in Progress*, Singapore: Institute of Southeast Asian Studies, pp. 31-94; ASEAN Secretariat and World Bank (2013). *ASEAN Integration Monitoring Report (AIMR)*, Jakarta and Washington

<sup>6</sup> WTO (2012) *World Trade Report 2012: Trade and Public Policies: A closer look at non-tariff measures in the 21<sup>st</sup> Century*. Geneva: World Trade Organisation

<sup>7</sup> Sally, Razeen. *Trade Policy*, New Century, The Institute of Economic Affairs, 2008; Nesadurai, Helen E S. "Trade Policy in Southeast Asia: Politics, Domestic Interests and the Forging of New Accommodations in the Regional and Global Economy", in *Routledge Handbook of Southeast Asian Politics*, ed. Richard Robison, London and New York: Routledge, 2012, 318-22.

<sup>8</sup> ASEAN Secretariat (2015), *ASEAN Integration Report*, Jakarta

<sup>9</sup> These measures are currently targeted towards priority integration sectors in ASEAN, including automotive products, textiles, healthcare products, cosmetics and electrical and electronic products.

<sup>10</sup> Damuri, Y.R. 'Indonesia's Implementation of Facilitation and Harmonization Measures under the AEC' in Tham Siew Yean and Sanchita Basu Das (ed.) *Moving the AEC Beyond 2015: Managing Domestic Consensus for Community-Building*, Singapore-ISEAS

c. Drawing FDI remains important, but individual ASEAN countries lack developed infrastructure uniformly. Since the inception of AFTA, what remains consistently important for the ASEAN countries is their desire to attract foreign direct investment (FDI) for national development. Of course, ASEAN delivered the comprehensive ASEAN Comprehensive Investment Agreement (ACIA) in 2010<sup>11</sup> comprising of four components – liberalisation, protection, promotion and facilitation – and to create a competitive investment climate in ASEAN<sup>12</sup>, but implementation at national level remained slow and uneven (particularly the ones of investment facilitation). This affects the level of FDI inflows, which though in 2014 have exceeded the quantum of inflows to China, has remained skewed towards few ASEAN countries. The latest surveys of the World Bank and the World Economic Forum, seem to show that ASEAN countries are divided, especially in terms of necessary domestic reforms with respect to quality of institutions, policies and infrastructure services that facilitate cross-border flows and hence improve investment attractiveness (Table 1). While countries like Singapore, Malaysia and Thailand rank high on the investment attractiveness scale; Brunei, Cambodia, Laos and Philippines rank low, leading to differences in attracting quantum of investment.

**Table 1: Investment Attractiveness of ASEAN Member Countries**

	Ease of Doing Business, 2015 <sup>1</sup> (rank)	Global Competitiveness Index, 2014-15 <sup>2</sup> (rank)	Enabling Trade Index, 2014 <sup>3</sup> (rank)	FDI to ASEAN	
				US \$million, 2003-2013	% of total
Brunei	101	28	--	8,796	1.11
Cambodia	135	95	93	7,808	0.99
Indonesia	114	34	58	10,6266	13.41
Laos	148	93	98	2,642	0.33
Malaysia	18	20	25	77,279	9.76
Myanmar	177	134	121	12,142	1.53
Philippines	95	52	64	22,147	2.80
Singapore	1	2	1	40,1002	50.62
Thailand	26	31	57	89,999	11.36
Vietnam	78	68	72	64,080	8.09

Note: 1- out of 189 economies; 2- out of 144 countries; 3- out of 138 countries

Source: World Bank (2015), *Doing Business 2015*; World Economic Forum (2014), *Global Competitiveness Index 2014-2015*; World Economic Forum (2014), *The Global Enabling Trade Report 2014*; ASEAN Secretariat (2015), *ASEAN Statistical Yearbook 2014*

<sup>11</sup> ACIA superseded earlier regional investment agreements –AIA that promoted liberal and transparent investment climate and ASEAN Investment Guarantee Agreement (ASEAN IGA) that was designed to protect and promote investments.

