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## ASEAN's Agenda and Russia's East Asian Summit Membership

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The year 2011 has a special significance for Russia and ASEAN, both symbolically and in a practical sense. On the one hand, the two parties mark the 15<sup>th</sup> anniversary of their official dialogue partnership. While on the other hand, in November Moscow, which already takes part in the ARF, ADMM-Plus, APEC and ASEM, will become a full-time member of the East Asian Summit (EAS).

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According to Dr. Tang Siew Mun of ISIS Malaysia, “the question that will be asked of Russia is: “What does Moscow bring to the table?” This is the litmus test of Russia's Asia policy. If East Asia is important to its future, Moscow has to work to ingrain itself into East Asia's landscape, particularly that of Southeast Asia.”<sup>1</sup>

True, Russia's Southeast Asian record in terms of trade and investments is not too impressive. One may even wonder why Russia is invited to the EAS at all – especially since the official invitation comes from none other than ASEAN. To figure it out, it may be good to take a quick look at the current agenda of the Association and then to see how compatible it is with Russia's national interests. Is Russia capable, at least theoretically, of responding to ASEAN's long-term needs?

Among ASEAN's major priorities is the acceleration of Southeast Asian integration by implementing the ASEAN Community blueprint. Without it, the members of the Association may find it hard not just to compete, but to cooperate on a more or less equal basis with bigger extra-regional partners. At the same time ASEAN's leaders are now emphasizing that ASEAN has to have a global identity and a global role to play. They also agree that regional security issues are to be discussed at the EAS, which has not been the case thus far.

How realistic then are these objectives? Are they interrelated, as major initiatives should be?

Desirable as it may be, speeding up the process of regional integration may be somewhat problematic due to the well known heterogeneity of ASEAN 10. Another, still more disturbing observation refers to the fact that the present attempt to accelerate regional integration takes place at the moment when the process of national integration remains unfinished in practically all the Southeast Asian countries. This is a major

<sup>1</sup> Tan Siew Mun, “Rethinking Russia's Engagement with East Asia”, *ASEAN Monthly Commentary* (June 2011), p. 6.

difference between ASEAN and the European Union: the foundations of the latter were laid down by integrated, mature nations.

With these problems of national and regional scope, how timely are the present attempts to secure a global role for ASEAN? Paradoxically, they are quite appropriate. As the global economy's center of gravity is shifting towards East Asia, the national and regional problems of this area, including those of Southeast Asia, are acquiring a global dimension. History obliges ASEAN and its members, like so many other countries, to respond to the challenges of national, regional and global types simultaneously and comprehensively.

Does this set of issues have anything to do with security? Yes, it does. A region that is becoming the global economy's center may anticipate not just new opportunities for international and cross-border cooperation, but a growth of conflict potential as well. Seekers of benefits and fortunes, innumerable and diverse, will establish partnerships there just as often as they will clash. The center is always the arena where global hegemony is contested, and the memory of two World Wars is a sad reminder of it. It is an open secret that in East Asia, elements of rivalry are becoming quite prominent in the US–China relations. Who may be sure at this point that this rivalry will not go out of hand? Against this background, ASEAN's decision to focus on regional security matters in the EAS framework is a justified step.

For ASEAN, further sharpening of the US–China disagreements is highly unwanted. If regional polarization develops to a sufficient degree, ASEAN and its members will be pressed, directly or indirectly, into taking sides. This is something none of them wants to do or can afford to do. Fortunately enough, this is still a hypothetical scenario. However, in case it unfolds, ASEAN as a political player might be paralyzed. A disruption of regional balance would threaten not only the economic prosperity of some particular countries, but of the whole East Asian area. Implementation of national and regional integration projects would be interrupted. No doubt, ASEAN is fundamentally interested in preventing it all by consolidating that middle ground in the regional security space which is vital for maintaining strategic balance. From ASEAN's perspective, an ally with a global status and a similar approach to regional security problems would hardly be an excessive element in the picture.

