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AFTA: Challenges and Solutions

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Introduction

The global trend for regional groupings or trade blocs in the 1990's coupled with uncertain implications of the New World Order had led the ASEAN countries to seriously work out a plan to strengthen economic co-operations and maximize the region's potential growth through a liberalization of intra-ASEAN trade and investment. As a result, the ASEAN Free Trade Area (AFTA) was formulated in 1992 during the fourth ASEAN summit in Singapore. AFTA comprises the ten countries of ASEAN i.e. Brunei, Burma, Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand and Viet Nam. The agreement involves phasing intra-regional tariffs down for a wide range of manufactured products through a mechanism called the Common Effective Preferential Tariff (CEPT) scheme . Members are committed to reducing these import tariffs on most products to 0-5 per cent by the end of 2002 (with later implementation dates for Cambodia, Viet Nam, Burma and Laos). Protocols concluded after 1993 have extended the coverage of AFTA to areas such as services and investment.

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As widely understood, AFTA implies free flow of products within ASEAN countries. An important issue has recently arisen and hotly debated i.e. whether ASEAN countries will as a whole benefit from the formation of AFTA. One would normally expect that member countries would enjoy some positive outcomes (more than the negative ones) from an economic integration. Can we guarantee those in the case of AFTA? A quite important point is that most of the ASEAN countries (except for Singapore) are categorized as developing and relatively new and not fully established in various manufacturing industries. Interestingly, approaching the AFTA dateline, some countries had asked for postponement and seemed not to be ready to face the reality of AFTA. Why? What are the problems with the current setting or framework of AFTA? Can we rectify those weaknesses? These are among the important questions that will be discussed in this paper. It is the main objective of this paper to identify the crux of the problem related to AFTA. The next section will briefly discuss the CEPT, followed by some review on the economic effects of regional integration in section 3. Even though the main objective is to identify the weaknesses, it is quite unfair to totally ignore the bright side of AFTA. Thus section 4 provides some discussion on the prospects of AFTA while the weaknesses or challenges of AFTA are described in section 5. Section 6 includes several recommendations on how to improve the weaknesses in AFTA.

CEPT

The scheme is a cooperative arrangement among ASEAN Member States that would reduce intra-regional tariffs and remove non-tariff barriers over a 10-year period commencing 1 January 1993. The goal of the Scheme is to reduce tariffs on all manufactured goods to 0-5% by the year 2002 for the original six member states, Malaysia, Singapore, Brunei, Thailand, Philippines and Indonesia while allowing some delay for the new members.

Inclusion List

The products included in this list have to undergo immediate liberalization through reduction in intra-regional (CEPT) tariff rates, removal of quantitative restrictions and other non-tariff barriers. Tariffs on these products should have been down to a maximum of 20% by the year 1998 and to 0-5% by the year 2002. The new Members of ASEAN are given an extra room until 2006 (Viet Nam), 2008 (Laos and Myanmar) and 2010 (Cambodia) to meet this deadline.

Temporary Exclusion List (TEL)

The list contains products that can be excluded from trade liberalisation only for a temporary period of time. Soon, they would have to be transferred into the Inclusion List and begin a process of tariff reduction so that tariffs would come down to 0-5%.

Sensitive List

Products such as unprocessed agricultural products are granted extra time prior to being integrated with the free trade area. Regular members have until 2010 to reduce tariffs to 0-5%, remove quantitative restrictions and other non-tariff barriers. As for the new members of ASEAN, they have up to 2013 (Viet Nam), 2015 (Laos and Myanmar) and 2017 (Cambodia) to meet this deadline.

General Exception (GE) List

These products are permanently excluded from the free trade area for reasons of protection of national security, public morals, human, animal or plant life and health and articles of artistic, historic and archaeological value. The provision on General Exceptions in the CEPT Agreement is consistent with Article X of the General Agreement on Tariffs and Trade (GATT). Malaysia has excluded weapons and alcoholic beverages for concession under the CEPT scheme.

Review on the Economic Effects of Economic Integration

Trade Creation

Trade creation occurs when domestic production of one member nation is replaced by lower-cost imports from another member nation. The trade creation effect leads to efficiency gains for member nations, because some countries shift from a higher cost domestic source of supply to a lower-cost supply from foreign source (another member country). Member countries eventually specialize in producing those items, for which they have a comparative advantage.