<sup>12</sup> ASEAN Secretariat (2009), *ASEAN Comprehensive Investment Agreement*, Jakarta

Hence, what becomes increasingly important for ASEAN regional integration is the development of necessary infrastructure. The ASEAN countries are planning physical infrastructure projects both at the national and the regional level. At the national level, Thailand has for example come up with the Transport Infrastructure Development Master Plan 2015-2022, covering rail, road, mass transit, air and water. The country's military government has identified 20 infrastructure projects costing nearly US\$50.2 billion to be undertaken before 2018<sup>13</sup>. Indonesia is envisioning itself as a 'global maritime fulcrum' and aims to improve the country's port infrastructure, shipping industry, and maritime tourism in the next few years. In the 2016 State Budget, the government earmarked US\$22.9 billion for infrastructure development, the highest amount ever allocated to the country's infrastructure plan<sup>14</sup>. Similarly, the Ministry of Planning and Investment of Vietnam estimated in 2014 that the country needs US\$500 billion for its infrastructure development over the next ten years. These will be mainly for new or upgrading of buildings, repairing seaports, airports, and electricity and water supply systems<sup>15</sup>.

Where regional initiatives are concerned, the ten ASEAN countries have agreed to both cross-border physical and institutional infrastructure projects. Some of the trade facilitation projects have already agreed to modernise and harmonise customs procedures, establish the ASEAN Single Window (ASW) and harmonise standards and conformance procedures. There are also a number of physical infrastructure projects, covering land, maritime and air transport, which are in addition to transport facilitation agreements and energy cooperation. All these cover detailed technical components, such as common road signs and route numbering systems across ASEAN, aviation safety and security. Transport facilitation arrangements also cover issues of transit transportation, customs for transit goods, cross-border transport service and multi-modal transport service in the region. However, implementation of these infrastructure connectivity projects remains incomplete and are a key challenge<sup>16</sup>.

It is only when the ASEAN countries are able to implement fully the ongoing infrastructure projects and furthermore commit to new ones that the region will be perceived by investors to have become more deeply integrated. Following this, there will be higher chances for FDI to flow more uniformly across an integrated region of 625 million people rather than to a subset of member countries<sup>17</sup>. Therefore, at this juncture, infrastructure – or better

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<sup>13</sup> Reuters, Thailand to launch big infrastructure projects next year, 30 November 2015, (<http://www.reuters.com/article/us-thailand-infrastructure-idUSKBN0TJ1PS20151130>)

<sup>14</sup> Indonesia-Investments, Government of Indonesia preparing 2016 infrastructure projects, 29 December 2015 (<http://www.indonesia-investments.com/news/todays-headlines/government-of-indonesia-preparing-2016-infrastructure-projects/item6322>)

<sup>15</sup> Tuoi Tre News, Vietnam needs US\$500 bn for infrastructure development in 10 years: Ministry, 8 May 2014 (<http://tuoitrenews.vn/society/21484/vietnam-needs-500bn-for-infrastructure-development-in-10-years-ministry>)

<sup>16</sup> ASEAN Secretariat (2015b), *ASEAN Integration Report*, Jakarta

<sup>17</sup> It should be noted that infrastructure is only one of the many determinants of FDI flows. Others are domestic institutions, governance, national policies and regulations, wage rate, and government incentives.

connectivity – becomes a key determinant for obtaining the full benefit of the trade and investment liberalisation that the countries have been pursuing for the last two decades. While its efforts have been noteworthy and can be considered the ‘software’ of economic integration, the ‘hardware’ of integration, i.e. building connectivity, is yet to fully materialise.

## **THE BIG BANG BY CHINA AND THE ROLE OF JAPAN AND THE US**

### Chinese Comprehensive Ambition of Greater Connectivity

As countries in ASEAN and in Asia continue to struggle with infrastructure deficiency and are increasingly discussing it at national and regional levels, it is China that has come up with its ‘Big Bang’ ideas of ‘One Belt, One Road’ (OBOR) and the Asian Infrastructure Investment Bank (AIIB), a US\$100 billion multilateral development bank.