Is Russia capable of playing such a role? At any rate, it has to try for the sake of its vital interests. Russia's future is dependent on its ability to continue and complete its own modernization, with a special emphasis on its Far Eastern territories and Siberia. Unless it happens, the country will not be able to become a legitimate participant in East Asian cooperation, to contribute to the growth of the region or to profit handsomely from this growth. But Russia may not succeed, too, if East Asia fails to sustain its economic dynamism. And to sustain it, the region – along with Russia – needs peace.

For Russia, just like for ASEAN, a clear-cut choice between the US and China is not an option. First, any such choice in the present circumstances would put Russia in a dependent, historically losing position in its relations with the party that it might choose to support. Second, even in its present shape Russia remains a geopolitical entity too big, too important and too powerful by any measurement. Its unambiguous readiness to follow any of the two competitors might result in such a degree of strategic polarization at both the regional and global levels that would threaten Russia itself (and by the way, ASEAN too).

If all of the above makes sense, Russia's best strategic bet – be it in the region or in the world as a whole – is some kind of active and flexible non-alignment (which should not be viewed as formalistic “equidistance” from the US and China). But for this strategy to work properly, the country has to have much more economic interaction with potential partners, including ASEAN.

To finish this article on a sober note and to register a point of agreement with an ASEAN colleague let me quote, once again, Dr. Tang: “Unless and until there is a substantive upswing of trade and investment in Southeast Asia, Russia will find itself lagging behind the US, China, Japan and South Korea. The celebratory mood due to gaining acceptance into the EAS will be short-lived, absent a sustained effort to deepen Moscow's engagement with the region.”<sup>2</sup>

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2 Tan Siew Mun, “Rethinking Russia's Engagement with East Asia”, *ASEAN Monthly Commentary* (June 2011), p. 7

## New Zealand-ASEAN Relations

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ASEAN is vitally important to New Zealand. Southeast Asia straddles vital communications routes for New Zealand's trade with North Asia, the Middle East and points beyond, and for inflows of technology, tourists and people.

New Zealand's story in Southeast Asia is well-known, distinguished and respected. In security and defence it has included participation in Asia during the Second World War; in the Korean War; in the Vietnam War; in the Malayan Emergency; in the defence of Malaysia during Indonesia's *Konfrontasi* and as a member of the South East Asia Treaty Organisation (SEATO), the Five Power Defence Arrangement (FPDA), the East Asia Summit (EAS) and as a dialogue partner of the Association of Southeast Asian Nations (ASEAN). In education the Colombo Plan, in which students from Southeast Asia's then developing countries studied in New Zealand is, as one New Zealand diplomat remarked to this author, "the gift that keeps on giving" and the amount of goodwill it generated is deep and long lasting.

ASEAN's success is important for New Zealand. ASEAN is New Zealand's "friend at court" in the region; it provides New Zealand with the entry ticket to the regional dialogues. If the EAS were to fail, then the next cab off the rank would probably be the ASEAN Plus Three. Were that to happen New Zealand (nor Australia, for that matter) would not have its voice in the conversation about the region and its future.

There are those who would want to follow the line that New Zealand is better and bigger in Asia, and in ASEAN, with Australia than without it. In his remarks to the Australian parliament, New Zealand Prime Minister John Key said that Australia and New Zealand are "stronger together".<sup>3</sup> Others have made the same point.<sup>4</sup> The ASEAN-Australia-New-Zealand-Free-Trade-Agreement (AANZFTA) and its potential give one form to this particular view. On economics that argument is sound. AANZFTA has created a free trade area between these twelve economies of more than 600 million people with a combined GDP of US\$2.7 trillion.

