CHAPTER I

1. INTRODUCTION

It has become a norm for nations to form economic clusters, which was exemplified in 1989 at the Uruguay Round of Multilateral Trade Negotiations when the United States clashed with the European Union (EU) over the latter’s reluctance to lower agricultural subsidies under the Common Agricultural Policy (CAP). In fact, ASEAN has not been left behind in this trend of cluster formation. At the 4th ASEAN Summit (January 1992) held in Singapore, ASEAN initiated the ASEAN Free Trade Area, or AFTA, to safeguard and protect the interests of the Asian and Asia-Pacific economies. It is a regional arrangement in the direction of liberalization of trade among ASEAN countries, wherein all tariff and non-tariff barriers to intra-regional trade are to be eliminated within a time frame of 15 years beginning January 1st 1993 to 2008.

The Malaysian economy is one of the most open economies in the world today, second to Singapore in South East Asia. Dependent on exports and FDI for its growth, Malaysia envisages AFTA as a means to pursue its goal of stimulating investment-climate and enhancing competition of its trade performance. It is believed that AFTA would complement a forward and an outward looking country such as Malaysia in promoting economic growth, as it is known for its lower levels of tariff as compared to Indonesia and Philippines, and also the biggest source of CEPT imports. Thus, it is believed that Malaysia stands to gain most from AFTA.

With so many economic alliances being forged in the world today to improve economic situations, AFTA would definitely have an impact on Malaysia’s trade and investment. There is also a need to explore avenues where Malaysia has a wider scope to gain through its active participation in AFTA to initiate its growth path. In order for Malaysia to
achieve these goals, it needs to tackle the implications of AFTA on its trade and investment; the crux of the discussion this research paper presents.

1.1 OBJECTIVE

Malaysia is believed to be the second leading beneficiary in its participation in AFTA, after Singapore. Despite the volume of theoretical literature that has been written on the subject of AFTA, not much has been focused on the implications of AFTA on Malaysian trade and investment. The objective of this paper is bi-dimensional. Firstly, it aims to assess the possible benefits of AFTA to Malaysia and the challenges faced. Secondly, it attempts to ascertain the probable implications of AFTA on the Malaysian trade and investment.

1.2 SIGNIFICANCE

In most studies, Malaysia was referred to as an example of a potential Next-Tier Newly Industrialized Countries (NICs) or Near-NICs. It has undertaken outward looking strategies in expanding exports and attracting foreign investments especially since the early 1980’s. It is felt that this research paper is timely and significant since Malaysia is an active participant in AFTA. Therefore, it is important to assess the impact of AFTA on Malaysia’s trade and investment as a platform of economic growth.

1.3 DATA AND METHODOLOGY

It is vital to point out that the study mostly relies on secondary data in discussing this research paper, which are obtained from various sources, viz. the official Central Bank Annual reports, various research papers and treasury reports of domestic banks,
trade publications, trade journals and articles, periodicals, reference books on AFTA, business magazines and statistical reports from the Ministry of International Trade and Industry (MITI) and Department of Statistics. As for the sources from the Internet, articles have been selectively chosen, written by well-known economists or published in recognized domestic and international organizations’ homepages. This paper also looks briefly into the experiences of other free trade areas such as NAFTA and MERCOSUR. These experiences would provide useful lessons for Malaysia.

1.4 ORGANIZATION OF THE CHAPTERS

This research paper is organized in 5 chapters. Chapter 1 begins with an introduction to AFTA, its objective, and the significance of this paper. This chapter also draws out a general insight into Malaysia’s commitment in AFTA. In Chapter 2, the literature reviews on economics of free trade areas and AFTA and its relation with economic growth. This chapter also draws out a general insight into the current Malaysian economic situation, and its involvement in FTAs. The crux of this paper will be dealt in Chapter 3, 4 and 5. Chapter 3 looks at the current world trade and global FDI situation, as development in the international environment affects the economic performance of Malaysia in the ASEAN region. Malaysia’s trade relations with ASEAN countries and the world are also presented. Furthermore, a brief review of the effect of NAFTA and MERCOSUR is laid out. Their experiences will provide useful tips for Malaysia. Chapter 4 aims to look at the benefits of AFTA to Malaysia and the challenges faced. There is a vast and growing literature on AFTA. However, implications on trade and investment in Malaysia have not received adequate attention. This chapter discusses the implication of AFTA on trade and investment in Malaysia. The trend in the role and size of FDI in
Malaysia is discussed as a basis of investment since FDI is regarded as central to the process of growth in the past decade. Other important implications of AFTA such as the implication on employment and on the government revenue are also discussed. The results, suggestions and concluding remarks are presented in the Chapter 5.

1.5 BACKGROUND OF AFTA

Established in January 1992, The ASEAN Free Trade Area (AFTA) is a collective effort by ASEAN member countries to eliminate tariffs and non-tariff barriers on intra-trade in the goods sector within a time frame of 15 years. It is an extension of earlier efforts to promote economic cooperation through several schemes such as The ASEAN Preferential Trading Agreement (1997), The ASEAN Industrial Complementation Scheme (1981) and The ASEAN Industrial Joint Venture Scheme (1983).

