

Chapter 4

Economic Cooperation and Regional Integration

4.1 Introduction

Although the original pledge of ASEAN founding fathers was to foster economic cooperation not integration, now ASEAN member countries are seeking the direction towards regional integration. Progress has been made in the regional cooperation of ASEAN despite its slowness. A key concern is, however, whether or how regional cooperation programmes could contribute to the integration process. This chapter will try to assess regional cooperation focused on mainly three sectors: trade, investment, and finance. It should be noted and investigated that regional economic cooperation expands towards East Asia cooperation namely ASEAN plus China, Japan and South Korea. On the other hand, the number of bilateral relations with non-ASEAN members through bilateral free trade agreements has increased. In this context, the second concern will be on the assessment of the effects of inter-regional cooperation and bilateralism on ASEAN integration.

4.2 ASEAN Free Trade Agreement and Trade Issues

In 1992, following the strengthening of EU and the creation of NAFTA, ASEAN at the Fourth ASEAN Summit in Singapore formally initiated the ASEAN Free Trade

Area (AFTA) to realize an FTA¹ within the 15 years beginning 1 January 1993.

The reduction or elimination of tariff is undertaken through the Common Effective Preferential Tariff Scheme. The deadline was subsequently changed from the original 15-year timeframe to 10 years. In 1995, a new timetable by 2003 was adopted in the light of the rapid development of the global economy. Unprocessed agricultural products which were exempted initially were included into the scheme. In the midst of the Asian financial crisis, ASEAN leaders reaffirmed their commitment to AFTA and even advanced the target of AFTA for 6 members namely, Brunei, Indonesia, Malaysia, Philippines, Singapore, and Thailand to 2002 from 2003. The six members also agreed the elimination of tariff with a few exceptional products by 2010 and with the newer members to follow a few years later.² Over the course of the next several years, the programme of tariff reductions was broadened and accelerated, and a host of 'AFTA Plus' activities were initiated, including efforts to eliminate non-tariff barriers and quantitative restrictions, and harmonize customs nomenclature, valuation, and procedures, and develop common product certification standards.

It has been believed that the implementation of AFTA could strengthen their economic competitiveness. The aim of AFTA was also to expand intra-ASEAN trade and

¹ From a theoretical view point, a Free Trade Area (FTA) represents a loose form of regional integration, which allows member countries to keep their own tariff regimes against non-members, while eliminating all trade barriers among themselves, unlike the Customs Union where member adopt common tariffs against the rest of the world. See Chapter 2.

² Owing to the difference in their economic structure from the original members and the later date of membership accession, the four new members were given different deadlines for the CEPT scheme: By 2006 for Vietnam, 2008 for the Lao PDR and Myanmar, and 2010 for Cambodia. The difference in time frames reflects difference in their accession dates, with the same time period provided for their tariff reductions, ASEAN Secretariat. www.aseansec.org.

to gain economies of scale and specialization to further deepen economic cooperation. And also it was anticipated that greater foreign direct investment would flow into the region as a result of ASEAN economic integration.³

4.2.1 Common Effective Preferential Tariff (CEPT) Scheme

The Common Effective Preferential Tariff (CEPT) scheme was designed to bring down tariffs on all manufactured and processed agricultural products, which meet a 40% ASEAN content requirement, to 0-5 percent by the year 2002/2003 (2006 for Vietnam, 2008 for Laos and Myanmar, and 2010 for Cambodia). Under the CEPT scheme, the Inclusion List (IL), the Temporary Exclusion List (TEL), the Sensitive List (SL), and the General Exceptions List (GEL) are used as key instruments to determine the pace and scope of liberalization.⁴ While the IL consists of the items subject to tariff reductions immediately to bring them down to the range of 0-5 percent by the year 2003, ASEAN members have the option of excluding products from the CEPT in three cases: Temporary Exclusions, Sensitive Agricultural Products, and General Exceptions. Temporary exclusions refer to products for which tariffs will ultimately be lowered to 0-5%, but which are being protected temporarily by a delay in tariff reductions.⁵ The SL is

³ Nattapong thongpakde, 'ASEAN Free Trade Area: Progress and Challenges', Mya Than ed., *ASEAN Beyond the Regional Crisis: Challenges and Initiatives*, Singapore: Institute of Southeast Asian Studies, 2001, p.51.

⁴ The tariff reductions are moving ahead on both the "fast" and "normal" tracks. Tariffs on goods in the fast track were largely reduced to 0-5% by 2000. Tariffs on goods in the normal track will be reduced to this level by 2002, or 2003 for a small number of products. Currently, about 81% of ASEAN's tariff lines are covered by either the fast or normal track. ASEAN Secretariat. www.aseansec.org.

⁵ This is permissible under the AFTA agreement, and is spelled out under a Protocol Regarding the Implementation of the CEPT Scheme Temporary Exclusion List. Malaysia invoked this protocol in 2000, delaying tariff reductions on completely-built-up automobiles, and automobile knock-down kits, in order to protect its local auto industry. ASEAN Secretariat. www.aseansec.org.

the list of unprocessed agricultural products to be phased into the IL between 2001 and 2003 and to be in the 0-5 percent ranges by 2010. A small number of sensitive agricultural products will have their deadline extended to the year 2010 for their shift into the CEPT scheme. In an agreement that has yet to be fully spelled out, the process of tariff reduction on these products will begin between 2000 and 2005, apparently depending on the country and the product. General Exceptions refer to products which a country deems necessary for the protection of national security, public morals, the protection of human, animal or plant life and health, and protection of articles of artistic, historic or archaeological value. Approximately one percent of ASEAN tariff lines fall into this category. The CEPT scheme will cover nearly 98 percent of all tariff lines in ASEAN by the year 2003; by then, the only products not included in the CEPT Scheme will be those in the General Exceptions category and sensitive agricultural products. In the longer term, the ASEAN countries have agreed to enact zero tariff rates on virtually all imports by 2010 for the original members and 2015 for the four newer ASEAN members.

A key feature of the CEPT is that the concessions are granted on a reciprocal, product-by-product basis. There are three conditions for a product to be eligible for concessions under the CEPT. 1) The product has to be included in the IL of both the importing and exporting countries; 2) To receive all concessions, a country must have a CEPT tariff of 20 percent or below on that product. If the tariff on a product that a country has included in the CEPT is above 20 percent, then it is eligible for concessions only in those member countries that also impose a CEPT rate that is higher than 20

percent; 3) It has to satisfy the local content requirement of 40 percent. In the short-run, the reciprocal nature of the CEPT scheme provides incentives for member countries to include commodities they wish to export in the IL and to reduce tariffs below 20 percent to receive concessions. Following inclusion, all tariffs must be phased down to the 0 to 5 percent range.

Another important feature of the CEPT is that member countries are required to eliminate quantitative restrictions on products on which they receive CEPT concessions, and eliminate other non-tariff barriers within five years after receiving concessions. Based on the UNCTAD classification of Non-tariff barriers (NTBs), a working definition of NTBs covers para-tariff measures, price control measures, finance measures, monopolistic measures, and technical measures.⁶

The average CEPT tariff rate of products in the Inclusion List will be approximately 2.7% by the year 2003, down from about 12.76% in 1993 at the start of the tariff reduction programme. On progress by ASEAN in the implementation of the AFTA, the six original ASEAN members have reduced tariffs on all products listed in their 2002 Inclusion List to 0-5 percent. Since 1 January 2003, tariffs on 99.55 percent (44,160 tariff lines out of a total 44,361 tariff lines) of products in the 2003 IL of the ASEAN - 6 have been reduced to the 0-5 percent tariff range. Products in their IL with above 5 percent tariff are these that have been transferred from the Sensitive List and General Exception List in 2003.

⁶ ASEAN Secretariat, 'AFTA Reader: New Time Frame: Acceleration of Tariff Reduction', Vol.III, ASEAN Secretariat, Jakarta, 1995.

The average tariff for ASEAN-6⁷ under the CEPT Scheme is now down to 2.39 percent from 12.76 percent when the tariff-cutting exercise started in 1993. The newer members of ASEAN that have their own schedule lagged behind the former group. In 2003, 87.85 percent of all products in the IL of the ten Member Countries tentatively have tariffs of between 0-5 percent and about 10.68 percent of these products have tariffs of above 5 percent. Ultimately, tariffs are planned to be completely abolished by 2010 for ASEAN-6 and 2015 for the newer members with flexibility on some sensitive products until 2018. The ASEAN-6 has committed to eliminate tariffs on 60 percent of their products in the IL by the year 2003. Currently, about 48 percent of products in the IL of the ASEAN -6 have zero tariffs.⁸

The high percentage of products in the CEPT Inclusion List indicates the substantial opportunity to be gained from trading with ASEAN countries under the CEPT environment. However, accessing tariff liberalization in AFTA is not simple as tariff policy shifts in the ASEAN members during the 1990s were done at three levels: unilateral tariff reforms, tariff reduction under multilateral framework such as GATT/WTO, and CEPT based tariff reduction. Until 2000, most-favoured nation (MFN) and CEPT tariff rates were not very different.

⁷ It refers to Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand.

⁸ ASEAN Secretariat, *ASEAN Annual Report, 2002 – 2003*.

Table 4.1 Average AFTA / CEPT Tariff Rates

	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	4.80	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
Vietnam	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, <http://www.aseansec.org/12025.htm>

Table 4.2 Number of Tariff Lines in the Tentative 2003 CEPT Package

	Number of tariff Lines					Percentage				
	IL	TEL	GEL	SL	Total	IL	TEL	GEL	SL	Total
Brunei	6,377	-	155	-	6,492	97.61	-	2.39	-	100
Indonesia	7,206	-	68	11	7,285	98.92	-	0.93	0.15	100
Malaysia	10,116	218	53	8	10,395	97.32	2.1	0.51	0.08	100
Philippines	5,632	-	16	10	5,658	99.54	-	0.28	0.18	100
Singapore	5,859	-	16	10	5,859	100	-	-	-	100
Thailand	9,211	-	-	-	9,211	100	-	-	-	100
ASEAN 6	44,361	218	292	29	44,900	98.80	0.49	0.65	0.06	100
Cambodia	3,115	3,523	134	50	6,822	45.66	51.64	1.96	0.173	100
Lao PDR	2,533	856	74	88	3,551	71.33	24.11	2.08	2.48	100
Myanmar	4,182	1,224	48	18	5,472	76.43	22.37	0.88	0.33	100
Viet Nam	6,296	-	139	51	6,486	97.07	-	2.14	0.79	100
CLMV	16,126	-	395	207	22,331	72.21	25.09	1.77	0.93	100
Total ASEAN	60,487	5,821	687	236	67,231	89.97	8.66	1.02	0.35	100

Source: Bureau of Economic Cooperation, ASEAN Secretariat
<http://www.aseansec.org/12025.htm>

There has been the trend of unilateral reduction of MFN tariff by core ASEAN members in particular between 1994 and 1996.⁹ Not surprisingly, the small difference between two tariff rates was less encouraged to manufacturers to apply for CEPT concession. As a result, only about 1.5 percent of intra-ASEAN trade in the mid-1990s utilized CEPT rules of origin certification, which suggest that CEPT-driven regional trade was very limited.¹⁰ Nevertheless, it has been noted that divergence between CEPT and MFN has been increased. For example, in Indonesia, the average MFN rate is scheduled to reduce to a maximum 10 percent by 2003, which is higher than the CEPT rate, although many MFN rates also will fall to a maximum 5 percent.¹¹

4.2.2 Intra ASEAN Trade

Along with the process of tariff reduction, another important economic indicator for regional integration is intra-ASEAN trade. Low intra-regional trade could weaken the significance of AFTA and limit the scope of integration. It is generally believed that the tariff reduction will further increase trade among ASEAN countries. In addition, enlargement of ASEAN also could increase the market size but also will enhance its resource diversification. Thus, it would enhance trade opportunity.