Taken together ASEAN and Australia are New Zealand's most significant trading partners. ASEAN is New Zealand's fourth most important export destination (behind Australia, the EU and China) and with two-way of \$10.2 billion again places ASEAN fourth in the line of significance. In the past five years New Zealand's exports to ASEAN and Australia combined have risen by 61 percent (compared with 33 percent in exports to the rest of the world). Over the last ten years, the figure is 70 percent ASEAN-Australia. Two-way trade with ASEAN and Australia combined in the past five years has increased by 38 percent and in the past ten years by 62 percent.<sup>5</sup>

Considering New Zealand, without Australia, in ASEAN presents a stark asymmetrical picture. New Zealand's 4.5 million people compares to almost 600 million in ASEAN. On GDP, NZ's US\$138 billion (estimate for 2010) is paltry compared with ASEAN's US\$1.5 trillion. New Zealand's trade with ASEAN was only 0.3 percent of the total ASEAN trade and its share of the inflow of foreign direct investment to ASEAN only 0.1 percent. This picture is starker still when compared to the wider region of Asia and not just the ten countries of ASEAN.<sup>6</sup> It may be fairer to compare New Zealand with individual countries of ASEAN, but even then New Zealand does not stand well, its GDP exceeding only that of the poorer ASEAN counties of Cambodia, Laos, Burma and Vietnam.<sup>7</sup> On these figures alone it is self-evident that New Zealand carries more economic heft, at least, when it partners with Australia in ASEAN and for that reason, this argument runs, any engagement in ASEAN should be by the two countries combined.

<sup>3</sup> <http://www.scoop.co.nz/stories/PA1106/S00324/john-key-address-to-australian-parliament.htm>

<sup>4</sup> Daljit Singh, *ASEAN's perspective of New Zealand's place in Asia*, Wellington: Asia New Zealand Foundation, 2011, p.1

<sup>5</sup> I am grateful to Vangelis Vitalis for providing these data.

<sup>6</sup> Singh, 2011, p.6

<sup>7</sup> Singh, 2011, p.6. New Zealand also has a higher GDP than Brunei, but Brunei's per-capita GDP, which may be a more accurate reflection of economic strength, is higher than all ASEAN countries except Singapore.

But New Zealand's engagement in ASEAN is not just economic. New Zealand has followed its own trajectory in relationships in the region. "If New Zealand can go it alone in ASEAN without Australia then it should", one scholar in Singapore noted to this author. But can it? Economically, perhaps not. But, arguably, New Zealand's engagement with ASEAN countries is qualitatively *better* than Australia's. New Zealand's self-effacing nature, its modesty, its exceptional skills in trade negotiations, its genuinely world-class SAS presence in Afghanistan: all these are on the positive side of the ledger for New Zealand alone.

New Zealand's demographic shifts, which were particularly dramatic in the period 1986-2006 and are projected to see larger populations, proportionately, of Asians, Maori and Pacific peoples in New Zealand by 2026,<sup>8</sup> challenge the very notion of what it means to be a New Zealander and what New Zealand's place is in the world. From Southeast Asia New Zealand is seen either as a Pacific nation or as part of Australasia. Neither category advances New Zealand's brand, its story, even if both have elements of truth to them. Is New Zealand an Asian nation? Southeast Asian countries would not consider it so, as testified both through the aforementioned categorisation of New Zealand in the region and by the controversy around admitting New Zealand (with Australia) to the East Asia Summit on the grounds that neither country is part of Asia.<sup>9</sup> The multicultural character of New Zealand, while not currently well-known, could further strengthen New Zealand's ties to the region. To that end, it may be argued that New Zealand shares more values and attributes with ASEAN, and Southeast Asia generally, than it does with its second largest-trading partner, and predominant focus of its attentions, China. For that reason, and many besides, there is strong reason for New Zealand to build on the firm foundation of its relationship with ASEAN.

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<sup>8</sup> See Richard Bedford and Elsie Ho, *Asians in New Zealand: Implications of a Changing Demography*, Wellington: Asia New Zealand Foundation 2008

<sup>9</sup> Amitav Acharya, *Constructing a Security Community in Southeast Asia: ASEAN and the problem of regional order*, Second Edition, New York, 2009, p.218

## Taiwan's *Guanxi* with ASEAN

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Taiwan is an important economic player in the ASEAN region. In 2008, Taiwan's trade with China stood at USD\$82 billion making it one of Asia's leading economies<sup>10</sup>. China (10.85 billion) and ASEAN (70 billion) are two of Taiwan's largest trading partners<sup>11</sup> replacing the US and European Union. Combined exports to China and ASEAN countries in 2010 accounted for 55% of Taiwan's total exports<sup>12</sup>. However prior to 2010, Taiwan's intentions to create FTA's with ASEAN member states seem to be constantly hindered by China's free trade agreements with ASEAN countries inevitably causing Taiwan to fall short of its full potential.

