

What impact has free trade area on economies of ASEAN-5 countries?⁽¹⁾

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Abstract. *The main object of this study is to evaluate the impact of free trade liberalization on ASEAN-5 countries, consisting of Indonesia, Malaysia, The Philippines, Singapore and Thailand. Since ASEAN free trade area agreement was declared on 28 January 1992, the cooperation among the members has increased rapidly and has fostered them to achieve higher levels of economy. Therefore, variables such as foreign direct investment and trade should be implied to find out the determinants of the increase of output per capita of these countries. Panel data regression analysis has been employed in order to analyze the data. The variable of foreign direct investment has a positive effect on increasing output per capita of ASEAN-5 economies. We have also found the evidence for which the variable of trade and dummy free trade area don't have significant effect on output per capita before the policy was totally applied (zero tariffs). However, after the policy of zero tariffs was applied, these variables proved to give significant positive effects on output per capita.*

Keywords: free trade area, ASEAN, foreign direct investment, economic integration, panel data analysis.

JEL Classification: C33, F14, F15, F21.

1. Introduction

Integrating economy for development in general can define as “removing all trade barriers (include tariff and quota), integrating more than one economies by following common policies in economy, technology, social-cultural and political dimensions against non-member countries (Paksoy, 2000: p. 9)”. By the advantages of economic integration, member countries should be able to gain a level of development in order to increase their productivities and capacities, sustain the competitive ability with other regional and prevent conflict of trade among members in a region. However, the main purpose of economic integration is to achieve high level of economy and prosperity by liberalizing trade among member countries of region, to ensure member of countries to be regionalized and also to effort member of countries to be involved in economic and political events in the world (Şanlı, 2003: p. 15).

Economic integration theory itself has been known as one of basic macroeconomic theory to estimate the effect of economic integration accelerating economic growth. Many scholars also agreed that economic integration should be put into consideration as an important policy in macroeconomics. According to Chou (1967), the theory of economic integration revealed that analyzing its effect towards economic growth could be possible to evaluate the achievements of an economic integration to robust level of economic development using static effect and dynamic effect as criteria. In term of technological and economic structure as constant assumption, by eliminating tariffs, static effect of economic integration provides rapid increases in international trade volume and welfare changes. While static effects are one-off time effect, dynamic effects of economic integration are sustained ones, which leads to changes in economic structures of member countries, include production capacities and resource efficiency (Seyidoğlu, 2015: p. 243).

A number of former studies predominantly has inspired by Viner (1950)’s finding which divided the effect of economic integration towards trade creation and trade diversion. According to Salvatore (2013), custom union (one of prominent level to explain economic integration) may create and divert trade among countries. After establishing custom union and eliminating trade barriers (tariff and quota), member countries prefer to cooperate with each other and against non-member countries, which will be difficult for them to trade due to tariff and quota policy. However, custom union also can divert trade among countries since all trade barriers (tariff and quota) have removed and member countries will gain more trade advantage with members than trade with non-member countries.

There are some success stories in the world that can explain the effect of economic integration to accelerate economic development of member countries. One of simple successful economic integration story is European Union’s PIGS countries (Portugal, Ireland, Greece and Spain) which decided to join European Union in the late 1970’s. After they became the member of European Union, these countries enjoyed high and rapid economy growth for some decades and foster them to jump into the group of high income countries in late 1980’s (Licandro, 2004). This evidence showed that economic integration has important role to develop the economy of members. On the other hand,