In fact, the share of intra-ASEAN export rose from 18.7 percent in 1990 to about 21.8 percent in 1996. After 1997 when the economic crisis hit the region, with the slow-

⁹ ASEAN Secretariat, *AFTA Reader*, Vol. IV, 1996.

¹⁰ Teh, Jr., R., 'Completing the CEPT Scheme for AFTA', 1999.

¹¹ Nallappan, K., Ong, B.H. and Tee, S.J., 'Privatisation and Deregulation', Tan Teck Meng, Low Aik Meng, John Williams and Choo Teck Min eds., *Business Opportunities in Indonesia*, Singapore: Prentice Hall, pp.41-61.

down of economic growth in the region, the share of intra-ASEAN export declined to 22.0 and 21.9 percent in 1998 and 1999 respectively. With continuing uncertainties in the recovery of the U.S. and global economies since 2001, members of ASEAN are in a better position to consolidate their respective economies by enhancing intra-ASEAN trade activities. The proportion of intra-ASEAN trade in 2001 and 2002 was 23.8 percent.¹² The trend in intra-ASEAN trade has been on the increase partly due to the positive effects of globalization. The growing market demand as a result of growing population and improved consumer purchasing power in the region provides the impetus for increased trading activities.

Despite the increase of intra-ASEAN trade since the establishment of AFTA, the share is still much smaller than those of the EU and NAFTA. Intra-NAFTA export was 47.3 percent of its total export in 2002, and intra-EU export was 61.8 percent in the same year. It reflects that the region highly depends on outside markets especially on the U.S. market. Among ASEAN countries, Malaysia was the largest exporter to the U.S. with US\$254 billion in 2003, while Thailand exported US\$15.18 billion to the U.S. as the second largest exporter. Overall, according to the U.S.-ASEAN Business Council, ASEAN is still the third largest export market for the U.S.¹³ The trade between the U.S. and ASEAN totalled US\$127.2 billion in 2003, of which US exports to the ASEAN countries amounted to US\$45.3 billion while imports from the ASEAN were worth US\$81.9 billion. Given the high dependency of the ASEAN economy on the U.S. as Table 4.5 and 4.6 show, a sharp downturn of the latter will affect the economic growth of

¹² WTO, *International Trade Statistics 2003*.

¹³ The European Union was the U.S.'s largest export market in 2003 with exports from the U.S. worth US\$150.5 billion followed by Japan at US\$452.1 billion. *New Straits Times*, 13 March 2004.

members of ASEAN.

Table 4.3 Merchandise trade of selected regional integration arrangements, 2002
(Billion dollars and percentage)

		Value	Share in total exports/imports				Annual percentage change		
		2002	1990	1995	2000	2002	1995-00	2001	2002
APEC (21)	Total exports	2779	100.0	100.0	100.0	100.0	6	-8	3
	Intra-exports	2023	67.5	72.4	72.7	72.8	6	-9	4
	Extra-exports	756	32.5	27.6	27.3	27.2	6	-5	-1
	Total imports a	3068	100.0	100.0	100.0	100.0	7	-7	4
	Intra-imports	2148	65.4	71.7	71.2	70.0	7	-8	4
	Extra-imports	920	34.6	28.3	28.8	30.0	7	-2	3
EU (15)	Total exports	2449	100.0	100.0	100.0	100.0	2	0	6
	Intra-exports	1509	64.9	64.0	62.4	61.6	2	-1	5
	Extra-exports	940	35.1	36.0	37.6	38.4	3	1	6
	Total imports	2447	100.0	100.0	100.0	100.0	3	-2	4
	Intra-imports	1514	63.0	65.2	60.3	61.9	2	-1	5
	Extra-imports	933	37.0	34.8	39.7	38.1	6	-4	1
NAFTA (3)	Total exports	1107	100.0	100.0	100.0	100.0	7	-6	-4
	Intra-exports	626	42.6	46.0	55.7	56.5	12	-6	-2
	Extra-exports	481	57.4	54.0	44.3	43.5	3	-6	-6
	Total imports b	1599	100.0	100.0	100.0	100.0	11	-6	2
	Intra-imports	609	34.4	37.7	39.6	38.1	12	-7	-2
	Extra-imports	990	65.6	62.3	60.4	61.9	10	-6	4
ASEAN (10)	Total exports	405	100.0	100.0	100.0	100.0	6	-10	5
	Intra-exports	97	20.1	25.5	24.0	24.0	5	-12	8
	Extra-exports	308	79.9	74.5	76.0	76.0	6	-9	4
	Total imports	353	100.0	100.0	100.0	100.0	1	-8	5
	Intra-imports	83	16.2	18.8	23.7	23.6	5	-12	9
	Extra-imports	270	83.8	81.2	76.3	76.4	-1	-7	4

a Imports of Canada, Mexico and Australia are valued f.o.b

b Imports of Canada and Mexico are valued f.o.b.

Note: The figures are not fully adjusted for differences in the way members of the arrangements in this table record their merchandise trade

Source: WTO, International Trade Statistics 2003

However, ironically, the U.S. economic slowdown may offer a good opportunity for ASEAN members to further enhance intra ASEAN trade. In comparison to other regional FTAs, ASEAN has achieved relatively higher growth rates in intra-regional trade. In 2002, the annual increase in intra-ASEAN exports and imports were 8 percent and 9 percent respectively, while the intra-NAFTA trade decreased by 2 percent in the same year. It could be considered a sign that trade between ASEAN members will be further enhanced, even if the trade and economic relations between the U.S. and ASEAN or member countries will remain a significant concern.¹⁴

¹⁴ According to the U.S.-ASEAN Business Council's annually report to the U.S. administration and Congress in 2003, five priorities were given to the bilateral trade issues. It included accelerating the concluding of the trade and investment framework agreement (TIFA) which would pave the way for a free trade agreement (FTA) between the U.S. and Malaysia. The other were establishing concrete timetable for US-Thailand FTA negotiations, identifying the next ASEAN FTA partner, accession of Vietnam to the World Trade Organization and establishing normal trade relations with Lao. *New Straits Times*, 13 March 2004.

Table 4.4 US-ASEAN Trade 2003 (US\$ Million)

	US Exports	US Imports	Total Trade
Brunei	35.8	422.5	458.3
Cambodia	57.9	1,262.8	1,320.7
Indonesia	2,520.1	9,520.0	12,040.1
Laos	4.7	4.2	8.9
Malaysia	10,920.6	25,437.7	36,358.3
Myanmar	6.9	275.7	282.6
Philippines	7,992.2	10,060.9	18,053.1
Singapore	16,575.7	15,158.2	31,733.9
Thailand	5,841.7	15,180.7	21,022.4
Vietnam	1,324.4	4,554.9	5,879.3

Source: US Department of Commerce
Quoted from *Business Times*, 3 August, 2001

Table 4.5 ASEAN-5 and the U.S economy

	To the U.S. as percentage of total	Value of exports as percentage of GDP
Philippines	29.8%	51.3%
Thailand	21.6	57.2
Singapore	19.0	97.5
Indonesia	13.0	35.0
Malaysia	21.9	24.1

Source: ING Barings
Quoted from *the Asian Wall Street Journal* 13 June 2000

A widely used outcome index for a country's exposure to trade is to express the sum of the country's exports plus imports as a percentage of GDP. In the context of ASEAN economic integration, the index is based on the total of intra-ASEAN exports plus intra-ASEAN imports as a percentage of the GDP of the country in question. The index is probably the most important indicator of ASEAN integration in the context of trade in goods.

ASEAN increased intra-ASEAN trade as a percentage of GDP from 25.7 percent in 1999 to 30.6 percent in 2000. It shows that not only the value of intra-ASEAN trade increased but also contribution and proportion in ASEAN economies. Not surprisingly, each member countries showed different levels of intra-ASEAN trade as share of GDP. The table also shows that the percentages of intra-ASEAN trade of some countries are dropping in some members and rising in some others. For example, Malaysia increased its trade as a percentage of GDP from 43.4 percent in 1999 to 45.0 percent in 2000 (see Table 4.6). But this increase was not as fast compared to ASEAN as a whole, although Malaysia performed well above the ASEAN average for that year. Based on figures from 1996-2000, intra-ASEAN trade is most important to the economies of Singapore and Malaysia and of least importance to Indonesia and the Philippines. While Indonesia had the increase of intra-ASEAN trade as a proportion of total trade expanding from 13.8 percent in 1996 to 18.5 percent in 2000, Brunei had the largest decline over the period.

In short, there has been a trend that tariff barriers to intra-ASEAN trade have been declining and intra-ASEAN trade has been increasing despite diversity in the pace among member countries. It should, however, be noted that some barriers to the implementation of AFTA still exist, such as political sensitivity in certain fields and Non trade barriers (NTBs), which will be discussed in the following section.

Table 4.6 Intra-ASEAN Trade and GDP by country, 1996-2000 (US\$ million)