In the case of full employment of domestic resources, trade creation increases the economic well being of member nations because it leads to greater specialization in production and trade, lower consumer prices, and higher disposable incomes. In addition, FTA members may also import from each other certain goods that are not previously imported due to high tariffs.

A trade-creating FTA may also increase the economic well being of nonmembers, since some of the increase in its economic growth will lead to higher income that will, in turn, translated into increased imports from the rest of the world. Gains from an FTA are expected to be large if the tariff to be removed is large, and if domestic supply and demand are more responsive to price changes over the long run.

Trade Diversion

Trade diversion occurs when lower-cost imports from a nonmember nation are prevented from entering the FTA by tariff or non-tariff barriers, and are replaced by higher-cost imports from a member nation. Trade diversion reduces world economic well-being since it shifts production from more efficient producers outside the FTA to less efficient producers within the FTA. The international allocation of resources becomes less efficient, and production shifts away from the pattern suggested by comparative advantage.

In reality, formation of FTAs contain both trade creation and trade diversion effects and may increase or decrease member welfare depending on the relative strength of the two opposing forces. FTAs will most likely lead to trade creation and increased economic well-being of member nations under the following conditions:

i. High pre-FTA trade barriers: This is likely to increase trade among members, rather than diverted from nonmembers to members;

ii. Larger number of countries: The more countries included in the FTA and the larger their size, the more likely that low-cost producers will be found among member nations;

iii. Competing versus complementary: An FTA formed by competitive, rather than complementary economies is more likely to produce opportunities for specialization in production and trade creation;

iv. Distance and proximity: When member nations are in close proximity to one another, transportation costs become less of an obstacle to trade creation

v. More lower cost countries: If the FTA contains countries with the lowest cost source of goods and services consumed by member nations, trade diversion is less likely to occur.

Trade Deflection

Trade deflection will occur if imports enter the FTA through the participating country, which has the lowest tariff. Of course, this assumes that transportation costs and other costs related to imports do not outweigh the difference in tariff rates[1].

In FTAs, Each participating country retains the power to erect her own separate protection against imports from the rest of the world. It is thus very likely that countries will maintain different tariffs and other barriers on products coming in from outside the FTA. This raises the possibility of trade deflection.

Under the assumption of constant terms of trade, the trade deflection effect will therefore limit the extent of trade diversion and will have welfare-increasing effects in member countries.

However if the terms of trade change, there will be an impact on distribution of welfare between member countries and the outside world. Trade deflection will reduce both the terms of trade gain for member countries and the terms of trade loss for the outside world, ceteris paribus.

[1] Trade deflection is potentially prevalent in the case of AFTA. The detail of it is discussed in section 5

Production and Investment Deflection

In addition to trade deflection, an FTA creates the possibilities of production deflection and investment deflection. Production deflection occurs if the producers of products with an imported intermediate input content shift production to countries which have the lowest tariffs on those inputs. To this statement must be added the provision that this will occur only if the tariff differential outweighs the difference in the costs of production. The production deflection will have an adverse impact on welfare because it causes the reallocation of resources contrary to what each country's comparative advantage would indicate a priori. This inefficient allocation may in turn cause a change in the pattern of investment. Ceteris paribus, investors will tend to invest in the member countries with the lowest tariffs on imported inputs or with the highest tariffs on finished products. This leads to so-called tariff factories.

The welfare effects of investment deflections are of course negative. These deflection effects are actually unintended aspects of FTAs. To avoid them, member countries of FTA usually impose rules of origin. These rules restrict the freedom of intra-area trade in products, which incorporate certain proportions of imported products or undergo certain transformation process in member countries. However these rules tend not to be very effective. In order to limit deflection effects, member countries are thus encouraged to reduce their own tariffs towards the level of the lowest tariffs in the FTA.

Prospects of AFTA

Larger market and Intra-ASEAN trade

The formation of AFTA is expected to further boost intra-ASEAN trade. AFTA provides opportunities for the ASEAN producers to enjoy a bigger market of 370.3 million people (population in the original six member countries in 2000) and with the GNP capacity of US$820 billion. A substantial economies of scale is possible in the enlarged market area. If firms were previously serving only the domestic market, the expanded market through AFTA can create export opportunities. With economies of scale, the increase in output lowers per unit costs and the price charged to consumers.