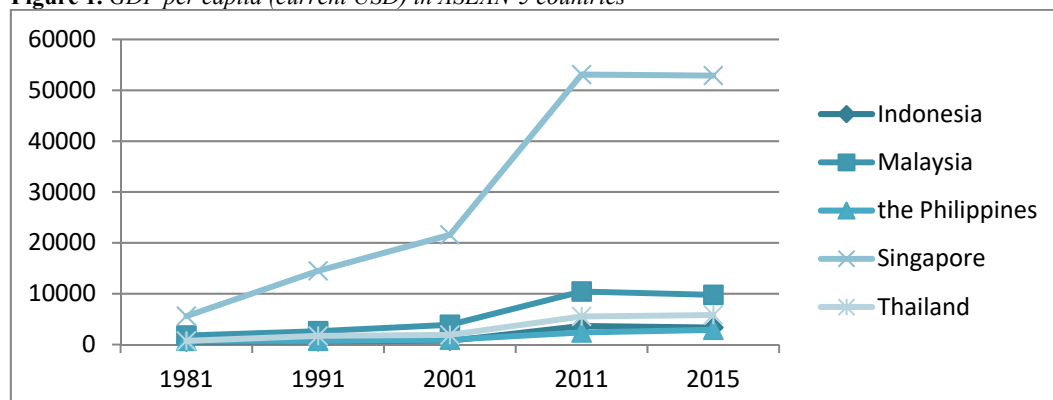
other regional integration such as North Free Trade Area (NAFTA), Central America Free Trade Agreement (CAFTA), Economic Community of West African States (ECOWAS), Southern Common Market (MERCOSUR), Andean Community of Nations (CAN), Central American Common Market (CACM) and Association of South East Asia Nations (ASEAN) are not experienced the success of European Union and tend to modest compare to European Union (Viotti and Kauppi, 2014: p. 411).

This study is expected to give evidence and evaluate the effect of regional economic integration, moreover with regional economic integration in Asian countries such as ASEAN. Since Asian countries grow rapidly in recent decades, the momentum to form regional economic cooperation among countries in Asia has risen, followed by the success of the European Single Market which started in 1992 and NAFTA in 1994. However, Sharma and Chua (2000) also agreed that economies of South East Asia should be moving forward to be more integrated in the future to obtain more advantages from current rapid economic growth.

While signing of ASEAN Free Trade Area in 1992, leaders from six countries of ASEAN member consist of Brunei Darussalam, Indonesia, Malaysia, The Philippines, Singapore and Thailand declared to decrease export and import tariff among the countries. The leaders made an agreement to push tariff into zero until 2010. After the agreement, other member countries such as Cambodia, Myanmar, People's Democratic Republic of Laos and Vietnam also decided to join the agreement and agreed to decrease their tariff into zero until 2015.

Recently some countries in South East Asia have been able to obtain the advantages after the agreement of ASEAN Free Trade Area was signed includes ASEAN-5 countries. The resilient growth of 5 countries in South East Asia (Indonesia, Malaysia, The Philippines, Singapore and Thailand) in recent years has been succeeded to increase their standard of living and tackling poverty problems by the increasing of their GDP per capita after AFTA agreement signed in 1992 as illustrated by Figure 1. Among these countries, only Singapore and Malaysia can achieve such rapid growth in their income per capita.

Figure 1. GDP per capita (current USD) in ASEAN-5 countries



Source: World Bank Data (2017).

Besides, Table 1 illustrated that some countries in South East Asia are also receiving high capital inflow by the rapid growth of Foreign Direct Investment inflow after AFTA agreement started in 1992. Singapore has received more FDI than other ASEAN-5 countries followed by Indonesia, Malaysia, Thailand and The Philippines. This achievement finally was able to gain more capital inflow and increase foreign' investment expenditures in ASEAN-5 economies.

Table 1. FDI net inflow (BOP, current USD) in ASEAN-5 countries

Country	1981	1991	2001	2011	2015
Indonesia	133	1,482	-2,977	20,564	20,054
Malaysia	1,264	3,998	553	15,119	10,962
The Philippines	172	544	760	2,007	5,835
Singapore	1,659	4,887	17,006	48,329	65,262
Thailand	290	2,013	5,067	2,473	9,003

Source: World Bank Data (2017).

ASEAN itself has plans for further integration with other regional cooperation in East Asia and Pacific. In 1989, as the growing interdependence of Asia-Pacific economies, ASEAN member countries agreed to join regional economic cooperation called APEC (Asia Pacific Economic Cooperation). Amelung (1992) believed that ASEAN will gain more benefits from larger cooperation intra-regional such as Asia Pacific cooperation or APEC. Capannelli et al. (2009) also found that ASEAN integration and 16 integrating Asian economies (include Australia, China, India, Japan, New Zealand and South Korea) in term of trade, direct investment, financial flows and other form of economic and social changes increased rapidly and same like what European Union approach. Moreover, ASEAN has taken a forward step to become more integrated since the ASEAN common market has been realized at the end of 2015. This step makes ASEAN now become one of the biggest single markets in the world where all factors of production can be easily moved among country's members and the further goal of ASEAN integration is become a single entity as outlined in the ASEAN Vision 2020 and integrating 3 pillars of ASEAN, politics, economy and social.