The landmark Economic Cooperation Framework Agreement (ECFA) between Taiwan and China was signed June 29, 2010<sup>13</sup>. The agreement will save Taiwan an estimate of NT\$26.1 in customs duty according to officials at the Ministry of Finance<sup>14</sup>. Mainland China will lower tariffs of 539 products and Taiwan will reciprocate with tariff reductions for 267 products. The agreement will iron out difficulties in two areas of particular interest among others; investments and intellectual property rights<sup>15</sup>. This preferential trade agreement is said to boost the USD110 billion bilateral trade exchange between the two countries, though it seems to be biased towards Taiwan.

The ECFA has paved the way for Taiwan to begin FTA negotiations with ASEAN members and other Asian countries leading to improved relationships between Taiwan and regional organizations. In August 2010<sup>16</sup> Taiwan and Singapore initiated discussions focusing mainly on an FTA called the 'Agreement between Singapore and the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu on Economic Partnerships (ASTA)'<sup>17</sup>. Taiwan is hoping to expedite negotiations and hopes that the ASTA will open Singapore's restricted financial sector to foreign financial service providers. Taiwan has also since started FTA talks with the Philippines and India in the hopes that these new FTAs will open the door to more trade agreements between Taiwan and agricultural economies within ASEAN.

Taiwan's cross-Strait relations have improved especially with the ink dry on the ECFA. More opportunities to participate in multilateral activities within the region seem to be the next progression. Its recognition with the WTO and the WHO not to mention membership with APEC and the Asian Development Bank has boosted the recognition of Taiwan, perhaps not as a state but as a valuable economic player<sup>18</sup>.

Taiwan may start exploring opportunities not just in the economic sphere but perhaps in service sectors and in areas of non-traditional security issues especially with such concerns as environmental protection, transnational crime and piracy in public spaces, trafficking and so forth which are issues riding high on the list of ASEAN states concerns.

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10 Taiwan Seeks Closer Economic Ties with ASEAN (March 23, 2010) The Jakarta Post  
<http://www.thejakartapost.com/news/2010/03/23/taiwan-seeks-closer-economic-ties-with-asean.html>

11 *ibid*

12 Hsu, K (October, 2011) Assessing Taiwan's Go South Policy. The 13th ASEAN-ISIS-IRR Dialogue: From ASEAN Centrality to a New Regionalism: The Implication for ASEAN and Taiwan

13 ECFA Signed (June 30, 2010) China Post <http://www.chinapost.com.tw/taiwan/china-taiwan-relations/2010/06/30/262692/ECFA-signed.htm>

14 *ibid*

15 Copper, J (August 6, 2010) The China-Taiwan Economic Cooperation Framework Agreement: Politics not just Economics <http://www.eai.nus.edu.sg/BB548.pdf>

16 Taiwan, Singapore begin free trade agreement discussions (May 23, 2010)  
<http://www.chinapost.com.tw/taiwan/national/national-news/2011/05/23/303403/Taiwan-Singapore.htm>

17 Singapore, Taiwan to discuss economic partnership (December 15, 2010) Channel News Asia  
<http://www.channelnewsasia.com/stories/singaporelocalnews/view/1099338/1.html>

18 Severino (2008) commented, "*Taiwan is participating in regional economic arrangements not as a state but as an economy, as it does in its membership in APEC, WTO and the Asian Development Bank. With this made clear, Taiwan and its international partners can conceivably expand the space of Taiwan's involvement in the more practical areas of cooperation among institutions, business firms and people.*"

Taking advantage of a change in the economic landscape, Taiwan will now move towards pursuing FTA's not only with ASEAN member states but also with Japan, US, EU and explore the possibility of participating in the Trans-Pacific Strategic Economic Partnership Agreement (TPP) to build up its influence and bolster its economic security<sup>19</sup>.