Specialization

On the production side, AFTA creates a larger ASEAN's internal production capacity, which can deliver lower prices and allow for specialization of production. More importantly, the reduction of high tariffs can promote trade in intermediate products and encourage an international division of labour in production within ASEAN..

Increased Competition

Businesses, especially those in monopolistic and oligopolistic markets, can become sluggish and complacent when protected by barriers to trade. With the formation of an FTA, trade barriers among members are greatly reduced or eliminated, and producers must become more efficient to effectively compete with foreign firms. Some may succeed; some may merge with other firms; others will go out of business. The higher level of competition is also likely to stimulate the development and adoption of new technology and new products. The result will be lower costs of production and, therefore, lower consumer prices for goods and services, new products, and improvements in product quality. It is important that member country governments enforce the new trade rules if these competitive forces are to operate effectively.

A more attractive place for FDI

Through AFTA, ASEAN can become more attractive in the eyes of MNCs. The formation of an AFTA is likely to stimulate outside investment in production and marketing facilities to avoid the discriminatory barriers imposed on nonmember products, taking advantage of the enlarged market. Investment in a FTA area is an alternative to the export of products from nonmember countries. Investment in a any of the AFTA member country will ensure "jumping the tariffs" in the sense that the products would not be restricted by tariff and non-tariff barriers.

Efficient Resource Use

Finally, since the AFTA includes ASEAN Investment Area (AIA), a free movement of labor and capital is likely to stimulate more efficient use of the economic resources of the entire bloc. Overall efficiency of industries and individual firms will likely increase with increased access to lower-cost capital and additional labor. Lower consumer costs and higher real incomes should follow.

Challenges of AFTA

Different Economic background and economic status

An obvious feature of the AFTA member countries is in terms of divergence in income and background. For example, we have a country like Singapore which is effectively a trading nation and has long history of free trade. The other is Brunei, which is also a non-producing nation except for petroleum. The rest of ASEAN countries are relatively low in income, still developing and dependent mostly on various primary sector or rather young manufacturing industries. They really need guidance and some sorts of protections before being able to compete with the world producers. The difference in background is in a way reflected in the pattern of readiness of each nation in embracing AFTA dateline. An indicator of readiness can be obtained from the members' proposal of the average import tariff with the smaller figures implying the higher degree of readiness. As shown in Table 1, as expected, Singapore and Brunei have the best scores for readiness i.e Singapore 0.00 (since the beginning) while Brunei 0.87 by the year 2003. The rest of the members seem not to be ready to fully remove the tariff by the dateline 2003.

Table 1: Average CEPT Tariff Rates for All products

Country	1998	1999	2000	2001	2002	2003
Brunei	1.35	1.29	1.00	0.97	0.94	0.87
Indonesia	7.04	5.85	4.97	4.63	4.20	3.71
Laos	5.00	5.00	5.00	5.00	5.00	5.00
Malaysia	3.58	3.17	2.73	2.54	2.38	2.06
Myanmar	4.47	4.45	4.38	3.32	3.31	3.19
Philippines	7.96	7.00	5.59	5.07	4.48	3.75
Singapore	0.00	0.00	0.00	0.00	0.00	0.00
Thailand	10.56	9.75	7.40	7.36	6.02	4.64
Viet Nam	6.06	3.78	3.30	2.90	2.89	2.02
ASEAN	5.37	4.77	3.87	3.65	3.25	2.68

Source: ASEAN Secretariat

Pressure on local industries

During the early stage of the AFTA planning, most ASEAN members were generally quite excited to see AFTA materialized, as they had not yet foreseen any potential negative effects of AFTA that can harm or threaten their local industries and economies as a whole. However, as the dateline draws nearer, there is sentiment of fear and worry that AFTA might cause distress to some local industries, especially the emerging industries. For example, Malaysia has asked for the postponement of automobile industry into the inclusion list in order to protect her national carmaker PROTON against competition from its own neighbor which has become a regional arm for world leader of auto industry from Europe and the USA[2]. In fact, the recent development indicates that except for Singapore, other ASEAN members are still not fully ready for AFTA. In a statement at the end of an annual meeting, foreign ministers of ASEAN said that rules were being worked out so that countries "experiencing real difficulties" could temporarily withdraw sensitive sectors from the free-trade agreements.