There are some studies which focus on the effect of economic integration towards Asian countries and other developing countries. Most of the studies revealed different perception about Asian economic integration. Hamilton and Winters (1992) note that ASEAN has a strong bias towards ASEAN intra-regional trade. The ASEAN economies do not have significant trend towards their members. However, it has a significant effect to other ASEAN member like APEC. Shams (2003) also gave an evidence of regional integration in developing countries such as MERCOSUR, which in general the members do not enjoy the effect of economic integration due to scarcity of larger and more developed countries in the neighborhood and the risk of trade diversion among member countries.

Since ASEAN member countries dominated by developing countries (Singapore and Brunei are the only developed countries), thus they need to wider their regional economic cooperation, especially with other regional neighbors in East Asia and Pacific like APEC (Sharma and Chua, 2000). Countries like Japan and South Korea, whose are rich of capitals and savings can flow their capitals and savings to other ASEAN member

countries like Indonesia and Thailand. In the other hand, rich resource countries like Indonesia and Thailand can channel their resource to poor resource countries like South Korea and Japan.

With these backgrounds, this study tried to purpose our objectives, evaluating the effect of ASEAN economic integration on the stage of Free Trade Area, which divided by two parts of policy analysis, before zero tariff applied and after zero tariff applied. This study is briefed into five sections. Section 1 is introduction of research, which is explaining the research background and questioning the research problems. In section 2, we construct the theories from some references to explain our expected hypothesis of relation dependent variables to independent variables. After the theories constructed, in section 3 it is important to interpret the research methodology and build the model of our analysis by expected hypothesis. Thus, in sections 4 and 5, the result of analysis and concludes of study will be described.

2. Empirical literature

Economic integration can promote the freedom of movement in terms of trade and factors of production among the member countries and give equal opportunity for social classes, regions and member countries. Balassa (1961, quoted by Hosny, 2013) illustrates economic integration as “the abolition of discrimination within area”. However, integration of economy according to Narendra and Goel (2014) limit the definition of economic integration as synonymous of globalization and limit it with regional economic integration. Thus, regional economic integration in particular is an agreement among member countries to reduce and ultimately remove tariff and non-tariff barriers to the free flow of goods, services and also factors of production. In addition, Ünsal (2005) explained that there are five forms of economic integration. They are Preferential Trade Agreements, Free Trade Area, Custom Union, Common Market and Economic and Monetary Union. Preferential Trade Agreements usually describe as affording to decrease tariff among participant countries than other member countries (Panagariya, 1998). However, if the participants pushing tariff to decrease or even pushing it into zero level, it can be defined as economic integration in the level of Free Trade Area. The most common model to describe the level of economic integration is Custom Union which is among participants should have a common trade policy. Common market is more developed than custom union since it allows factor production to be distributed among participant countries freely. Finally the most advance models of economic integration itself is economic union where participant countries have one common policy of monetary and economic (Ünsal, 2005).

There are some empirical literatures that constructed some model of economic integration in analyzing its effect towards growth of economy, especially in the level of free trade area. *Vamvakidis (1997)* whom analyse the impact of international trade on economic growth of 138 countries as its observation found that free trade and growth of economy having significantly positive correlation with time period started from 1980 through 1970.

On the other hand, *Barro and Sala-I-Martin (1995)* stated that trade protection using tariff policy in trade is possible to give negative impact on economic growth.

It is also important to review some worthy empirical works on European Union integration. According to *Cecchini Report (1988)*, the static effect of regional growth is invariably around 2.5-6.5% towards the income of European Economic Community. *Baldwin and Seghezza (1996)* believed that there is a positive effect of free trade in European Union towards economic growth for medium term.