Taiwan has long realized the necessity to have space from the mainland, however in the past China's FTA agreements with ASEAN has put a damper on Taiwan's dialogues with ASEAN member states. According to Zhao Hong<sup>20</sup> Taiwan is an export-oriented economy and very dependent on external trade to sustain its economic development over the past decades and therefore needs to diversify its economic relations to reduce reliance on the mainland<sup>21</sup>. However with negotiations progressing between Singapore, ASEAN member states are keeping a close eye, monitoring China's reactions to the various bilateral agreements being negotiated before starting the ball rolling on their FTA's with Taiwan. Perhaps it is also important to note that For ASEAN the ECFA means greater competition especially for countries like Malaysia and the Philippines who's export market are similar to that of Taiwan's therefore causing a greater need for ASEAN member states to boost their competitiveness also.

Realizing that ASEAN is the 'only game in town', Taiwan seeks inroads to further integrate as ASEAN promotes inclusive growth, connectivity to the global market place, social safety nets through vibrant small and medium enterprise and narrowing the development gap between the ASEAN-6 and CLMV countries<sup>22</sup>. As most of Taiwan's industry is dependent on successful small and medium enterprises, Taiwan can take advantage of this to further integrate with ASEAN economies.

Having invested heavily in Vietnam (machinery and electronics) and Cambodia (textile) without the benefit of FTA's, Taiwan is seen to be relatively competitive in its exports through the region be it in form of FDI's or production networks. As a member of the World Trade Organization, Taiwan can utilize multilateral trade strategies which might be easier now that Taiwan's President Ma Ying-jeou in 2010 promoted Taiwan's diplomatic truce maintaining a delicate balance with its ally the US and with China<sup>23</sup>.

Taiwan's history with China has not only affected trade but its strategic geographical positioning has also led to its concerns about China's heavy presence in the South China Sea which was discussed in great detail at the 13<sup>th</sup> ASEAN-ISIS-IIR Dialogue held in Taiwan in mid-October 2011, revealing Taiwan's deep uneasiness not only at China's increased military procurement exercises but that of ASEAN members states also.

Three decades after Taiwan's 'Go South' policy was implemented, its foreign trade structure has changed and witnessed enhanced relationships between China and ASEAN member states. With the ECFA underway, Taiwan is no longer isolated from embarking on FTA's with ASEAN members noting that its trade efforts will be effectively facilitated. This triangular partnership between Taiwan, China and ASEAN needs to be carefully nurtured and enhanced further. However, Taiwan has to tread carefully on issues pertaining to the South China Sea as China is easily offended and decades of polite diplomacy and its new economic friendship will come undone if China is the least bit slighted.

<sup>19</sup> Hsu, K (2011) The Taiwan-ASEAN Partnership in Economic Integration: Looking Ahead

[http://www.aseancenter.org.tw/upload/files/OUTLOOK002\\_01.pdf](http://www.aseancenter.org.tw/upload/files/OUTLOOK002_01.pdf)

<sup>20</sup> Visiting Senior Research Fellow at the East Asian Institute (EAI), National University of Singapore. Professor at the Research School of Southeast Asian Studies, Xiamen University, China.

<sup>21</sup> Zhao.H (2011) Taiwan-ASEAN Economic Relations In Context of East Asian Regional Integration, International Journal of China Studies Vol. 2, No. 1, April 2011, pp. 39-5

<http://ics.um.edu.my/images/ics/IJCSV2N1/zhao.pdf>

<sup>22</sup> Lim, H (October 2011), ECFA and Regional Economic Integration – ASEAN and Taiwan. The 13<sup>th</sup> ASEAN-ISIS-IIR Dialogue: From ASEAN Centrality to a New Regionalism: The Implication for ASEAN and Taiwan

<sup>23</sup> Taiwan Seeks Closer Economic Ties with ASEAN (March 23, 2010) The Jakarta Post

<http://www.thejakartapost.com/news/2010/03/23/taiwan-seeks-closer-economic-ties-with-asean.html>

## The Sovereign Debt Crisis: Implications for ASEAN

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The ASEAN economies do not have the sovereign debt problems of their European counterparts. They and, indeed, the region as a whole, are in a fundamentally different context and set of circumstances, with reliance on trade and foreign investment to drive their economic growth. Furthermore, the macroeconomic and financial lessons of the 1997/98 Asian Financial Crisis remain fresh in the minds of many, and that is to err on the side of caution. Thus, they were able to largely weather the sharp downturn of 2009 without lasting damage.