			Brunei	Cambodia	Indonesia	Laos	Malaysia	Myanmar	Philippines	Singapore	Thailand	Vietnam	ASEAN
1996	(1)	GDP	6,143.60	na	226,814.00	na	100,888.00	na	82,840.00	90,957.00	182,106.00	24,658.00	714,406.60
	(2)	I-T	3,295.00	na	13,859.00	na	37,376.30	na	6,982.10	61,803.60	21,868.70	5,622.60	150,807.40
	(3)	A-T	6,928.10	na	100,462.80	na	149,549.60	na	47,925.60	240,761.00	128,340.30	18,399.60	692,367.00
	(4)	(2)/(1)	53.6%	na	6.1%	na	37.0%	na	8.4%	67.9%	12.0%	22.8%	21.1%
	(5)	(2)/(3)	47.6%	na	13.8%	na	25.0%	na	14.6%	25.7%	17.0%	30.6%	21.8%
1997	(1)	GDP	5,102.00	na	219,066.00	na	100,213.00	na	82,764.00	94,495.00	155,865.00	26,843.00	684,448.00
	(2)	I-T	1,473.20	na	14,263.90	na	38,088.80	na	8,309.00	66,190.70	21,647.30	4,563.60	154,536.50
	(3)	A-T	5,024.90	na	92,954.10	na	154,445.90	na	61,160.20	264,147.00	120,909.80	19,640.60	718,282.50
	(4)	(2)/(1)	28.9%	na	6.5%	na	38.0%	na	10.0%	70.0%	13.9%	17.0%	22.6%
	(5)	(2)/(3)	29.3%	na	15.3%	na	24.7%	na	13.6%	25.1%	17.9%	23.2%	21.5%
1998	(1)	GDP	3,865.00	na	99,665.00	na	72,237.00	na	65,548.00	82,259.00	112,751.00	27,788.00	464,103.00
	(2)	I-T	811.90	na	13,905.90	na	34,551.40	na	8,249.90	49,645.80	13,752.80	6,124.20	127,041.90
	(3)	A-T	3,200.00	na	76,184.50	na	138,075.10	na	59,156.30	211,298.80	88,193.20	20,854.80	596,962.70
	(4)	(2)/(1)	21.0%	na	14.0%	na	47.8%	na	12.6%	60.4%	12.2%	22.0%	27.4%
	(5)	(2)/(3)	25.4%	na	18.3%	na	25.0%	na	13.9%	23.5%	15.6%	29.4%	21.3%
1999	(1)	GDP	2,166.40	3,289.00	141,638.00	na	79,037.00	6,500.00	76,076.00	82,671.00	122,577.00	28,677.00	542,631.40
	(2)	I-T	1,270.80	707.2	13,061.90	na	34,297.80	1,275.40	9,450.10	55,510.30	17,889.30	5,806.30	139,269.10
	(3)	A-T	4,061.10	2,192.40	72,668.80	na	147,965.70	2,621.00	65,779.40	225,623.10	104,428.90	23,283.00	648,623.40
	(4)	(2)/(1)	58.7%	21.5%	9.2%	na	43.4%	19.6%	12.4%	67.1%	14.6%	20.2%	25.7%
	(5)	(2)/(3)	31.3%	32.3%	18.0%	na	23.2%	48.7%	14.4%	24.6%	17.1%	24.9%	21.5%
2000	(1)	GDP	4,315.00	3,343.00	150,625.00	na	89,659.00	6,900.00	74,683.00	92,701.00	122,518.00	31,319.00	576,063.00
	(2)	I-T	1,173.90	630.6	17,664.90	na	40,343.40	1,506.80	10,938.00	71,075.30	25,575.60	7,132.40	176,040.90
	(3)	A-T	3,236.70	2,786.40	95,638.80	na	177,802.00	3,413.30	69,465.60	273,032.60	117,143.00	29,943.00	772,461.40
	(4)	(2)/(1)	27.2%	18.9%	11.7%	na	45.0%	21.8%	14.6%	76.7%	20.9%	22.8%	30.6%
	(5)	(2)/(3)	36.3%	22.6%	18.5%	na	22.7%	44.1%	15.7%	26.0%	21.8%	23.8%	22.8%

Note: na: not available, I-T: Intra-ASEAN Trade, A-T: All Trade
Source: ASEAN Statistical Yearbook

4.2.3 Domestic Interests and AFTA

Unprocessed Agricultural Products

In the process of implementation of CEPT, some politically sensitive sectors such as agriculture remain far from the liberalization targets. Despite agreement which included unprocessed agricultural products into the CEPT scheme in 1994 to expand the scope of AFTA, major trade crops such as rice and sugar, which account for 12.9 percent of the total tariff lines in agriculture, were placed on the Sensitive List. As Table 4.7 shows, 68 percent of the total value of intra-ASEAN imports in the region was excluded from the list. Moreover, disputes among members in particular between Indonesia and Thailand eventually led to the adoption of new categories and schedules for agricultural trade liberalization, which was formalized in the Protocol on Sensitive and Highly Sensitive Agriculture Products.

Table 4.7 Unprocessed agricultural products by Category in 1995

Item	Number of Tariff Lines	Percent
Immediate Inclusion	1,358	68%
Temporary Exclusion	402	20%
Sensitive	235	12%
TOTAL	1,995	100%

Source: The ASEAN Secretariat, <http://www.aseansec.org>

The CEPT Scheme cannot guarantee the full implementation of AFTA mainly due to trust problems. Non-conferment of CEPT concessions on products can arise and disputes need to be resolved. There can be deferments of the transfer of products to the IL. Trade protection for their own industries by different ASEAN members is a major obstacle to economic integration. ASEAN is a very diverse community in terms of economic development, political stand and cultural interests. For instance, Malaysia protects its automotive and agricultural industries, the Philippines wants to protect its chemical sector and Thailand its agricultural sector. These trends of protectionism seem to be natural given the infant stage of each industry and domestic interests, which might become economic and political burdens to each government. For the purpose of this study, it will briefly review the case of Malaysia's protection of its auto industry.

Malaysian Automobile Industry and AFTA

The substitution of high-cost partner products is actually a positive thing, labelled as trade creation, as it brings about a more efficient allocation of resources. However, negative trade diversion occurs when imports from partner countries, due to preferential treatment, displace cheaper imports from non-member countries, as it implies a shift from a more efficient source to a less efficient one. Consumers in high-tariff countries are expected to gain benefits most, as prices under FTAs would be lower than before, while little changes are expected in low-tariff countries.¹⁵ Since Malaysia is a relatively low-tariff country, with trade-weighted average tariff rate being roughly 8 percent, the expected consumer gain will not be as large as that of their counterparts in Thailand or the Philippines.

¹⁵ See Chapter 2.

However Malaysia has a much higher tariff on some items in particular automobiles, even though most of ASEAN core members maintain high import tariffs on automobiles mostly in order to protect auto producers from import competition. Under the CEPT scheme, tariffs on auto parts will be lowered to 20 percent by 2000 and were expected to fall to the 0-5 percent by 2002/2003. Malaysia, however, delayed inclusion of 218 tariff lines of completely built-up (CBU) and completely knocked-down (CKD) automotive products until 2005. This was Malaysia's response to problems faced by the domestic automotive industry due to the regional financial crisis of mid-1997 and 1998, which caused the combined effects of a weakened Ringgit and reduced purchasing power.¹⁶ Malaysia announced the austerity budget of the year 2002. While it includes a gradual approach toward the reduction of import duty¹⁷, the Malaysian government will still keep the protection policy on the automobile industry till 2005 when import duties are to be reduced under the WTO agreement.¹⁸

Under the Common Effective Preferential Tariff of the AFTA, Malaysia is committed to reducing import duty for motor vehicles to 20% effective Jan 1, 2005, and subsequently to 0.5% from Jan 1, 2008. Malaysia has no commitment to reduce import duty for vehicles imported from non-ASEAN countries. Just one year before the targeted year 2005, the government announced the reduction of import tariffs, to meet AFTA, to as low as 40% for imported vehicles assembled overseas but also imposed excise duty of

¹⁶ Although Malaysia has long had a domestic car industry based on the assembly of foreign vehicles, the former Malaysian Prime Minister Mahathir introduced local automobile manufacturer in the early 1980s as part of heavy industry programme.

¹⁷ It shows a reduction of import duty on several items such as textiles (25 to 20 per cent), suitcases (25 to 20 per cent), and beverages (from 30 to 20 per cent). *The Edge*, 24 December 2001, p.45.

¹⁸ Despite protection measures, it was understood that in long term, local automaker should be competitive in liberalized world market.

between 30% and 100% on all imported cars to make up for the loss of revenue from the cut in import taxes. The Government reduced import duty for CKD passenger cars from ASEAN to 25 percent from 42 percent for all engine types. It would also reduce import duty on CBU passenger cars from 150 percent to 300 percent to 70 percent to 190 percent. For CKD passenger cars from non-ASEAN countries, the import duty has been reduced to 35 percent and for CBU 80 - 200 percent.¹⁹ The new excise duty would remove most of the benefits from the import duty cuts and even could stimulate price increase. Excise duties were previously levied only on locally manufactured products, though cars made by national carmakers (Proton and Perodua) enjoy a 50-per-cent rebate. Implementation of unequal excise duties on motor vehicles depending on their country of origin could be used as a tool to protect national carmakers.²⁰ And it would still be viewed as a trade barrier and a form of price discrimination against foreign makes. In fact, the government had all along insisted that Proton was ready to stand on its own and would not discriminate against foreign cars that fulfill the requirements of the AFTA.

However, Proton is said to have asked the government for the 50% rebate on the excise duty to be continued for an indefinite period.²¹ Furthermore, in response to a Malaysian Automotive Association's (MAA) memorandum, the government is formulating incentives to encourage sourcing of locally manufactured parts in the automotive assembly industry. MAA had proposed that raw materials be exempted from import duty, the introduction of value-added incentives for use of locally made parts,

¹⁹ *The Star*, 1 January 2004.

²⁰ Reese Loh, 'Discrimination spawns inefficiencies in local car industry', *The Edge*, 23 March 2004.

²¹ It was understood that Proton's CEO, Tengku Tan Sri Mahaleel Ariff had proposed to Mahathir during the latter's last day as prime minister that protection extension for a further 20 years. *Ibid.*

introduction of free zone concept (FZC) for local assemblers, and locally made parts be exempted from excise duty. The FZC concept would also include a change in point of collection of import duty from the port of entry to factory. According to the Malaysian Ministry of International Trade and Industry, full exemption from import duty can be considered for raw materials or components, regardless of whether the finished products are meant for the export or domestic market.²² Furthermore, Proton's new advisor, Mahathir Mohamad the former Prime Minister, stressed the need for protection.²³ These proposals are based on the concern about national interest. The removal of support will lead to the collapse of the local auto industry. Then, there would be problems with unemployment and vulnerability against price fluctuations of imported products. Nonetheless, there is little disagreement that protection for the national car industry cannot exist in the long term as Malaysia's position on AFTA was becoming untenable while it posed problems in other areas as well.

The Malaysian stand on the automobile industry has been criticized by other member countries in particular Thailand which is the second largest manufacturer after Malaysia in the region. In 2001, Malaysia accounted for 34 percent of the ASEAN motor vehicle market (See Table 4.8). The increased share of the Malaysian car market in the ASEAN region paradoxically was caused by economic crisis, which hit the car market in three other car manufacturing countries (Thailand, Indonesia and the Philippines). Thailand's geographical proximity attracted the inflow of investment from major foreign

²² *The Edge*, 6 April 2004.

²³ *The Edge*, 3 May 2004.

carmakers who aimed at the Malaysian market.²⁴ Automotive tariffs in Thailand under the CEPT were reduced to 0-5 percent in 2000, ahead of the CEPT schedule, although the MFN rates were set at 33 percent for CKD and 80 percent for CBU.²⁵ Indonesia lowered tariffs on fully- assembled cars to 5% on Jan 1, 2002, and expressed concerns about the possibility of a given country sacrificing rather than gaining benefits. There is also increasing fear that the rapidly developing and huge scale of the China market will threaten ASEAN countries. For instance, China's car market with sales of 2.4 million units a year as of 2001 is already twice the size of Southeast Asia's.²⁶ Furthermore, its entry into WTO will be more attractive to foreign investors who seek access to a huge market and an inexpensive manufacturing base, in particular for cars and other goods. Thus, unless the Malaysian car makers can compete without any protection at the expense of local consumers, the car project cannot be considered successful case despite its current small profit.²⁷

²⁴ Helen E.S. Nesaurai, *Globalisation, Domestic Politics and Regionalism*, New York: Routledge, 2003, p. 146.

²⁵ Ministry of Industry, Thailand, *Automotive Industry in Thailand*, 2000, p.11.

²⁶ *The Sun*, 2 Feb 2002.

²⁷ For the first three quarters of its financial year ended March 31, 2004, a net profit of Proton recorded decreased to RM318.52 million from RM831,837 million in the previous corresponding period. *The Edge*, 3 May 2004.