Herekson et al. (1997) resulted that member countries in European Community (EC) and European Free Trade Area (EFTA) have significantly increases on their growth rates in long term. The growth effect is estimated in approximately 0.6-0.8%. *Badinger (2001)*'s study found that the European Union economic integration had a positive impact towards economic growth and with observation between 1950-2000, if European economies was not integrate, the average growth rate per decade would be 0.4 percentage points lower for some EU countries. Another study by *Cuaresma et al. (2008)* found that European Union membership have positive and asymmetric influences on economic growth in the long term (which is relatively higher for poorer countries). Economic integration also positively influenced growth in the long run, in the study of economic integration in the European Union by *Pehlivan (2013)*.

In case of ASEAN integration, a study by *Plummer et al. (2014)* found that by the applying of ASEAN Economic Community and Regional Economic Comprehensive Partnership all ASEAN economies will gain benefits on their income growth, rising about 8% and 18% in respectively. *Nguyen and Ezaki (2005)* resulted that Vietnam as a member of ASEAN enjoyed rapidly growth on its market and positive improves welfare and income-distribution after participated in the China-ASEAN free trade area and signed a bilateral package with United States. The empirical result of *Ismail et al. (2009)* revealed that AFTA has impact on increasing of FDI from European Union more than other USA and Japan and also found that USA and Japan have significant investments on ASEAN-5 more than other members. Moreover, *Ardiyanti (2015)* also estimated a positive effect of AFTA on the member's countries trade performance in term of export.

Some empirical studies also found the opposite effect of economic integration on the growth of economy. *De Melo et al. (1992)* believed that there is no significant effect relationship between economic integration and long term growth in observation of 101 countries, include OECD and developing countries. Similarly, *Vanhoudt (1999)* also revealed no evidence of economic integration's positive effect towards growth of European Union membership or non-membership in 23 OECD's countries observation.

3. Data and methodology

This study investigates the effect of free trade area agreement among ASEAN countries since 1992 who signed by six countries (including Brunei Darussalam). However, this study will only concern on ASEAN 5 dominant economies such as Indonesia, Malaysia, The Philippines, Singapore and Thailand. We use a dummy variable to analysis the effect

of the AFTA agreement. (Herenkson et al., 1997) and Sachs and Warner (1995) are used dummy variable in their analysis to find some indicators that have possibility for effecting growth of economy. For the period of 1981 through 1992, the value is 1 and the period of 1992 through 2015 the value is 0. Other variables that are used in this analysis can describe as follows:

Table 2. *Variables descriptions*

Variables	Symbol	Sources
GDP per capita is defined as total gross domestic product of country divided by population of country in a year (in current US Dollar). This includes total gross value added of all goods and service by producers in the economy plus any product taxes and minus any subsidies.	GDP _{it}	World Bank Data (2017)
Foreign direct investment is confine as cross-border's capital inflow of country that reported by the economy. Calculated by total of equity capital, reinvestment of earnings and other capital. This includes a resident in one economy that having control and has a significant degree of influence on the management of an enterprise that is resident in another economy. Data used are in current U.S. dollars.	FDI _{it}	World Bank Data (2017)
Trade is measured by total of merchandise goods exports and imports divided by the value of GDP (as share of GDP) and calculated in current U.S. dollars.	TRD _{it}	World Bank Data (2017)

The analytical framework will be estimated by panel data regression analysis in two different parts due to the Common Effective Preferential Tariff (CEPT) aims zero tariff policy for all products for ASEAN-6⁽²⁾ in 2010 (Kraichitti, n.d.). First, we applied sample period of observation before zero tariff policy applied from 1981 through 2010 in ASEAN. The second, our sample period of observation is ASEAN free trade area after applying zero tariff policy (from 1981 through 2015). Moreover, by Hausman Test analysis, the two models of Fixed Effect Model and Random Effect Model are possible to be selected. Rayp and Standaert (2017) also suggest other variables such as Foreign Direct Investment and Trade can be used to measure integration in term of economy. Therefore, we also applied these variables in our panel data model as follows:

$$D.\log.GDP_{it} = \beta_0 + \beta_1 D.\log.FDI_{it} - \beta_2 D.\log.TRD_{it} + \beta_3 DummyFTA_{it} + e_{it} \quad (1)$$