Individual versus collective regional gain

Despite ASEAN's strong economic performance and extensive cooperation in non-economic areas of activity, economic cooperation within the ASEAN framework has proceeded slowly[3]. Institutional efforts to boost intra-regional trade and especially investment have had, at best, a marginal effect on economic activity. Agreement in early 1992 to form AFTA marked a new departure and was hoped to refresh and strengthen the earlier forms of cooperation, however, up till now the steps or efforts taken towards enhancing a more solid, strategic and real economic cooperation among the ASEAN members are less than satisfactory. Even within the current framework of AFTA, each nation seems to be taking steps and measures that are more "individualistic" rather than

[2] Malaysia was initially quite excited to see the potential ASEAN market for her domestic auto industry, thus included the product into the inclusion list. In the meanwhile, Thailand was also making a separate plan for her own auto industry (joint venture with foreign producers from Japan, USA and Europe who have foreseen the opportunity of marketing their products in ASEAN through Thailand.

[3] ASEAN countries have already formulated various economic co-operation schemes, i.e., ASEAN Industrial Cooperation (AICO), ASEAN Investment Area (AIA), and cooperation in Services Liberalization, but they do not seem to achieve significant outcome.

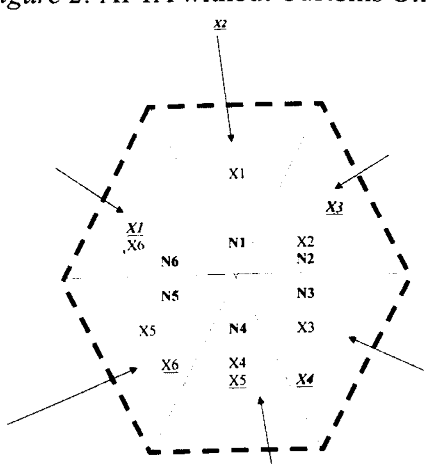
"collaborative" or "complementary" types. For example, a member country has been busy with Japan, Europe and the USA for collaboration in automobile industries, while another member with Japan and New Zealand for various goods to be marketed in the region as AFTA approaching its dateline. If this kind of unhealthy trend persists, then ASEAN, as a whole will not gain collectively from AFTA, in fact they will lose. The emerging industries will definitely suffer instead of prosper. Instead of becoming stronger and more competitive, they will become weaker and more dependent on others.

Conceptually, the challenge and threat of AFTA to the local industries may be analyzed using the following Figures (1, 2, and 3). Figure 1 shows a situation of pre-AFTA where each member imposes similar barriers to ASEAN and non-ASEAN countries. For simplicity, we only assume six nations (N1, N2, N3, N4, N5 and N6) involved in the economic integration with their six new industries X1, X2, X3, X4, X5 and X6 respectively. Before FTA is formed, each nation imposes relatively higher barrier for products, i.e. N1 imposes high tax barrier on X1, N2 on X2 and so forth in order to protect their relatively infant and emerging industries. When FTA is formed, as shown in Figure 2, trade barriers among members are lowered (as indicated by the disappearance of bold lines between member countries) while barriers towards non-members are left non-standard (up to each individual member to decide). Thus, each member will set barriers towards non-members such that their welfare and benefits will be maximized. Unfortunately in doing so, they might or might not realize that members' welfare would be affected by some of their trade policies towards the non-members. Specifically, they might totally remove tariff on products that are of the specialization of the other member countries in the FTA. A worse case scenerio might emerge where a member country might allow itself to become a "gate of entrance" for the products from a more advanced and established producers from outside the FTA (that will put pressure on local products). As shown in Figure 2, N1 produces X1 and at the same time welcomes industry X2 from a more established world producer to operate with her border. This will negatively affect the new and emerging industry X2 in nation N2. To complete the story, N2, which produces X2 also, welcomes industry X3 from a more established world producer to operate in her land targeting for the neighboring FTA markets, and N2's action will negatively affect locally new industry in N3. N3, N4, N5 and N6 are also involved in this unwise and non-strategic business collaborations with the rest of the world as shown in Figure 2, and all of them would as a matter of fact lose simultaneously.