Two key reasons for China to introduce the AIIB were Beijing’s unhappiness with the governance structure of the existing International Financial Institutions (IFIs); and Asia’s need for infrastructure financing. China has long been advocating for expanding resources in the International Monetary Fund (IMF) and raising the voting-shares of emerging economies. This has been stalled by the US Congress. China has also been arguing with the World Bank for more resources for infrastructure, but things were bogged down by environmental and social safeguard measures and excessive bureaucracy<sup>18</sup>. It was around this time that it was estimated that Asia would require infrastructure investments of US\$8.3 trillion in 2010-2020. Although precise infrastructure needs were said to vary by country and region, there is a general consensus that developing countries need infrastructure investments across the board, ranging from energy and water to transportation<sup>19</sup>. Against this humongous sum, the 2014 disbursement of the World Bank’s US\$24.2 billion and the Asian Development Bank’s US\$21 billion for infrastructure funding was highly inadequate.

The OBOR is a larger initiative than AIIB. It connects China with the countries of Central Asia (which were along the traditional Silk Road) through road infrastructure; and links the Chinese coast via Southeast Asia to the Indian Ocean and all the way to Europe through maritime routes. Since OBOR will be implemented bilaterally between China and different host countries, it can be seen as China integrating itself closely not only with its Asian neighbours but also with Europe. OBOR becomes a tool that promotes the alignment of flow of trade and investment through good infrastructure<sup>20</sup>. Indeed, ASEAN-China FTA becomes important in this regard and complements the OBOR initiative. Participation of all

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<sup>18</sup> David Dollar, ‘China’s rise as a regional and global power: The AIIB and the ‘one belt, one road’, Brookings, Summer 2015

<sup>19</sup> Asian Development Bank and Asian Development Bank Institute (2009). *Infrastructure for a Seamless Asia*, Manila and Tokyo

<sup>20</sup> Samir Saran and Ritika Passi, ‘Seizing the ‘One Belt, One Road’ Opportunity, Observer Researcher Foundation (ORF) online

ASEAN members in AIIB also reaffirms ASEAN's willingness to undertake joint ASEAN-China economic integration.

It should be noted that the Chinese vision document on OBOR lays out five layers of connectivity – policy, physical, economic (trade and investment), financial and human (people-to-people bond)<sup>21</sup>. While physical connectivity talks about transport infrastructure – covering road, sea-routes, aviation and ICT – and increased connectivity through customs clearance and multimodal transport facilities across borders, policy coordination among participating governments is an important parameter in implementing the initiatives. Economic connectivity entails investment and trade liberalisation and facilitation, leading to a free trade area and covering issues from the WTO Trade Facilitation Agreement. It also includes plans for customs clearance facilities and the establishment of a 'single window' on border ports to reduce trade costs and time. Financial integration discusses the deepening of financial cooperation through building currency stability system and mentions the Asian Bond Market, AIIB, and different infrastructure financing modalities that had been recently announced. Finally, human connectivity ensures popular support for the entire initiative by promoting cultural and academic exchanges, media cooperation and expanding the scale of tourism.

All these put together can be viewed as a comprehensive *FTA plus economic integration* initiative by Beijing – and this time it not only includes the smaller Southeast Asian nations or bigger Asian economies of Japan, South Korea or India with whom China has varied geopolitical issues but also Central Asia, South Asia and parts of Europe. Beijing seems to have learnt from ASEAN's experience of what components of economic integration work (like liberalisation and facilitation) and what may always remain a work in progress (such as elimination of non-tariff barriers, and narrowing the development gap). It does not include domestic regulatory issues of competition policy, intellectual property rights, environmental standards or labour laws as they may not be practical for several of the less developed countries in the region. Moreover, as most of the benefits under liberalisation have been reaped, it is the issue of better connectivity that needs to be popularised among interested parties to move towards a deeper regional integration. Of course, ASEAN does not want to miss this opportunity and is striving to align its regional agenda to a bigger well-encompassing OBOR.