D.log.GDP_{it} is Gross Domestic Product per capita of a country *i* in a period of *t*; D.log.FDI_{it} is Foreign Direct Investment, net inflows (BoP current US Dollar) of a country *i* in a period of *t*; D.log.TRD_{it} is trade (in term of total merchandise trade) variable of a country *i* in a period of *t*; DummyFTA_{it} is dummy free trade area variable of a country *i* in a period of *t*; β_0 is constant; β_n is regression coefficient; e_{it} is disturber coefficient. As explained on literature review and the theories, it can be expected hypothesis of the effect of variables as follows:

Table 3. *Expectation effect of independent variables towards dependent variables (GDP_{it})*

Independent variables	Hypothesis on both of policies
Foreign Direct Investment (FDI _{it})	(+) significant
Trade (TRD _{it})	(+) significant
Dummy of Free Trade Area (FTA _{it})	(+) significant

4. Findings

4.1. Unit root test

Before we analyse variables with panel data regression, it is important to check the stationary of data that are used. The unit root test of Im, Pesharan and Shin W-stat (IPS)

result in Table 4 show that the probability of GDP variables, FDI variables and Trade variables are significant at 5 percent. It can be concluded that our data is stationary in first difference. Therefore, these data is possible to use for further panel data regression.

Table 4. *The unit root test result of all variables*

Method	Probability		
	GDP variables	FDI variables	Trade variables
Im, Pesaran and Shin W-stat	0.0000** I(1)	0.0000** I(1)	0.0000** I(1)

Note: **Statistically significant at 5 percent (*p-value* less than 0.05) and *Statistically significant at 10 percent (*p-value* less than 0.1).

4.2. Regression results

As we mentioned above, some variables of our analysis might be possible to determine and evaluate the effect of free trade area in ASEAN-5 countries in two scenarios, before zero policy applied and after zero policy applied. Since the Hausman tests results probabilities with value 0.93 and 0.97 in respectively and it is bigger than a probability value of 10%. Therefore, it can be assumed that both of two policy scenario, *Random Effect Model* is the best model to interpret them. From the results of analysis in Table 5, both of F-statistic probabilities have significances less than 5%. Thus, it can be concluded that the independent variables (FDI_{it} , TRD_{it} , $DummyFTA_{it}$) have a simultaneous influence on both dependent variables (GDP per capita). The R-square of analysis for after zero tariffs applied is fit to interpret the analysis result than the R-square of before zero tariff applied.

The variable of $D.log.FDI_{it}$ or Foreign Direct Investment has a positive effect and significant towards GDP per capita both of before zero tariff applied and after zero tariff applied. It can be concluded that before zero tariff policy, FDI only affected output per capita of a country with value 0.031111.

Table 5. *Panel regression analysis result of GDP per capita with random effect model*

Variables	Before zero tariff applied		After zero tariff applied	
	Coefficient	Prob.	Coefficient	Prob.
Constants	0.070263	0.0000	-0.064858	0.0520
$D.log.FDI_{it}$	0.031111	0.0049**	0.177152	0.0000**
$D.log.TRD_{it}$	-0.132435	0.1883	0.840112	0.0000**
$DummyFTA_{it}$	-0.011995	0.5189	0.105479	0.0133**
Hausman Test	Prob.chi square : 0.9340		Prob.chi square : 0.9871	
R-square	0.047800		0.639489	
Prob(F statistic)	0.025328		0.000000	

Note: **Statistically significant at 5 percent (*p-value* less than 0.05) and *Statistically significant at 10 percent (*p-value* less than 0.1).

However, after zero tariff policy has applied, in certain period FDI effecting more output per capita (with value 0.177152) and more significant (with p-value 0.0000). This result is incline with Di Mauro (2000) finding who suggests country's member should be able to receive more and more FDI by the impact of economic integration (impact in commercial changes and monetary integration), then increasing investment and output. Besides, FDI also creates two main channels of economic integration of non-members in member countries. This two main channel could be as trade creation among members or trade diversion (Ünsal, 2005). Moreover, Sharma and Chua (2000) suggest ASEAN needs

to create cooperation with to other regional like East Asia. Thus, countries like Japan and South Korea can channel their abundant of savings and capital through FDI investment into ASEAN countries.