Figure 1: pre-AFTA

	Labor intensive	Capital intensive	Knowledge intensive	Resource based	Up-stream	Middle-stream	Down-stream
Viet Nam	XXX	-	-	XXX	XXX	X	X
Indonesia	XXX	X	X	XXX	XXX	XX	XX
Malaysia	X	XX	XXX	XX	X	XXX	XXX
Philippines	XXX	X	XX	XXX	XXX	XX	XX
Singapore	-	XXX	XXXX	-	-	XX	XXX
Thailand	XXX	XX	XX	XXX	XXX	XX	XX
Brunei	-	XX	XX	XX	XXX	XX	X

Figure 2: AFTA without Customs Unions



[1] WTO permits departure from Article I (non-discrimination which binds the signatories to grant to the products of other members treatment no less favorable than accorded to the product of any other country) with respect to customs unions and free trade area (Article XXIV).

Most of the locally new or emerging industries would most likely be driven out of the industries, as they are not able to compete with the world established and prominent producers.

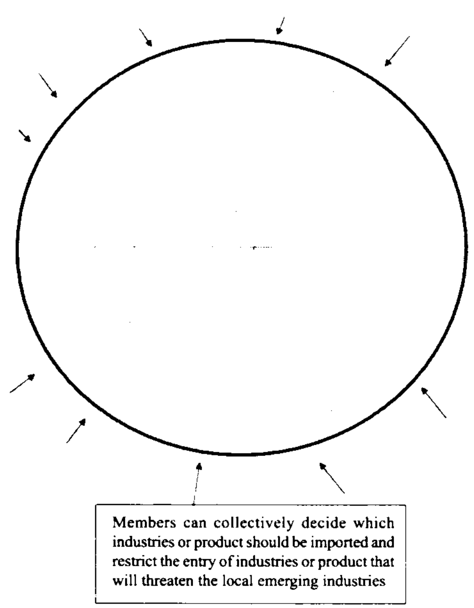
Suggested Solutions

How to approach the AFTA weaknesses and challenges?

Common trade policy towards non-members

First of all, ASEAN must have a common policy towards the non-members. This can be achieved if they can transform FTA into a more solid economic integration i.e. customs unions[1], which technically similar is to FTA but includes in addition a set of common policies and barriers (Common External Tariff) towards the rest of the world as illustrated in Figure 3. It should be stressed that we are not promoting the customs unions for the whole ASEAN economies, but just for the emerging industries. Thus members can collectively decide which industries or products should be imported and restrict the entry of industries or products that can weaken the ASEAN emerging industries.

Figure 3: Customer Unions



Referring to the illustrative example in section 5, knowing that X1, X2, ..., X6 are of the specialization of FTA member countries, then FTA council or committee should set common restrictions on those products. At the same time, they can remove barriers for the other products that are not of their specialization i.e. X7, X8, ..., Xn

It should also be noted that we are not promoting for permanent protection for the emerging industries. The main purpose is to temporarily protect and strengthen the new industries in the region and to come up with a more solid and strategic process of economic integration. ASEAN economic integration through AFTA is quite unique because most of the nations are still developing, except Singapore, and new in various manufacturing industries. Without proper planning, they would not really benefit from the free trade arrangement. When some of the members are positioning themselves as "gates of entrance", bringing in products from other non-member nations and market them to their neighbors at lower tax barrier, then, in theory, it seems that intra-industry trade would increase but effectively more trade actually takes place between ASEAN and non-ASEAN countries, and more dangerously, the local new industries are being driven out.

Identifying members' strength and weaknesses

AFTA should enhance the process of economic integration in the region, which is primarily similar to the current trends such as the relocation of offshore Japanese production in response to rising domestic costs and barriers to Japanese imports in major markets

To achieve this, they should collectively identify:

i. What types of emerging industries should be ventured?
ii. Which nations should venture in which emerging industries?
iii. Identify the linkages within and across the industries, i.e. upstream versus downstream, labor versus capital intensive, low versus highly skilled industries, knowledge-based versus resource-based, etc.