Table 4.8 Motor vehicle sales in ASEAN

	Sales Units				Growth '01/2000		Share of ASEAN 10(%)			
	2001		2000		%		2001		2000	
	PC	CV	PC	CV	PC	CV	PC	CV	PC	CV
Malaysia	327,447	68,934	282,103	61,070	16	13	57.0	11.4	54.9	10.5
Thailand	104,502	192,550	83,106	179,083	26	8	18.2	31.8	16.2	30.8
Indonesia	35,384	264,287	46,928	254,019	-25	4	6.2	43.7	9.1	43.6
Philippines	23,684	52,986	28,826	55,123	-18	-4	4.1	8.8	5.6	9.5
Asean main4	491,017	578,757	440,963	549,295	11	5	85.5	95.7	85.9	94.4
Vietnam	9,428	10,128	6,575	7,382	43	37	1.6	1.7	1.3	1.3
Laso*	370	10	46	306	704	-97	0.1	0.0	0.0	0.1
Myanmar*	380	640	243	542	56	18	0.1	0.1	0.0	0.1
Cambodia*	5	145	5	203	0	-29	0.0	0.0	0.0	0.0
Singapore	69,416	14,638	61,111	23,778	14	-38	12.1	2.4	11.9	4.1
Brunei*	3,990	690	4,501	635	-11	9	0.7	0.1	0.9	0.1
Total ASEAN	574,606	605,008	513,444	582,141	12	4	100	100	100	100

*Preliminary for 2001 PC=Passenger cars CV=Commercial vehicles

Source: *Business Times*, 31 January 2002

4.2.4 Bilateralism and AFTA

ASEAN countries' individual pursuit of bilateral free trade agreements (FTAs) with external partners has been a controversial issue since it may be seen as divergent from the aspiration for closer regional economic cooperation. There are perceptions that the growth in bilateral FTAs is potentially harmful to regional cooperation as they could undermine the importance of existing multilateral trade arrangements like AFTA, because FTAs provide a more direct and relevant link between two trade partners.

The Case of Singapore

In particular, Singapore has been criticized by other ASEAN members for pursuing its own bilateral FTAs. Among others, Singapore has FTAs with New Zealand, Japan and the United States²⁸. Indeed, the Republic is under negotiation with Australia and the European Free Trade Association (EFTA). Some observers suggest that a deal with EFTA could open the way for Singapore to explore a bilateral trade pact with the countries of the European Union as well.²⁹

The main reason for pursuing Bilateral Trade Agreements (BTAs) with other non-ASEAN countries is the slow implementation of AFTA.³⁰ Singapore argues that

²⁸ The negotiators were tackling a "comprehensive range of subjects, including trade in goods, trade in services, investment, e-commerce, customs, textiles, and dispute settlement," the Singapore government said in an earlier statement. In 2000, US merchandise exports to Singapore totaled US\$17.8billion, a 9.7 percent increase over 1999. Despite its small population, Singapore is the U.S.'s 10th largest trading partner. *The star*, 25 May 2001.

²⁹ *Business Times*, 6 November 2001.

³⁰ Singapore High Commissioner for Malaysia, K. Kesavapany said "poor progress of AFTA coupled with the growing need to have links with stronger economies, have prompted Singapore to establish BTAs with non-AESAN members. *Business Times*, 14 August 2002.

bilateral FTAs can step up momentum for trade liberalization and its approach to FTAs is consistent with the rules of the World Trade Organization - notably the principle of Most Favoured Nation (MFN), under which trade concessions offered to one partner are offered to all others.

It is well known that Singapore has an open economic structure and is highly dependent on external trade, as shown in Table 4.6. In nominal terms, Singapore's total merchandise trade has risen almost seven times from US\$ 40 billion in 1980 to over US\$ 270 in 2000, an annual average growth of 9.6 percent.³¹

Singapore's moves to bolster its integration with the global economy via the FTA route finds a parallel with that of the U.S. in the early 1990s. The U.S., when faced with opposition from the EU and some developing economies during the Tokyo Round of GATT negotiations, decided to liberalize via the preferential trading route rather than the MFN or multilateral route via GATT. With uncertainty over the progress of multilateralism, regionalism has been pursued mainly through AFTA and APEC (Asia Pacific Economic Cooperation). However, the slowness of regional liberalization that was affected by economic crisis in 1997-1999 led Singapore to pursue a policy of aggressive bilateralism.

Under these circumstances, the economic slowdown of Singapore can be seen as another factor for its aggressive bilateralism. Immediately following the regional financial crisis, while domestic exports rebounded speedily in 1999, re-exports still

³¹ Ministry of Trade and Industry, Singapore (MTI), *Economic Survey of Singapore*, Third Quarter 2001.

suffered negative growth. However, the rapid growth of total exports in 2000 was largely due to a belated but definite rebound in re-exports. The non-oil component of the city state's domestic exports registered a negative growth of 3.2 percent in the first six months of 2001 compared to a positive growth of 11.6 percent during the same period a year earlier. The decline in this component of exports dramatically intensified in the latter half of 2001.³²

The proliferation of a number of overlapping FTAs raises many technical problems with respect to the implementation of Rules of Origins (ROOs). ROOs give rise to significant costs due to the need for administrative surveillance and implementation. In practice, ROOs are complicated, as they have to take into account tariffs on imported intermediate goods used in products produced within the FTA. The book-keeping and related costs escalate sharply as production gets more integrated internationally (the so-called "spaghetti bowl" phenomenon), and countries get involved with an increasing number of separate but overlapping FTAs.³³ In this context, there are concerns that such FTA bids by Singapore could have a negative effect on the implementation of AFTA, even though such deals are not violating any multilateral agreements as claimed and argued by Singapore itself.

Malaysia expressed strong concerns about the trend. International Trade and Industry Minister Datuk Seri Rafidah Aziz said the secretariat has been asked to look into all the provisions of such bilateral agreements. Malaysia clearly expressed that it did not

³² Ibid.

³³ Ramkishan S.Rajan and Rahul Sen, 'Singapore New Commercial Trade Strategy: The Pros and Cons of Bilateralism', 2002, p.11.

intend to seek such bilateral agreements but also holds the view that bilateral FTAs will undermine creating AFTA. Malaysia prefers a close economic partnership (CEP) concept rather than non-ASEAN FTAs linkage. The Malaysian minister argued that the CEP concept was more suitable for the time being as it also could function to promote trade and investments flow if it is designed to be market driven.³⁴ In addition, Malaysian Foreign Minister Syed Hamid Albar has said that ASEAN members should think twice before entering into arrangements with countries outside the region, lest this undermines the 10-member grouping.³⁵

Disagreement on the bilateral trade agreement approach of Singapore can be understood for the following reason. As Jacob Viner emphasized, eliminating the internal trade barriers in a customs union will lead to more trade among the partners, by cheaper imports from more efficient industries in a member state of the union and this trade creation should add to welfare. On the contrary, there will be trade diversion effects as well. If third countries were the lowest-cost suppliers prior to the establishment of a customs union, the imposition of the common tariff puts these suppliers at a competitive disadvantage after creation of the union (See Chapter 2). It implicates that the bid for bilateral free trade agreement by Singapore, which is currently being pursued within multilateralism, at least theoretically could cause some negative effects such as trade diversion in the process of AFTA even though Singapore has one of the most liberal trade and investment regimes in the region. On the other hand, bilateralism can be seen as a way to overcome the so-called "convoy problem", whereby the least willing member

³⁴ *Business Times*, 24 November 2000.

³⁵ *The Straits times*, 18 November 2000.

holds the pace of trade integration back. Bilateral trade agreement is generally easier and faster than multilateral negotiations.³⁶ In fact, Thailand and the Philippines had indicated their interest in having FTAs with Japan and the U.S. In the case of Thailand, it is interested in having bilateral FTAs with China and Australia.³⁷ The U.S. is keen to form bilateral FTAs with individual ASEAN countries such as Indonesia and the Philippines, while Singapore has already completed its FTA with the U.S. This is because Indonesia and the Philippines are members of the World Trade Organization (WTO) and the Trade and Investment Framework Agreement (TIFA). Not having an FTA with the U.S. could put Malaysia at a disadvantage if neighbors do have the benefit of such an agreement.

Malaysia, which initially had some reservations about bilateral FTAs, was starting to believe that such agreements could be a viable option for now. Malaysia started negotiations with Japan on a free trade agreement. The bilateral FTA forms part of a very comprehensive proposal called the Close Economic Partnership (CEP) framework, which also encompasses aspects of co-operation covering, among others, education, culture, information technology and agriculture.³⁸ It also is expected to start negotiations with the U.S., China and South Korea. Even though Malaysia's political relations with the United States have been controversial issues such as the war on terrorism and the U.S. invasion of Iraq, the latter remains a very important source for Malaysian economic growth in terms of trade and investment. US investment in Malaysia is worth over US\$20 billion and bilateral trade was more than US\$34 billion in 2002.³⁹ Hence, a US-Malaysia FTA

³⁶ Richard E. Baldwin, 1997, p.878.

³⁷ *Business Times*, 21 September 2002.

³⁸ *The Star*, 11 February 2003.

³⁹ Department of Statistics Malaysia, <http://www.statistics.gov.my>.

can be seen as one obvious way of capitalizing on the opportunities that are available even though a US-Malaysia FTA is not a solution to all woes.⁴⁰

It seems, however, clear that the Singapore policymakers are of the opinion that FTAs are building blocs and complementary to rules-based multilateralism.⁴¹ The web of overlapping FTAs, as well as the intercontinental dimension of many new agreements, leads to change of the traditional concept of regionalism among neighboring countries and a conceptual shift away from multilateralism towards trading strategies based on numerous selective preferential agreements comprising no more than two or three parties.⁴² In addition, a case might be made that Singapore's bilateral approach and change of other member countries' policies in favour of bilateralism could push ASEAN to seriously explore the possibility of a flexible mechanism such as the ASEAN-China FTA and even one with Japan, which will be discussed in the later part of this chapter.

4.2.5 East Asia and Trade Issues

It has been observed that Southeast Asia and East Asia still depend much on external partners in term of trade. Intra-regional trade in Southeast Asia remained at 23.6 percent, while that between Northeast Asian Countries namely China, Korea, and Japan was only 18 percent in 2000. These figures show that the economic interdependence of

⁴⁰ It is expected that a FTA between the U.S. and Malaysia can boost Malaysia's exports by up to 10 percent and ensure that the country does not lose its competitiveness to Singapore. *Business Times*, 15 November 2002.

⁴¹ For instance, the Singapore Prime Minister, Goh Chok Tong, has reportedly noted: "AFTAs should not be pursued at the expense of the multilateral trading system. We must continue to invest efforts towards the launch of a New Round (of multilateral trade negotiations), to ensure that the gap between FTAs and the WTO does not grow so wide that it becomes irreconcilable.", *Business Times*, Singapore, 5 December, 2000.

⁴² P.J. Lloyd, 'New Regionalism and New Bilateralism in the Asia-Pacific', Institute of Southeast Asian Studies, Visiting Researchers Series No.3, 2002, pp.14-15.

both regions still remains at initial levels compared with other regional communities. For instance, EU has a 60 percent intra-trade ratio and NAFA has 42 percent. However, it is worth to keep in mind that the ratio of intra-regional trade of East Asia (ASEAN plus three) is more than 33 percent, which implies that East Asia could develop into as an economic unity.