Having said all of this, ASEAN economies are not without their economic vulnerabilities. Already this year, regional equity markets have been shaken a number of times by fears that Europe's sovereign debt crisis will spread out towards ASEAN through first- and subsequent-round trade, investment and financial channels. ASEAN's openness is both a boon and a bane, enabling it to achieve higher-than-average rates of economic growth during good times but relatively sharper downturns.

ASEAN policymakers have come to recognize that they cannot do much about factors outside of their control. And most, if not all, are acutely aware of the need to try and strengthen their public finances and economies before the onset of challenging times and not while in the midst of them. So how are they doing? The short answer appears to be with varying degrees of political commitment and success. Much hinges on the actual versus the expected economic outturns, and herein lie the major risks going forward.

As indicated earlier, most ASEAN economies took a solid hit in 2009 but then recovered strongly in 2010. Exports contributed strongly to recovery but so too did increases in public expenditure. Public expenditure rose across ASEAN in 2009 and despite some moderation since then remains largely at elevated levels. (Indonesia seems to be an exception.)

Not surprisingly, fiscal deficits and public debt levels have risen in tandem and are trending higher than 2008 although in almost all cases, announced policy directions are to bring them down. Expected fiscal deficits though are sensitive to GDP growth forecasts, as are public debt levels, which are forecast to shrink by 1-3 per cent of GDP by end-2011 assuming that economies grow as expected.

It should be noted that external debt has been growing for three economies – Indonesia, Thailand and Malaysia – even though debt service ratios (debt repayments and interest over exports) are mostly in the single digit with the exception of Indonesia. If the three major credit rating agencies are any indication, the sovereign bonds of ASEAN are generally stable (in the case of Indonesia, positive) but with the notable exception of Vietnam, which is continuing to face quite severe macroeconomic challenges. (See, Figure 1 below)

Figure 1: ASEAN Sovereign Bond Ratings

Country	S&P	Fitch	Moody's
Cambodia	B+ (stable)	-	B2 (stable)
Indonesia	BB+ (positive)	BB+ (positive)	Ba1 (stable)
Malaysia	A- (stable)	A- (stable)	A3 (stable)
Philippines	BB (stable)	BB+ (stable)	Ba2 (stable)
Singapore	AAA (stable)	AAA (stable)	Aaa (stable)
Thailand	BBB+(stable)	BBB (stable)	Baa1 (stable)
Vietnam	BB- (negative)	B+ (stable)	B1 (negative)

Source: Asianbondonline.abd.org (accessed 24 Oct 2011)

Note: Brunei, Lao and Myanmar have not been assigned ratings by the three rating agencies.

Turning now to the implications for ASEAN, three central questions appear to have a pivotal role, viz.:

- (1) What will be the depth and duration of the sovereign debt crisis and are affected economies (including the US) doing enough to resolve the problem?
- (2) Have ASEAN economies done enough to completely or partially avert the risks of global economic downturn? What more can they do?
- (3) What can ASEAN-10 do collectively and in collaboration with dialogue partners to ensure stable growth?

On the first question, the answer appears to be unclear and uncertain to the ASEAN policymaking community. World attention has focused on the Eurozone-17's efforts to resolve the Greek default problem. Failure to do so would almost certainly lead to contagion to the rest of Europe, notably Italy and Spain and the sovereign debt problem would migrate from being very severe to virtually intractable. As analysts have pointed out, however, enormous political and financial capital is being spent on financial bailouts and not longer-term economic growth. Economies have either to cut debt and compress their economies or attempt to grow-out of debt with modest spending. There is a need to seriously look at increasing potential output and growth trajectory and a final resolution is highly unlikely to be cheap or short-term.