#### Japan, the US and their Modalities on Connectivity

While China's connectivity plan initially caught Japan and the US off-guard, they soon enhanced their own approaches of region integration. Japan already has a comprehensive FTA with the ASEAN countries since 2008 and it has been investing in ASEAN infrastructure for a long time through several avenues – private firms, government bodies and multilateral agencies like the Japan International Cooperation Agency (JICA), the Japan

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<sup>21</sup> National Development and Reform Commission (NDRC), Ministry of Foreign Affairs and Ministry of Commerce, People's Republic of China, 'Vision and Actions on Jointly Building Silk Road Economic Belt and 21<sup>st</sup>-Century Maritime Silk Road', 28 March 2015



Bank for International Cooperation (JBIC), and the Asian Development Bank (ADB). However, in the past two years, Japan has been trying to beef up its role as a provider of infrastructure and finance in Asia. In addition to Japan's expression of interest for several national projects in ASEAN countries,<sup>22</sup> it has promised to cut the time taken to approve infrastructure loans from three years to between 18 months to 2 years to create an edge for itself. The country has agreed to bear more financial risk, thereby ending its practice of requiring government guarantees for each loan. Moreover, the Japanese Prime Minister, Mr. Shinzo Abe, announced in 2015 that Japan and the ADB would provide US\$110 billion in infrastructure funding in Asia over the next five years<sup>23</sup>.

The US, of late, also decided to make its presence felt in the Asian region through economic integration. It signed the Trans-Pacific Partnership (TPP) deal in February 2016 with 11 Asia-Pacific countries. Four ASEAN countries are already a party to this trade agreement and another three have explicitly expressed their interest. The US did not stop there and to end criticisms that the US is dividing ASEAN through its trade policy, US President Barack Obama, invited all ten ASEAN Leaders to California for a special summit in February 2016, where they together launched a new initiative called the ASEAN-US Connect. Washington cleverly used the word 'connectivity' here and has incorporated all its existing initiatives under a single framework<sup>24</sup>.

The ASEAN-US Connect consists of four pillars – business connect, energy connect, innovation connect and policy connect – and focuses on energy infrastructure, young entrepreneurs, the private sector (including the small and medium-scale enterprises), and policy coordination. The initiative also promises of three centres – Jakarta, Singapore and Bangkok – coordinating US economic engagement in the region and creating a network among policy makers, entrepreneurs, investors and businesses<sup>25</sup>.

Hence, it is not just the ASEAN countries, but the bigger economies of China, Japan and the US that are increasingly realising the importance of connectivity to regional integration.

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<sup>22</sup> For example, in November 2015, the Japanese and the Philippine governments signed a US\$2 billion loan agreement for a rail project, the largest assistance package ever awarded by Japan. Its Mitsui & Co. got engaged in a major expansion of Jakarta's main port. And an Indonesian-Japanese consortium has begun work on a US\$3 billion mass rapid transit system through Jakarta's downtown.

<sup>23</sup> The Straits Times, Japan aims to streamline lending practices of ADB (<http://www.straitstimes.com/asia/east-asia/japan-aims-to-streamline-lending-practices-of-adb>)

<sup>24</sup> The US-ASEAN Connect is said to consolidate a number of existing mechanisms between the two sides, including US Trade and Development Agency, US-Asia-Pacific Comprehensive Energy Partnership, Young Southeast Asian Leaders Initiative and US-ASEAN Trade and Investment Agreement

<sup>25</sup> Sanchita Basu Das, 'Can the US-ASEAN Connect Initiative Create Stronger US-ASEAN Economic Relation?', *Asia Pacific Bulletin No. 339*, April 7, 2016, East West Centre, Washington DC

## CONCLUSION

While it was the ASEAN countries who first paid formal attention to connectivity as the avenue to regional integration, China soon followed suit with a Big Bang of initiatives and developed an encompassing vision for developing physical, institutional, policy and financial infrastructure. Japan is also not being left behind and announced some new and improved ways of infrastructure funding for the ASEAN region. Following these, the US recognised the importance of engaging ASEAN and decided to support regional integration through enhanced connectivity. For almost all of these countries, they realise that as tariff has already been reduced or eliminated in earlier initiatives of FTA and many other initiatives under comprehensive economic partnership agreements are going to generate only incremental welfare over a long term, the next phase of benefits of regional integration are going to come from better connectivity of physical, institutional and policy infrastructure.

While economic liberalisation and cooperation has become the ‘software’ of regional integration, connectivity is the latest buzzword and the ‘hardware’ for such integration, without which benefits of trade and investment cooperation can be nullified.

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