Table 4.9 The Weight of Intra-Regional Trade in East Asia (%)

	1996	1997	1998	1999	2000
Northeast Asia	17.9	17.5	16.0	17.6	18.6
ASEAN	22.1	21.9	21.2	22.1	23.6
East Asia	36.6	35.2	31.5	33.9	33.9

Source: Park Bun Sun, 'APT and a free trade area between China and ASEAN,' *Global Issue*, Vol.46, 2001.

Trade issues which were discussed under the EAVG and EASG,⁴³ were largely divided into two categories. One is trade facilitation and the other is trade liberalization. These issues reveal other internal and external issues that should be taken simultaneously such as harmonization of multilateralism and regionalism, rearrangement among APEC, AFTA, and ASEM, strengthening the role of the private sector, and economic gap between two sub-regions. For the first step, it suggested to take easy tasks first, for instance, customs issues such as standardization, endorsement, quarantine, and settlement of disputes and so on. However, they reached the common sense view that the eventual goal of cooperation in trade should be trade liberalization through various vehicles such

⁴³ The East Asia Vision Group (EAVG) was initiated at the ASEAN+3 Summit in Hanoi in 1998 to discuss long-term cooperation in the region. East Asia Study Group (EASG) was proposed at the ASEAN+3 Summit in Singapore in November 2000, to assess the recommendations of the EAVG and explore the idea and implications of an East Asia summit. The 14-member study group consists of 13 senior officials from the ten ASEAN members plus China, Japan and Korea along with the secretary-general of ASEAN. The Working Group of the East Asia Study Group has been set up to assist the senior officials.

as AFTA, APEC, and WTO. Under this circumstance, they also discussed the early implementation of trade liberalization as well as by sectors, participation of China, Japan, Korea into the AFTA, or the creation of an East Asia Free Trade Area (EAFTA).⁴⁴

The study group also focused on facilitating and liberalizing investment. For the facilitation of investment, the core role of ASEAN Investment Area, creation of investment information centres, and some incentives for Small and Medium size companies have been suggested. For further deepening cooperation, they argued the need for an investment agreement among them, and AIA to expand to East Asia in scope.

The Southeast Asians are negotiating their ASEAN Free-Trade Area (AFTA) with China and Japan while a North-East Asia Free-Trade Area of China, Japan and South Korea is being studied in all three countries, and might merge with AFTA into a grouping that covers the whole of East Asia.⁴⁵ In 2002, ASEAN and China agreed to create an FTA covering 1.7 billion consumers with a combined gross domestic product of US\$2 trillion (US\$1=RM3.80), and two-way trade of US\$1.2 trillion. The FTA is due to be established by 2010 for the six senior members of ASEAN, Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand, and 2015 for the four other newer members. The steady progress made in ASEAN-China FTA negotia

⁴⁴ Even more specifically, it was tabled that the creation of East Asia Free Trade Area in manufacture field will be completed till 2005, rest of fields including services till 2010. See *Final Report of East Asia Study Group*, ASEAN plus Three Summit, 2002.

⁴⁵ At the ASEAN summit in 2001, a senior Japanese official said Tokyo had just signed a bilateral FTA with Singapore and would like to see how that developed first. Japan would also be monitoring the progress of the ASEAN Free Trade Area (AFTA) before it could take a position on an East Asian FTA. Mr. Goh and Dr Mahathir, however, disclosed that the East Asian leaders have agreed to create a secretariat to strengthen the so-called 'ASEAN Plus three' process involving ASEAN and the three East Asian economies. *Business Time* (Singapore), 26 November 2001.

tions had nudged Japan to hasten the process of its own FTA with ASEAN. Although Japan has had 30 years of cooperation with ASEAN, it only agreed to a Treaty of Amity and Co-operation with ASEAN late last year. This was followed by talks on bilateral FTAs with Malaysia, Thailand and the Philippines.

In the event that ASEAN and the three East Asian economies agree to establish a FTA, there could be several modalities to choose from.⁴⁶ The first form is a region-wide FTA involving all the thirteen countries concerned. Second is an East Asia FTA comprising a network of FTAs: ASEAN-China, ASEAN-Japan, ASEAN-Korea, Japan-China, Japan-Korea and China-Korea. Third, an East Asia FTA between ASEAN on the one side and a Northeast Asian FTA on the other can be considered. If the concern is over cost and time for the adjustment process, the first could be the best option as it would involve region-wide economic integration of 13 separate entities into a single and unified market. The individual countries could gain more from such comprehensive liberalization. Even though this form of regional integration is the most difficult to achieve, it represents the ultimate goal in the long run.

The second is to 'weave a web of free trade agreements' together across the region to form an East Asia FTA. It would involve six FTAs. There is already a strong commitment to create FTA between China and ASEAN, and the ASEAN-Korean FTA is likely to follow. The FTA between Singapore and Japan could stimulate other FTAs between the other ASEAN countries and Japan. The matter of three FTAs among the three Northeast Asian Economies relates to both the second and third options. Given the

⁴⁶ Mohamed Hafiah Piei, 'Prospects for an East Asian Trade Pact', *New Straits Times*, 30 November 2002.

close bilateral economic relationship between Japan and Korea, the FTA between the two holds good prospects. The creation of a Korea-Japan FTA⁴⁷ could contribute to the inclusion of China and possibly reduce the potential political tensions among them. The inclusion of China would effectively lead to two other bilateral FTAs (China-Japan and China-Korea), which eventually form the Northeast FTA. However, none of the three option is likely to be achieved easily or in the near future due to several considerations, which are discussed in the next section.

⁴⁷ According to the Korean Institute for International Economic Policy (KIEP), the proposed Korea-Japan FTA is expected to further aggravate Seoul's chronic trade deficit with Tokyo in the short term. This would eventually be offset, however, by more direct investment from Japanese firms and enhanced productivity, resulting in a sharp increase in the GDP. Korea's trade deficit with Japan would increase by US\$6.09 billion in the constant price terms of 1995 when the agreement is signed, due to the sharply lower import duties. As of 2000, the average tariffs on Japanese imports are 7.9 percent, compared with Japanese import duties of 2.9 percent on Korean products. Thus the elimination of tariff will trigger an influx of Japanese products into the Korean market. Korean has been sensitive of the FTA with Japan, as believe that the pact would favor Japan. *The Korean Herald*, 24 May 2000.

Table 4.10 ASEAN's major ongoing bilateral agreement negotiations at regional level

ASEAN – China

At the summit of ASEAN – China on the 6th of November 2001 in Brunei, it was agreeable in the Framework for Economic Cooperation between ASEAN and China to be completed within 10 years, including Early Harvest in terms of tariff reduction and removal of any related impediments in sectors which both of them have been ready. In addition, the negotiation of FTA among them is expected to be held in the year 2002.

ASEAN – Japan

In January 2002, ASEAN and Japan have set up an expert group on ASEAN – Japan to conduct the study of ASEAN-Japan Closer Economic Partnership. The report of the study is planned to present in late 2002.

ASEAN – the Republic of Korea

At the summit of ASEAN and the Republic of Korea on the 6th of November 2001 in Brunei, East Asia Study Group has been assigned to study the possibility of the FTA.

ASEAN + 3 (China, Japan, and the Republic of Korea)

East Asia Vision Group (EAVG) consisting of representatives from private sectors has proposed ways to tighten the East Asia regional cooperation as well as establishment of FTA between ASEAN, China, Japan, and Korea (i.e. EAFTA : East Asia Free Trade Area) to the leaders of ASEAN+3 which in turn forwarded to East Asia Study Group (EASG) comprising representatives from public sectors to consider such initiative carefully.

ASEAN – Australia and New Zealand (CER)

In principle, it is agreeable in the Framework for AFTA – CER Closer Economic Partnership (AFTA – CER CEP) and Initial CEP Work Programme. At this early stage, ASEAN has proposed Mutual Recognition Agreements on Electrical and Electronic Equipment and on Food to be the first activity under the CEP.

ASEAN – India

In May 1998, initiated by India, ASEAN and India agreed to set up a working group on the study of AFTA – India Linkages for Enhancement of Trade and Investment.

Source: ASEAN Secretariat, <http://www.aseansec.org>

4.3 Investment and ASEAN

4.3.1 Investment and AFTA

Investment is a crucial input for economic growth. Capital flows comprise two types of capital: (a) foreign direct investment and (b) portfolio capital (bonds and equities). This section will focus on assessing FDI flows and intra-FDI. Among the components of resource flows to the ASEAN countries, FDI constitutes a considerable share, indicating the importance of FDI as a major source of finance for economic development. Between 1990 and 1997, FDI represented an annual average of 40 % of the net resource flows to the ASEAN countries, with Malaysia, Myanmar and Viet Nam having more than 50% FDI composition (see Table 4.11 and 4.14). A high percentage of FDI to net private capital flows in the 1990s is almost the norm for many developing countries, and this is true for ASEAN.⁴⁸ Thus, the concurrent economic goal of ASEAN probably is to attract inflow of foreign directive investment (FDI) to ASEAN by enhancing market access and creating a more vibrant, stable, and competitive regional economic climate. It is hoped that inflow of FDI will transfer technology, enhance productivity and economic growth in the long term.

There have been nascent moves to liberalize investment within ASEAN. In 1987 ASEAN members signed the Promotion and Protection of Investment aiming to provide equitable treatment of ASEAN based firms in other member countries. The protocol was amended in 1996 to urge members to simplify investment procedures, approval process,

⁴⁸ ASEAN Secretariat, 'Asean Investment Area', <http://www.aseansec.org/4947.htm>

and other related law and regulations. In order to strengthen administrative transparency, the Framework Agreement on the ASEAN Investment Area (AIA) was signed in 1998 with the goal of creating a liberal investment environment for ASEAN investors by 2010 and all investors by 2020. However, in the midst of regional economic crisis, such discriminatory measures against foreign investors could worsen the inflow of investment to the region. Through an amendment in 1999, the coverage of AIA was extended to agriculture, forestry, fisheries, mining, as well as services incidental to all these sectors but still kept the different schedule against foreign investors.⁴⁹ As a result of the second amendment of the AIA by the AIA Council⁵⁰ in 2001, the original deadline of full national treatment and market access privilege against foreign investors was to be replaced by 2010. These changes to the schedule of investment liberalization reflected the fear of losing FDI flows to ASEAN which rapidly decreased since the mid-1990s in particular since the economic crisis in 1997~1998. With increasing uncertainty of the world economy and increasing diversion of FDI to China, FDI and growth became priority to governments in ASEAN. The agreement was based on the prediction of further recession in the world economy following the September 11. It reflects ASEAN's economic structure, which heavily depends on the external market such as the U.S., EU, and Japan. In this context, ASEAN members agreed to the amendments of the AIA, even though the decline of FDI flows to ASEAN during the 1990s was not due to the ASEAN-foreign distinction in AIA.⁵¹

⁴⁹ See *ASEAN Annual Report 2001-2002*.

⁵⁰ The AIA Council, a ministerial-level council, was established by 1998 AIA agreement, to oversee matters pertaining to the investment agreement.

⁵¹ Helen E.S. Nesadurai, 2003, pp.124-126.