To achieve a more harmonized, strong and robust economic integration that can make ASEAN more competitive globally, then ASEAN must work together towards specialization based on the strength (comparative advantage) of each country. Generally, ASEAN comprises nations of various characteristics and qualities for example Indonesia with large land area, population and reasonable cost of labor; Thailand as one of the world leading exporter of various staple good and products; Malaysia which is endowed with quite large amount of skilled labor and has been an important center for a lot of manufactured products especially electrical and electronic; Singapore which has the world top class port facilities, financial and trading centers and potential for various high tech industries; and the other nations with their own specialties and strength. A conceptual criterion for specialization for each ASEAN member countries is shown in Table 2. Through this specialization strategy, employment in each nation can be maximized, competitiveness will be elevated, export will expand, value added will increase and strong growth will prevail.

Table 2: Conceptual Specialisation of Industries in ASEAN

	Labor intensive	Capital intensive	Knowledge intensive	Resource based	Up-stream	Middle-stream	Down-stream
Viet Nam	XXX	-	-	XXX	XXX	X	X
Indonesia	XXX	X	X	XXX	XXX	XX	XX
Malaysia	X	XX	XXX	XX	X	XXX	XXX
Philippines	XXX	X	XX	XXX	XXX	XX	XX
Singapore	-	XXX	XXXX	-	-	XX	XXX
Thailand	XXX	XX	XX	XXX	XXX	XX	XX
Brunei	-	XX	XX	XX	XXX	XX	X

Note: X = minimal; XX = moderately suitable; XXX = very suitable; XXXX = extremely suitable

Bringing FDI into the right sector

FDI should remain an important backbone for a more competitive and leading manufacturing activities and at the same time acting as a stimulant for the local emerging industries. However, FDI should be strongly encouraged in industries that will not put pressure on or weaken local emerging industries. ASEAN should work hand in hand to identify certain key industries that should be ventured by MNC whereby it does not adversely affect the ASEAN's local industries, but on the other hand can stimulate local SMI and can complement various local advantages such as cheap labor and local resources in Indonesia and Thailand, and a relatively higher skilled ones in Malaysia and Singapore. A more strategic regional collaborations and co-operations rather than individual or country specific strategies would indeed be more appealing to MNC.

In short, ASEAN through AFTA need to improve or strengthen their togetherness and identify steps how they can be more complimentary to each other. Their policies and planning should match and on the other hand avoid destructive or unproductive rivalry competition. They should think of having common policies towards the rest of the world. Having the common idea of removing barriers among themselves is very great but it seems that that is not perfectly enough. The current setting of AFTA can be harmful to the local emerging and young industries if there is no common policy to protect them from the more advanced and established producers outside.

Concluding Remarks

An integrated market on a regional scale, in theory, opens up larger opportunities for countries and industries in it, opportunities to sell their products and acquire production inputs at lower costs, for the benefit of all. Countries and industries around the world practice various forms of economic integration, not only in the most advanced case of the European Union, but also in the European Free Trade Association of non-EU members, the North American Free Trade Area, the Common Market of the South (MERCOSUR), the Closer Economic Relations between Australia and New Zealand, and the Common Market for Eastern and Southern Africa that is emerging.

Unlike other economic blocs, AFTA is unique in the sense that the diverted trade would be effectively small under the current framework of FTA. Why? Because ASEAN members eliminate barriers among themselves, but barriers towards non-ASEAN members are not harmonized and left to each member to decide. This allows some ASEAN countries to cooperate with non-members (which are probably more competitive and technologically more advanced as compared to the members) instead of cooperating within member. It is worthwhile to stress here that we are not against any cooperation with outside countries so long as it is not in conflict with the interest of the member. If those unwise practices continue, the members would suffer. Thus, a stronger economic integration such as customs union that could take care better the interest of the member is probably quite relevant for ASEAN. On top of this, the policy environment in the ASEAN member countries must be conducive. Some policy directions to strengthened the economic foundation in order to increase the efficiency, productivity and competitiveness of the emerging industries include: (i) stronger government support and commitment for R&D; (ii) human resource development programs must be intensified to build up a pool of researchers and technical personnel required by the new industries; (iii) intensifying technology adoption; (iii) infrastructure development; (iv) positioning ASEAN as the global center; (v) establishment of national and international logistics and marketing network; and (vi) promoting private sector participation.

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