The result analysis of variable $D.log.TRD_{it}$ or Trade is different in both of two our policy of analytical framework. Trade variable does not have a significant effect towards GDP per capita of the countries. However, after zero policy applied on AFTA, trade influencing positively towards GDP per capita of a country in certain period as 0.840112. Increasing trade in general should be increasing together in output of a country. Frankel and Romer (1999) claiming that there is increasing in GDP per capita by 2.4% accompanied with increasing trade by 1%. However, since most ASEAN member countries top 10 major trade partners are non ASEAN's members and only 24 percent trade within ASEAN members, trade might not possible to give an effect towards GDP per capita of the members and create possibility of trade diversion among the members (Table 6).

Table 6. Top ASEAN trade partner countries/region in 2015

Trade partner country/Region	% Share to total ASEAN trade		
	Exports	Imports	Total Trade
ASEAN	25.8	21.9	23.9
China (People's Republic of)	11.3	19.4	15.2
Japan	9.6	11.4	10.5
EU 28	10.8	9.2	10.0
United states	10.9	7.6	9.3
Korea, Republic of	3.9	7.0	5.4
Taiwan	2.8	5.6	4.1
Hong Kong	6.5	1.1	4.0
India	3.3	1.8	2.6
Germany	2.2	2.6	2.4

Source: ASEAN (2017).

The result of variable $DFTA_{it}$ or Dummy of Free Trade Area is also different with our expecting hypothesis. AFTA does not have significant influence on GDP per capita in period sample of before zero tariff policy applied. However, AFTA has a significant effect towards GDP per capita after zero tariff policy applied to value 0.105479. Therefore, it is important to note that zero tariff policy in AFTA has effort ASEAN-5 countries to be more integrated and foster them to obtain more advantages from ASEAN Free Trade Area in the future.

Herenkson et al. (1997) have pointed that traditional economic integration does not have a permanent effect on economic growth. On the contrary, some scholars claimed that regional integration could give a long-run effect on growth of economy. Asian integration trade has tended to increase rapidly until the mid of 1980 as their share of world trade increase and traded more intensively with other non-Asian economies. Sharma and Chua (2000) revealed that the recent developments of free trade area in ASEAN only give less effect of economic impact since ASEAN only have 25 percent trade share with ASEAN member countries themselves. This evidence can create such trade diversion among the members. Capannelli et al. (2009) explained that trade of economies in MERCOSUR also increases after they become more integrated with other regional economies and Shams (2003) also believed that MERCOSUR economic integration generally does not have a

significant effect towards economic integration due to scarcity of larger and more developed countries in the neighborhood and the risk of trade diversion among member countries.

5. Conclusion

The result analysis of this study found some important notes to evaluating the progress of integration in ASEAN, especially after AFTA was signed in 1992. All variables of our analysis resulted positive and significant effects on output per capita of ASEAN-5 countries after AFTA applied fully zero tariff policy among the members. However, only the variable of Foreign Direct Investment has a positive effect and significantly influences output per capita of ASEAN-5 countries before AFTA applied zero tariff policy. The variable of trade and dummy free trade area do not have significant influence on the output per capita.

The AFTA's zero tariff policy itself has ensure ASEAN countries (especially ASEAN-5 countries) to be more integrated and by beginning ASEAN Community in 2015, it can be a moment for ASEAN countries to obtain more advantages by applying a more developed level of economic integration in the future. Some scholars by Hamilton and Winters, (1992); Sharma and Chua, (2000); Frankel, 1993; Petri, (1993) also agreed that ASEAN needs to wider its cooperation towards other regions such as East Asia and Pacific (especially with other developed countries in ASEAN-6). ASEAN members, which are in general rich of resources can improve their trade performance by channeling their resources to developed countries in East Asia developed countries which in general rich of capitals and savings, otherwise East Asia developed countries also can invest in ASEAN member countries. Therefore, ASEAN-5 countries can sustain their rapid growth of economy and achieve high level of economy by integrating their economies with other regions.

Notes

- (1) This paper had been presented in International Economics, Finance and Econometrics Symposium (EFEOS) in 17-18 May 2017 and awarded as the second best paper in economics field.
- (2) ASEAN-6 consists of Brunei, Indonesia, Malaysia, The Philippines, Thailand and Singapore.

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