It is not easy to investigate clearly how regional integration (in ASEAN's case, it could be AFTA) will influence FDI yet since multiple layers of distortion to trade and investment are involved.⁵² The most significant fact in gauging the effects of FTA on investment in ASEAN is that FTA inherently discriminates against non-members who are potential investors while it expands market size and liberalizing trade among members. Theoretical surveys on the relationship between FTA and FDI revealed several features as follows. First, if an integrating region with higher external tariffs provides a favourable investment environment, investments, which seek tariff jumping will be increased. Second, inflow of investment is likely to look for low-tariff countries at the expense of high-tariff countries since firms can offset the cost of tariff of the latter by intra-regional exporting from the former. Third, the competitive advantage in certain industrial sectors is not a sufficient factor to attract FDI.⁵³ Fourth, the larger the region relative to non-member countries, the greater is the responsiveness of regional multinational activity to integration. Finally, improved access to large countries upon integration inflow of FDI tends to favour small members.⁵⁴

4.3.2 FDI Trend

Global foreign direct investment (FDI) continued to fall in 2002, when world FDI inflows fell by an estimated 22.2 percent to US\$580.3 billion- the second straight year that FDI has declined. During the 2001 slowdown, it plunged by 45.3 percent to US\$745.5 billion. The decline has been associated with the slump in worldwide mergers

⁵² Jeffery Heinrich and Denise Eby Konan, 'Prospects for FDI in AFTA', *ASEAN Economic Bulletin*, Vol. 18.No.2, 2001, p.141.

⁵³ Other factors being considered to decide investment are the financial deregulation in the industrial and developing countries, as well as advances in technology and new financial instruments.

⁵⁴ *Ibid.*, p144.

and acquisitions, and has been concentrated in developed countries, but in contrasting ways. While FDI fell for most members of the Organization for Economic Cooperation and Development in 2001, the decline in 2002 was largely due to the drop experienced by the U.S. and UK, the two main recipients of FDI in the 1990s. FDI to North America plummeted by 67.4 percent from US\$158.2 billion in 2001 to US\$51.5 billion in 2002. For the European Union, FDI slid 13.4 percent from US\$332.6 billion in 2001 to US\$288 million. On the other hand, FDI to developing economies remained resilient, growing by 8.1 percent to US\$314.4 billion in 2002. FDI to Asia-Pacific turned around from the 31.5 percent drop in 2001 to chalk up an 8.7 percent rise to US\$113.4 billion. China received the lion's share again at a record US\$54.7 billion, up 16.9 percent from 2001.⁵⁵ The UN Conference on Trade and Development (UNCTAD) said the share of FDI in overall investment had also risen to some 9% at the end of the 1990s, more than twice its stake at the beginning of the decade. However, UNCTAD noted that there had been a tapering off in cross-border mergers and acquisitions. This reflected a slowdown in the rate of asset disposals and lower pressure for corporate restructuring, particularly in countries hit by the financial crisis of the late 1990s.⁵⁶

4.3.3 Intra-ASEAN FDI

FDI flows to ASEAN increased by 52.4%, from \$12.4 billion in 2002 to \$18.9 billion in 2003, which confirmed that SARS had not affected FDI flows to the region.⁵⁷ However, Table 4.9 shows that there was a fairly sharp decline in total FDI flows to ASEAN from 1997 to 2000. Along with the decline of FDI inflows to ASEAN, the

⁵⁵ *The Edge*, 1 April 2003.

⁵⁶ *The Star*, 15 June 2001.

⁵⁷ ASEAN Secretariat, <http://www.aseansec.org/16072.htm>

proportion of ASEAN in world FDI recipients has been decreased from 7.7 percent in 1995 to 1.8 percent in 2001 followed by sharp dipping in 2000 to 0.7 percent. Even the share in the FDI inflows to developing countries also showed a decline from 33.7 percent to 13.7 percent during the same period.

The main focus of investment should be on intra-ASEAN investment. Intra-ASEAN investment refers to investment by ASEAN investors in ASEAN countries other than their own. Intra-regional investment in developing East Asia fell, but its share of total inflows to the sub-region increased from 37% in 1999 to 40% in 2001, supported by relocations of investment, growing regional production networks and continuing regional integration efforts (Table 4.10). Intra-ASEAN FDI increased from 7% in 1999 to 17% in 2002, reflecting the continuing improvement in the private sector's recovery from 1997–1998 financial crisis aided by regional integration.⁵⁸

While the share of intra-ASEAN investment is small and starting from a low base, it is anticipated that it will grow as ASEAN develops into a more integrated unity. As mentioned above, the effects of AFTA on investment still remain ambiguous in this study. ASEAN which attracted only about 5 percent of world FDI over the past 20 years now faces the challenges from a rising China market and other regional markets. However, according to the UNCTAD report there were some positive signs that more regional integration will lead to increase of FDI inflows to the region. AFTA and AIA could help provide assurance of market access, involving a deeper tariff-cutting programme and investment matters. These regional projects could impact positively on

⁵⁸ UNCTAD, *World Investment Report 2003*, p.46.

investors who seek markets, resources and efficiency. In fact, FDI flows to ASEAN had increased steadily, particularly after the signing of AFTA and until the financial crisis in 1997-1998.⁵⁹

⁵⁹ Ibid., p.47.

Table 4.11 Foreign Directive Investment Flows to Selected Regions 1989 – 2001 (US\$ million)

	1998-1994(ANN.AVE)	1995	1996	1997	1998	1999	2000	2001
World	202,328	330,516	386,140	478,082	694,457	1,088,263	1,491,934	735,146
Developed Countries	138,251	203,311	219,908	267,947	484,239	837,761	1,227,476	503,144
Developing Countries	60,431	112,537	152,685	191,022	187,611	225,140	237,894	204,801
ASIA	37,673	75,217	93,331	105,828	96,109	102,779	133,707	102,066
ASEAN	13,942	25,367	29,370	30,369	18,504	19,691	11,056	13,241
Share of World (%)	6.9%	7.7%	7.6%	6.4%	2.7%	1.8%	0.7%	1.8%
Share of ASIA (%)	37.0%	33.7%	31.5%	28.7%	19.3%	19.2%	8.3%	13.0%
Share of Developing Countries (%)	23.1%	22.5%	19.2%	15.9%	9.9%	8.7%	4.6%	6.5%

Source: ASEAN FDI Database: Data compiled from UNCTAD - World Investment Report 2002.

Table 4.12 Intra-regional FDI flows in developing Asia, 1999-2001 (US\$ Millions)

1999 Source economy							
Host economy	ASEAN	China	Hong Kong	South Korea	Taiwan	Sub-total of reporting host economy (A)	Total in reporting host economy (B)
ASEAN	1685	78	886	510	347	3506	25029
China	3275a	..	16363	1275	2599	23512	40318
Hong Kong, China	759	4981	..	231	171	6142	24581
Total above	5719	5059	17249	2016	3117	33160	89928
Percentage of A/B						37%	
2000 Source economy							
Host economy	ASEAN	China	Hong Kong	South Korea	Taiwan	Sub-total of reporting host economy (A)	Total in reporting host economy (B)
ASEAN	1259	58	1045	153	580	3095	18625
China	2838a	..	15500	1490	2296	22124	40715
Hong Kong, China	7703	14211	..	69	535	22518	61940
Total above	11800	14269	16545	1712	3411	47737	1E+05
Percentage of A/B						39%	
2001 Source economy							
Host economy	ASEAN	China	Hong Kong	South Korea	Taiwan	Sub-total of reporting host economy (A)	Total in reporting host economy (B)
ASEAN	2334	151	-365	-304	113	1929	15211
China	2970a	..	16717	2152	2980	24819	46878
Hong Kong, China	1930	4934	..	100	518	7482	23776
Total above	7234	5085	16352	1948	3611	34230	85865
Percentage of A/B						40%	

Source: Quoted from UNCTAD, World Investment Report 2003, Table II.1.

a : Covers Indonesia, Malaysia, Philippines, Singapore and Thailand.

Table 4.13 Intra-ASEAN FDI share of total FDI by host country (1995-2000), %

	1995	1996	1997	1998	1999	2000	1995-2000
Brunei	53.4	54	54.0	43.	46.2	36.2	48.3
Cambodia	na	na	na	na	na	na	na
Indonesia	14.0	3.1	5.8	-11.7	-15.6	-5.1	5.0
Lao PDR	7.4	80.2	74.6	62.5	62.9	41.0	57.2
Malaysia	30.2	19.8	41.2	15.4	11.4	4.6	23.3
Myanmar	30.4	39.4	36.8	22.5	13.5	35.4	30.8
Philippines	13.0	4.5	10.8	6.1	6.7	5.1	7.5
Singapore	7.0	3.8	20.6	2.4	4.1	2.5	7.8
Thailand	8.0	13.6	8.2	7.7	9.3	11.9	9.3
Vietnam	21.8	18.2	21.1	23.5	19.5	15.7	20.2
ASEAN	15.2	10.2	19.8	9.6	8.5	9.4	12.9

Source: ASEAN Statistical Yearbook, 2001, tables VI.1 and VI.3.

Table 4.14 FDI in ASEAN from ASEAN by Source Country, 1995-2000

(US\$ Million and Percentage)

		1995	1996	1997	1998	1999	2000	1995-2000
Brunei	Value	311.3	353.1	384.9	247.2	275.1	217.5	1,1789.1
	Share	9.8	13.3	7.2	13.3	19.6	22.4	11.6
Cambodia	Value	na	na	Na	na	na	na	na
	Share	-	-	-	-	-	-	-
Indonesia	Value	608.9	193.3	272.2	-37.1	-427.8	-232.6	376.9
	Share	19.1	7.3	5.1	-2.0	-30.5	-24	2.4
Lao PDR	Value	6.5	102.6	64.4	28.3	32.4	13.9	248.1
	Share	0.2	3.9	1.2	1.5	2.3	1.4	1.6
Malaysia	Value	908.4	730.6	1,217.7	254.9	227.0	60.5	3,399.1
	Share	28.5	27.6	22.6	13.7	16.2	6.2	22.0
Myanmar	Value	96.7	228.6	323.3	153.9	41.2	72.0	915.7
	Share	3.0	8.6	6.0	8.3	2.9	7.4	5.9
Philippines	Value	204.8	73.9	139.4	109.9	114.2	88.5	730.7
	Share	6.4	2.8	2.6	5.9	8.1	9.1	4.7
Singapore	Value	503.2	332.9	2,131.3	136.5	283.7	157.8	3,454.4
	Share	15.8	12.6	39.6	7.3	20.2	16.3	22.9
Thailand	Value	160.6	308.1	297.5	569.6	569.5	389.0	2,294.3
	Share	5.0	11.6	5.5	30.6	40.5	40.1	14.8
Vietnam	Value	387.3	328.7	547.2	398.7	289.3	202.4	2,153.6
	Share	12.1	12.4	10.2	21.4	20.6	20.9	13.9
ASEAN	Value	387.3	328.7	547.2	398.7	289.3	202.4	2,153.6
	Share	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: ASEAN Statistical Yearbook, 2001, table VI.3.