On the second question, whether ASEAN economies are doing enough, I would venture that on the present course, most seem unable to weather a moderate to severe downturn without tipping into recession. In the event of slower or negative growth, there will be few choices but to curb and cut public spending for those economies with public debt levels above 50 per cent of GDP (Laos, Malaysia and Vietnam). Depending on depth and duration, even those above 40 per cent (Thailand, Philippines and Myanmar) may need to introduce spending restraints to stay out of trouble. In Thailand, Malaysia and Philippines, private investment rates have generally been sluggish and public investment appears to have filled the gap left by private sector. In these cases and in the event of a downturn, some negative pro-cyclical effects should be anticipated. It would seem imperative that these economies find ways to encourage true private equity and not public debt-driven economic growth.

As to what ASEAN as a collective can do, while it is still early days, the recently announced ASEAN Infrastructure Fund seems to be a good start. I say 'start' because the Fund would need to progressively ramp-up in size if it is to make an impact. It is uncertain at this point what credit ratings will be assigned to the hybrid capital that is being planned and the market demand for such instruments. (Would it carry explicit or implicit guarantees by participating countries and what credit rating would be assigned?) Apart from this, it is essential that the ASEAN Economic Community become much more economically substantive than the present directions would suggest (both pre- and post- 2015). Much has been said about this but it bears repeating. Finally, ASEAN needs to rapidly deepen economic and financial integration with China, India, S. Korea, Australia and New Zealand. Not only is political commitment essential but, in view of the enormous risks, so is the timing of these efforts.



## ASEAN Infrastructure Fund and Its Limitations

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On 24 September 2011, the long-awaited ASEAN Infrastructure Fund (AIF) was formally launched in Washington D.C. with a planned start-up capital of USD485.2million. The idea was first mooted in May 2005 by then Malaysian Prime Minister Tun Abdullah Ahmad Badawi in the hope that each ASEAN country would utilise more than USD\$700 billion of its foreign exchange reserves to promote infrastructure development and support the realisation of the ASEAN Economic Community (AEC) by 2015<sup>24</sup>.

AIF is a corporate entity wholly owned by ASEAN governments and the Asian Development Bank (ADB). It will subsequently issue bonds for additional funding. AIF's basic equity structure comprises of Member States' contribution, a hybrid capital of USD\$162million and debt. All AIF shareholders have agreed that the disbursement will not commence unless and until at least 80 percent of the first tranche equity contributions, i.e. USD\$129.4 million, have been contributed.

Malaysia, followed by Indonesia, is the largest contributor to the AIF from ASEAN. The ADB plans to contribute USD\$150 million to the AIF and seems to be contributing even more to the fund than the stipulated amount as each project under the AIF will also be co-financed by the bank.

An old Chinese proverb states that, "if you want to be rich, you must first build roads". Infrastructure investments are important not only to stimulate a sluggish economy but also to ensure that long-term development goals are attainable. As private sector investments have been decreasing in recent times, the public sector needs to enhance its efforts and the AIF is one such way to accomplish this.

A greater focus on ASEAN's infrastructure deficit will ultimately yield higher intra-regional trade and growth levels within a more physically connected region. According to ADB and ADBI's study, the ASEAN region needs around USD60 billion a year for the 2010-2020 period<sup>25</sup>. As such, developing logistics infrastructure within ASEAN is envisaged to drive intra-regional trade to at least 40% (currently at 24.5 %), a figure ASEAN officials believe would serve as a basis for AEC.

Despite a wide range of choices for infrastructure financing in the region, the AIF presents itself with a set of limitations that are common to all cross-border initiatives. Firstly, let us examine the limitations of AIF itself, and secondly, the external risks derived from cross-border financing.