4.3.4 Foreign Direct Investment and China

China, which recently joined the WTO, has agreed to a free trade agreement with ASEAN.⁶⁰ If a free trade area is created between China and ASEAN, it is expected to make a huge impact on the world economy. China and ASEAN have a combined gross domestic product (GDP) of almost US\$1.7trillion and a total external trade worth nearly US\$1.3trillion.⁶¹ It is also timely as China has cut tariffs in recent years to the current average of 15 percent ahead of its WTO entry. It eventually could lead the formation of an East Asian Trading Bloc. It is also expected that, if such an agreement is to take place, the electrical and electronics industry, textiles and perhaps the automotive industry in ASEAN will be the biggest beneficiaries.⁶²

Apart from these prospects, most of ASEAN countries do not hide their worries about China's potential threat to the ASEAN economy. Given the broad similarity in trade structure and the fundamentally competitive nature of economic relationships, there are more possibilities that China and ASEAN would compete, rather than complement one other.⁶³ The main concerns are hard competition in the world export market and rivalry in attracting foreign direct investment. Some economists estimate that as much as one-third of Chinese exports compete with Southeast Asian nations.⁶⁴ In particular, Malaysia

⁶⁰ For the evolution of bilateral relationship between China and ASEAN, see Alice D. Ba, 'China and ASEAN,' *ASIAN Survey*, Vol. XLIII, No.4, 2003, pp.622-647.

⁶¹ ASEAN Secretariat, <http://www.aseansec.org>

⁶² Singapore is the most favour to China's a closer economic relationship with ASEAN. Singapore's Trade and Industry Minister, Brigadier-General George Yeo said that it(China's bid to the FTA with ASEAN), is a positive move. *Business Times*, 24 November 2000.

⁶³ John Wong and Sarah Chan, 'China-ASEAN Free Trade Agreement', *ASIAN Survey*, Vol.XLIII, No.3, 2003,p.523.

⁶⁴ *The Asian Wall Street Journal*, 17~18 August 2001.

expressed concern over the China threat.⁶⁵ In a recent survey on Japanese foreign direct investment (FDI) outlook conducted by the Japan Bank for International Cooperation (JBIC), 327 out of a total of 401 respondents or 82 percent of the manufacturers surveyed named China as their top investment destination.⁶⁶

Foreign direct investment (FDI) inflow to Asia and the Pacific region recorded US\$ 95.1 billion according to a United Nations report.⁶⁷ The report noted that Hong Kong, China's financial gateway accounted for about half of the US\$143 billion (US\$1 = RM3.80) directed into Asia while Southeast Asian countries' share shrank from 30 percent in the mid-1990s to just 8.3 percent in 2000 (see Table 4.9).

A recent paper by Morgan Stanley's economist Daniel Lian points out that Southeast Asia could lose some economic benefit as both China and ASEAN are competitive in seeking foreign direct investment and used export oriented economy.⁶⁸ According to him, there are two possible scenarios. One is the status quo and the other is that Southeast Asia is likely to be a resource base for China and losing its competitiveness in manufacture. The latter is backed by several factors. First, China's huge domestic market and dynamic economy which develop various parts and sectors together will contribute to keeping labor cost advantage without severe downturn by product cycle. Second, its huge market is attractive to foreign investors as MNCs seek

⁶⁵ International Trade and Industry Minister Rafidah Aziz said the study would look at the entire spectrum of ASEAN and China economic relations. Mahathir expressed his concern that "China needed to be carefully worked out so that cheaper Chinese-manufactured products do not overwhelm South-East Asian industries." *The Star*, 5 November 2001.

⁶⁶ JBIC, 'the Outlook of Japanese Foreign Direct Investment', November 2001.

⁶⁷ UNCTAD, *World Investment Report*, 2003, Table 1.2.

⁶⁸ *Business times*, 29 December 2001.

cost saving operations as well as markets. As a result of losing competitiveness and FDI, Southeast Asia will have a few policy options such as depreciation of currency and will be less dependent on trade. To avoid the decrease in living standard, Southeast Asia should choose the way to be a resource-based economy to supply resources to China. ASEAN must be presented to the outside world as a single, borderless market of 500 million people, with a higher spending power than China, to perk investor interest. These potential threats by China are not only to the ASEAN countries but also to Japan. Japan has offered to set up a strategic partnership with ASEAN.⁶⁹

Table 4.15 FDI inflows to major Asian economies, 2001 and 2002 (US\$ Billions)

	2001	2002
Asia and the Pacific	106.9	95.1
China	46.8	52.7
Hong Kong, China	23.8	13.7
India	3.4	3.4
Korea, Republic of	3.5	2.0
Malaysia	0.6	3.2
Philippines	1.0	1.1
Singapore	10.9	7.7
Taiwan	4.1	1.4
Thailand	3.8	1.1

Source: UNCTAD, *World Investment Report*, 2003 Table 1.2.

⁶⁹ Japan's Vice-Minister of Finance Haruhiko Kuroda he suggested the early completion of the AFTA. He said the timetable set for AFTA's cutting tariffs to below 5% for trade within the region by 2002 and eliminating all tariffs by 2018 was not good enough. *The star*, 2 December 2001.

However, there is also optimism on ASEAN's competitiveness. According to the report by Singapore's Ministry of Trade and Industry, China's gains in foreign direct investments (FDI) have not been at the expense of ASEAN and the alleged threat posed by China to ASEAN has been overstated. It is pointed out that the Asian financial crisis in 1997-1998 was the real reason for the post-1997 sharp drop in FDI flows to ASEAN and the decline was not closely related to China's increasing attractiveness as an FDI destination. The perception that China is getting the lion's share of FDI in Asia has been based on the assumption that FDI flows to Asia is a zero-sum game, i.e. an increase in FDI to one country must be at the expense of another country, the report comments. The report said data from the 1990s showed that this was not the case of China and ASEAN as both economies had experienced strong FDI growth throughout the period from 1989 to 1997, during which FDI flow to China shot up from 3.4 billion US dollars to 44 billion US dollars while FDI to ASEAN-5, namely, Indonesia, Malaysia, the Philippines, Singapore and Thailand, burgeoned from 7.6 billion US dollars to 27 billion US dollars. Similarly, ASEAN and China both experienced a drop in FDI during the Asian financial crisis, and FDI to ASEAN and China moved up in tandem again in 2001. Investment to ASEAN and China can grow concurrently as was before the Asian financial crisis, the report reaffirms.⁷⁰ The report also notes that main investors in ASEAN have not been diverting FDI to China and from 1995 to 2000 developed countries, namely the U.S., Japan and the EU, and have consistently invested more in ASEAN-5 than in China. Citing the economic logic that a country with larger GDP should attract more FDI than another country with a smaller GDP, the report says that China's share of world FDI has

⁷⁰ Friedrich Wu, 'Foreign Direct Investments to China and Southeast Asia: Has ASEAN been losing out?', *Economic Survey of Singapore*, 2002.

not been excessive. On FDI outlook for China, the report said that FDI outlook for China would be even brighter in the years ahead as China's entry into the WTO will create more opportunities for foreign investments.

ASEAN countries, moreover, were endowed with ample human resources and natural resources and each country has its own attractions. Given that each ASEAN country is medium to small in size, it is essential for the grouping as a whole to improve its attraction as a market as well as a production base in order to compete with China.

In short, considering the rapid economic development of China, the agreement to create a free trade area between China and ASEAN could bring significant change in ASEAN and East Asian economic order, even though Japan and Korea which comprise 60% and 10% of Asia's GDP respectively, are not involved directly. While slower growth in China will undoubtedly hit export growth of its trading partners, its known impact on domestic demand of exporting countries is more difficult to unravel (see Table 4.16). According to CIMB Securities, it is estimated that weakening import demand from China will shave 0.07 percentage point from the GDP growth for Malaysia and 0.14 percentage point for Singapore. China now ranks as Malaysia's fifth largest trade partner, after Singapore, US, Japan and the EU. Its share in Malaysia's total exports strengthened from 1.9 percent in 1991 to 6.1 percent in 2003. Currently, imports from China have been expanding gradually from a small share of 2.2 percent in 1991 to 8.2 percent in 2003.⁷¹

⁷¹ *The Star*, 1 May.

Table 4.16 Impact of a Slowdown in China's demand on selected ASEAN Economies

	% Share of exports to GDP	% Share of exports to China	Major export items to China	% of exports to China	Estimated direct impact on growth*(%)
Malaysia	109.7	6.1	Electronics Electrical Products Palm Oil Chemical Products Metal	37.1 8.8 16.6 12.0 4.2	0.07
Philippines	42.1	6.0	Office machines Commodities	24.8 47.6	0.03
Indonesia	27.8	5.0	Mineral, Chemical, Wood Products electrical machinery Oil & gas	4.4 1.6	0.01
Thailand	64.5	7.3	Nuclear reactors Electrical machinery Rubber& articles	22.9 13.8 13.7	0.05
Singapore	199.9	7.0	Electrical machinery Petrochemicals, Primary chemicals	n.a n.a	0.14

*For every 1% point drop in export share to China

Source: CEIC, CIMBS estimates Quoted from *the Star*, 1 May 2004

4.4 Regional Cooperation in Financial and Monetary Fields

4.4.1 Cooperation in the Financial Sector

Since the economic crisis of 1997~98 which was initially triggered by the financial crisis, ASEAN member countries more actively seek regional cooperation in monetary and fiscal policy. This trend emerged partly due to the inefficiency of the International Monetary Fund's (IMF) strict conditional programme during the economic crisis. IMF implemented traditional austerity policies such as deflationary fiscal and monetary policies under certain conditions, while failing to understand the implications of fiscal restriction in the Asian context.⁷² It was known that investor sentiment, herd behaviour, trans-border contagion and the reversal of short-term capital inflows were primarily responsible for the crisis rather than macroeconomic problems and moral hazard.⁷³ It has been argued that the IMF-imposed policy exacerbated the macroeconomic crises in the region. Indeed, recovery of the region including Malaysia that introduced capital controls without IMF emergency credit facilities indicates that reform should be focused on creating new conditions for further recovery.⁷⁴ The atmosphere of objecting to the IMF type of conditions for currency swap arrangements in Asia was widespread. East Asian countries recognize the need to reform their own institutions in order to supplement existing structures and to ensure that they will never again be dependent on outsiders.⁷⁵

⁷² Robert Wad and Frank Veneroso, 'The resources lie within', *The Economist*, November 7-13, 1998.

⁷³ Jomo K.S., 'From Currency Crisis to Recession', Jomo, K.S. ed., *Malaysian Eclipse: Economic Crisis and Recovery*, London: Zed, 2001, pp.1-13.

⁷⁴ Ibid., pp. 271-293.

⁷⁵ Fred Bergsten, 'East Asian Regionalism: Towards a Tripartite World', *The Economist*, July 2000, pp.15-21:23-26.

Regionalism in Southeast Asia or East Asia has been proceeding more rapidly on financial issues than on trade. This looks unusual: in the European Union and other big precursors, the sequence was the other way around. But trade arrangements are politically difficult and slow to organize. Monetary agreements can proceed without discrimination against outsiders, unlike most trade deals. Regional cooperation in the financial sector has been pursued in three aspects, namely repurchasing agreements, surveillance mechanism, and macro-economic policy coordination.

The Chiang Mai Initiative

The Chiang Mai Initiative was launched on the sidelines of the Annual Meeting of the Asian Development Bank (ADB) in Chiang Mai in 2000. This initiative culminated in May 2001 at the ADB meeting in Honolulu, which dropped the idea of a pool of hard currencies but expanded the existing repurchase agreements and swap arrangements to APT. The ASEAN member countries signed a new ASEAN swap arrangement (ASA) ⁷⁶ in 2000 to increase the regional grouping's swap facility membership and enlarge its fund size from US\$200mil to US\$1bil. The plan calls for the establishment of a system of currency swaps among ASEAN and Japan, China and South Korea. This brought the total size of the network of the bilateral swap arrangements (BSAs) to US\$31.5 billion.⁷⁷ Japan had already signed with Malaysia and Thailand in 1999. The currency protection agreement signed between Japan and Malaysia involved a total credit line of US\$3.5billion. It has been reported that Japan has agreed to provide an additional US\$6billion to the currency safety net. Under these bilateral swap arrangements, countries

⁷⁶ The swap arrangement is essentially a spot sale/purchase of a currency and a simultaneous forward purchase or sale of the same currency.

⁷⁷ ASEAN Secretariat, <http://www.aseansec.org/6319.htm>.

in trouble can draw 10% of the money agreed upon straight away, free from IMF conditions.⁷⁸ Concerning the moral hazard problem, some conditions were implemented on interest rate and IMF linkage.⁷⁹ The interest rate structure⁸⁰ that may be considered higher was designed to discourage the continued use of the facility as medium-term financing.⁸¹ Despite the relatively small scale of money, such bilateral agreements could reduce the possibility of speculative attack as it will increase the financial capacity of individual countries even though they cannot completely prevent it.⁸²

Along with BSAs, Malaysia and Thailand are searching new ways of payment on their bilateral trade which depends on their own currency. To avoid high dependence on the US dollar, Malaysia has signed similar agreements with over 30 countries.⁸³

The ASEAN Surveillance Process

ASEAN has also created a surveillance mechanism to try to anticipate and head off future crises, using sophisticated early-warning indicators, and the Northeast Asian countries are jointly keeping an eye on short-term capital movements in the vicinity. The ASEAN surveillance Process (ASP) that was agreed in 1998, however, was to be informal, simple, based on the peer review process, and complementary to the IMF global surveillance. The ASEAN Surveillance Coordination Unit (ASCU) was set up at the

⁷⁸ Ibid..

⁷⁹ Any swap seeking countries should negotiate with the IMF for its assistance, expect for the first 10 percent of the BSA facility.

⁸⁰ Interest rate will be based on the London Interbank Offered Rate (LIBOR), plus 150 basis points for the first drawing and first renewal.

⁸¹ Worapot Manupipatpong, 'The ASEAN Surveillance Process and the East Asian Monetary Fund', *ASEAN Economic Bulletin*, Vol.19, April 2002, p.117.

⁸² Giovanni Capannelli, 'The Monetary Dimension of Economic Regionalism in Asia and Europe: A new Strategy for Co-operative Engagement', UMESP Discussion Paper, No. 10, 2001, p.25.

⁸³ *New Straits Times*, 7 July 2002.

ASEAN secretariat as well as in ASEAN members to coordinate the ASP and monitor global economic and financial developments.⁸⁴ However, it has been observed that members of ASEAN showed the reluctance to implement the fund's recommendation in particular on exchange rate policy not because of its deficiencies but because it is a political issue.⁸⁵

In addition, an effective system to strengthen regional financial cooperation would need to intensify exchange of information, which is currently conducted bilaterally, increase consultations, and coordinate macro-economic policy among countries in the region.⁸⁶

The Idea of an Asian Monetary Fund

The apparent failure of international organisations such as the International Monetary Fund (IMF) to foresee the crisis and deal effectively with it led to renewed calls for some sort of regional monetary fund. As a result, there has been a spate of post-crisis initiatives to explore monetary and exchange rate cooperation. In September 1997, Japan proposed an Asian Monetary Fund (AMF) to pool regional funds for quick disbursement in an emergency.⁸⁷ This proposal did indeed receive support from other potential creditor countries, such as Singapore and Taiwan. The idea was also welcomed at the political level by Malaysia and Indonesia. Proponents of the AMF argue that a

⁸⁴ Worapot Manupipatpong, 2002, p.112.

⁸⁵ Ibid., p.113.

⁸⁶ Giovanni Capannelli, 2001, p.25

⁸⁷ The proposed AMF would be capitalized to the amount of \$100 billion, with half of its reserves coming from Japan, and the remaining \$50 billion from other regional powers, such as Taiwan, Singapore, Hong Kong and mainland China. The proposed AMF would build on Asia's savings surplus, foreign exchange reserves, and net-creditor status to finance the debt of the Crisis-affected countries. Given that this debt amounted to around \$300 billion dollars, the region possessed more than adequate resources to effectively deal with the problem. Wade, Robert and Frank Veneroso, 1998, pp.19-21.

regional monetary fund could provide additional funds, bolstering the IMF's role as a lender of last resort. And the governors of such a fund could respond speedily to an incipient crisis with macro-economic advice that is more appropriate for Asian economies, rather than prescriptions from IMF.⁸⁸

However, the Japanese proposal was met with strong resistance from both Washington and the IMF. The latter, which is not very much independent of the former, objected on grounds that such a fund would merely duplicate the facilities available at the Fund itself. In addition, IMF claimed that the setting up of AMF would exacerbate the moral hazard problem as a regional lender of last resort.⁸⁹ In addition, there were reservations from China and South Korea, which were afraid of Japanese regional ambitions.⁹⁰ As a result, the idea of AMF could not be realized. Apart from external pressure, leadership problem was one of the obstacles to the idea of AMF. Given its economic power and initial proposal, Japan could be a leader of AMF. Even in 1998, Japan presented a plan called the Miyazawa Plan, which offered US\$30 billion to aid crisis hit economies in the region. However, Japan did not show political willingness to be a leader, which would cause possible conflict with the U.S. as the latter maintains a significant economic and military role in the region. The rivalry between Japan and China could be seen as another factor hindering future regional cooperation.⁹¹

⁸⁸ Salil Tripathi, 'Watch out, the AMF rise again', *The Asian Wall Street Journal*, 26 September 2000.

⁸⁹ Phillip Y. Lipsky, 'Japan's Asian Monetary Fund Proposal' *Stanford Journal of East Asian Affairs*, Vol. 3, 2003, p.103.

⁹⁰ Shaun Narine, *Explaining ASEAN: Regionalism in Southeast Asia*, London: Lynne Rienner, 2002, p.177.

⁹¹ *Ibid.*, p.183.

4.4.2 The Idea of Common Currency

There is much talk of common currency baskets and joint intervention arrangements in East Asia, to replace both the discredited dollar pegs of the past and the costly free floats imposed by the crisis. Hong Kong and the Philippines have proposed an Asian currency unit on the euro model: an idea that would obviously take years to come to pass, but would not even have been considered a little while ago.⁹² It is expected that a single monetary unit, which eliminates cross border currencies can enhance East Asia's attractiveness and the flow of foreign direct investment to the region.⁹³

Given the economic diversity of ASEA Plus Three, a practical approach towards regional monetary integration would be to begin with smaller sub-groupings.⁹⁴ Dr. Hafla Pie at the workshop organized by the Asia-Europe Institute in January 2001, defined the three stages for the creation of a common currency for Asia as follows. The first stage is a gradual approach but is different from the European Union's experience, which consists of the following steps. 1) Generalizing common basket band, 2) Asia currency Area: common unit such as ECU but without anchor money: peg on Asian common unit 3) Creation of currency Area by clustering on by one such as ASEAN (Singapore and Brunei), used to be under common currency (China, Hong Kong, and Taiwan), and Japan and Korea. The second stage is characterized by harmonizing three clusters: binding, Asian Monetary Fund. The final stage, which is expected to be completed by 2020, is full monetary integration with first implementation for advanced

⁹² *The Economist*, 13 July 2000.

⁹³ According to Subramanian Pillay (Univestiti Sains Malaysia), beside eliminating foreign exchange uncertainties, operation costs for foreign firms in the region would be lowered. *New Straits Times*, 7 August 1999.

⁹⁴ Hazel Yuen Phui Ling, 'Optimum Currency Areas in East Asia', *ASEAN Economic Bulletin*, Vol. 18, No. 2, 2000, p. 214.

countries. However this scenario could face difficulties, mainly due to strong nationalism and sub-regionalism in the countries concerned.

In this context, even the idea of an Asian Monetary Fund (AMF) seems beginning to evolve as China, which condemned the original Japanese proposal, supports the initiatives.⁹⁵ The importance of regional cooperation in monetary issues has increased since the Asian economic crisis towards stabilizing the currency and on a longer term, for launching the key currency. Meanwhile, APT countries could develop a common stand to strengthen their negotiating power on the restructuring the international financial and monetary system.⁹⁶

Furthermore, it is expected that in the long term, a currency swapping system and even the single currency issues will be significant factors for the region's financial stability. In fact, the currency swapping system is expected to reduce the present high dependency on the US dollar and to expand membership to include China, Japan, and Korea.

⁹⁵ Dr Mahathir said East Asia could consume more Japanese products if Japan helps East Asia to prosper again. "But first help us recover by investing in our countries and setting up the Asian Monetary Fund," he said. Japan has the financial strength and the technology to contribute towards East Asia's recovery and growth," he told a symposium on promoting mutual understanding between Asia and Japan, especially Kansai, organised by the Mainichi Shimbun, *Business Times*, 1 January 2001.

⁹⁶ Even IMF seems to have changed its stance on the idea of an Asian Monetary Fund. IMF managing director Horst Kohler said "If they (Asian countries) feel that an Asian Monetary Fund is an answer, they should go ahead. We are open to the idea of AMF." He said it was entirely up to the Asian countries to do whatever that was necessary to protect and to determine how best to help them at a luncheon address organised by the National Press Club and the Malaysia Press Institute. *The Edge*, 3 September 2003.

4.5 Conclusion

This chapter examined the trend that tariff barriers to intra-ASEAN trade have been declining and intra-ASEAN trade has been increasing despite diversity of the pace among member countries, even though the share of intra-ASEAN trade is still much smaller than those of the EU and NAFTA. The AFTA framework needs to be expanded to sharpen ASEAN's competitive advantage. Thus, ASEAN has addressed trade facilitation, harmonizing tariff nomenclature and customs procedures, among other things. It has also moved to liberalize investment and services, since they are vital to an integrated market.

The establishment of an early warning system and emergency loan system has been pursued to stabilize regional currencies. In this sense, the creation of an Asian Monetary Fund and strengthening of the Asia Development Bank have been argued constantly.

ASEAN's difficult task of absorbing its four newest and least developed members namely Vietnam, Laos, Myanmar and Cambodia, is eased by their gradual compliance with AFTA and other initiatives, which encouraged the acceptance of trading norms and practices.

On the other side, it is predicted that APT or East Asia group could be a threat to ASEAN mainly due to the emergence of China and lack of Japan's ability for leadership.

Rivalry between China and most ASEAN countries could undermine the latter's competitiveness in export and FDI. Expanding the regional group could provoke more trade-related conflict, even though it is not yet conclusive. There is also a growth gap between the two sub-regions, which does not seem to narrow in the near future. However, Southeast Asia's socio-economic environment is still stable for business.

ASEAN has still a long way to go towards regional integration. The lack of political commitment to deeper integration can be found in protectionism of local industries and reluctance to reduce sovereignty in financial cooperation. The non-intervention policy still remains very much an important principle of ASEAN, which eventually has to be at least modified as economic cooperation deepens. These political issues, which are seen to be the main challenges to further regional integration, will be discussed in the next chapter.