To put it succinctly, there are three main risks associated to the AIF's capital structure and operations that may affect the effectiveness of the fund. Firstly, the possible delay of equity contributions from ASEAN member countries will defer the implementation of the AIF even further. As the first installment of equity contribution will be pooled in July 2012, any possible postponement to the deadline will disrupt the financing of preliminary AIF projects worth USD\$300 million. These preliminary projects are scheduled to be presented for member countries' approval in the same year. Secondly, the AIF has to attain a high investment-grade rating in order to ensure that the lending rate, lending volume and return on equity are adjusted to keep borrowing cost at a minimum. And thirdly, as the AIF will, in due course, finance risky and complex non-sovereign projects within the region, the issue of disbursement and prioritizing the list of projects will further complicate the administration of this miniature-sized fund.

Similar to any cross-border initiatives, AIF is also exposed to external risks that may limit its full potential. Firstly, prioritizing cross-border infrastructure projects requires coordination between two or more sovereign countries, particularly when there is a mismatch between countries and regional interest for infrastructure projects. In the case of the AIF, preliminary projects for 2012 and 2013 are still subject to further approval by recipient countries even after a nod by the AIF Board.

Secondly, the possibility of a drastic movement of the transaction currency can be very detrimental to the fund size and cost of borrowing. Considering that AIF is transacted in US Dollars, returns from infrastructure investment has to be adjusted based on currency movement. And since financial returns from

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24 Fiscal Policy Coordination in Asia: East Asian Infrastructure Investment Fund by Dato' Dr. Mahani Zainal Abidin, ADBI Working Paper Series No.232, July 2010.

25 Infrastructure for a Seamless Asia, Asian Development Bank and Asian Development Bank Institute, 2009.

these investments cannot be locally transacted in the US Dollar, this raises further questions over the rate/price that governments should charge to cover the cost of infrastructure investment.

Thirdly, the issue of duration of mismatch and size of investment play an important role in the complexities of cross-border infrastructure financing. Massive infrastructure investments present itself with long implementation periods to create assets that yield financial returns over an even longer tenure. Furthermore, justifying an increase in traffic and other positive financial returns from infrastructure projects in less developed or populated areas has proven to be very difficult. As such, future costs and revenue streams for these types of investments are particularly hard to ascertain.

Fourthly, domestic politics is also part of the (hidden) project assessment. Although ADB and ASEAN are considered neutral in selecting priority projects under the AIF, key local stakeholders and interest groups may influence the outcome of these “foreign” projects.

Finally, regional infrastructure projects usually involve additional project management, commercial and sovereign risks that lengthen their preparation as well as complicate the implementation process. In some cases, project management may not even reach the final financing and implementation stage due to lengthy process of vetting, appraisals, tendering practices. Many are dropped for a variety of reasons, including unrealistic demand and cost assumptions, poor technical design, inability to realize adequate financial returns, lack of project sponsors and inadequate financing.

To sum up, the AIF does not seem to address these challenges and differentiate itself from other cross-border financing initiatives.

As reiterated by the former Prime Minister of Thailand recently, a bigger funding mechanism with the participation of Plus Six partners would give a sizable financing muscle to the region<sup>26</sup>. AIF’s fund size of USD\$485.2 million is too small and will not be sufficient to finance major infrastructure projects within the region. A bigger financing mechanism, such as the USD\$10 billion China-ASEAN Fund on Investment Cooperation and the idea for an East Asian Infrastructure Development Fund, will provide a bigger infrastructure boost in the region than the AIF. Furthermore, China is also considering a proposal to set up a USD4.7 billion ‘ASEAN Bank’ with aims to promote SMEs development and fund infrastructure projects within ASEAN and south-western China<sup>27</sup>.

The AIF is a long-overdue idea. Reaching a consensus on the establishment of AIF took more than six years and without a speedier institutional set-up, ASEAN member countries will not be able to utilize the fund to its maximum.

Now that the AIF is officially set-up, the question is, where and how does the AIF plan to strategically make itself relevant to its members?

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26 One ASEAN: What must we do? And how close are we?” by H.E. Abhisit Vejjajiva, Bangkok Post, 13 October 2011

27 EXCLUSIVE - China eyes creation of ASEAN Bank by Reuters, Thursday 27 October 2011