1.51 OBJECTIVES OF AFTA

The objectives of AFTA are to increase the ASEAN region's competitive advantage by creating an integrated regional market that would enhance international competitiveness and to increase intra-regional trade and investment to allow rapid economic development in the region. It also envisages to facilitate efficient utilization of scarce resources and to provide opportunities for ASEAN member countries to further strengthen their competitive advantage. AFTA aims to create employment opportunities and narrow economic gaps among ASEAN countries through industrial linkages, specialization and economies of scale.

1.52 TIME FRAME

AFTA lays out a comprehensive programme of regional tariff reduction between member countries to be completed within a time frame of 15 years beginning January 1st.
1993 to 2008. When AFTA agreement was originally signed, ASEAN consisted of 6 members, viz. Malaysia, Singapore, Brunei, Thailand, Philippines and Indonesia. Later, Vietnam joined in 1995; Lao PDR and Myanmar in 1997 and Cambodia in 1999. All four countries were required to sign on the AFTA agreement in order to join ASEAN.

However, in September 1994, at the 26th ASEAN Economic Ministers (AEM) meeting in Chiang Mai, Thailand, the six original members of ASEAN (ASEAN-6), agreed to move forward the earlier deadline from 15 years to 10 years ending by 1st January 2003. This has accelerated the trade liberalization process and reaffirmed the seriousness in which ASEAN regards the achievements of a free trade area in the region. As for the new members, the time frames to meet AFTA’s obligation varies: Vietnam 1996-2006, Lao PDR and Myanmar 1998-2008 and Cambodia 2000-2010. Besides, all tariffs between member countries must be abolished by 2005 to create a completely free trade area. Furthermore, a host of “ATFA-plus” activities that contains measures such as harmonization of standards and customs procedures, macroeconomic consultations, promotion of venture capital and reciprocal recognition of tests and certification of products were initiated.

1.53 THE COMMON EFFECTIVE PREFERENTIAL TARIFF SCHEME (CEPT)

The main instrument for the actualization of AFTA is a comprehensive tariff reduction scheme known as the CEPT Scheme launched in 1993. It covers manufactured products, processed and unprocessed agricultural products. The CEPT Scheme is more sectoral as compared to item-by-item approach in the previous liberalization attempt under ASEAN PTA ( Preferential Trading Agreement) (Ariff 1994a, p.15). The PTA has had little impact on intra-ASEAN trade due to the narrow product coverage and shallow tariff cuts.
Under CEPT:

i) Tariffs between member countries are to be reduced to 0-5 percent for ASEAN-6 by 2003.

ii) QRs (Quantitative Restrictions) and NTBs (Non-tariff Barriers) are to be abolished,

iii) Elimination for all import duties for ASEAN-6 is by 2010 and 2015 with flexibility for CLMV (Cambodia, Lao PDR, Myanmar and Vietnam).

iv) 60 percent of the products will be at 0 percent tariff in 2003.

The CEPT Scheme adopts two approaches, namely the Fast Track and the Normal Track. The Fast Track applies to 15 product categories as listed in Table 1.1, agreed to at the 4th ASEAN Summit for accelerated tariff reductions (Kumar, 1992). For CEPT products with tariff rates of 20 percent or less, tariffs were reduced to 0-5 percent within 5 to 7 years, by 1st January 1998 while tariffs that were above 20 percent in 1993 were reduced to 0-5 percent within 7 years, by 1st January 2000.

The Normal Track deals with tariffs on products that are not included in the CEPT Scheme. Tariffs were reduced over a period of 7 to 10 years. For products with tariff rates of 20 percent or less, this programme reduced them to 0-5 percent within 7 years, by 1st January 2000, while for those with tariff rates of 20 percent or more, they were reduced in two stages: first, to 20 percent in 5 years, by 1st January 1998 and subsequently from 20 percent in 5 years to 0-5 percent by 1st January 2003.
Table 1.1

Intra-ASEAN CEPT Exports, 1990 (In US$ millions)

<table>
<thead>
<tr>
<th></th>
<th>Indonesia</th>
<th>Malaysia</th>
<th>Philippines</th>
<th>Singapore</th>
<th>Thailand</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pulp</td>
<td>12.3</td>
<td>2.7</td>
<td>0.0</td>
<td>8.2</td>
<td>0.9</td>
<td>24.1</td>
</tr>
<tr>
<td>Textiles</td>
<td>396.4</td>
<td>2008.4</td>
<td>4.6</td>
<td>95.2</td>
<td>59.4</td>
<td>2564.0</td>
</tr>
<tr>
<td>Vegetable oils</td>
<td>17.7</td>
<td>359.9</td>
<td>7.4</td>
<td>30.9</td>
<td>1.7</td>
<td>417.5</td>
</tr>
<tr>
<td>Chemicals</td>
<td>31.1</td>
<td>61.7</td>
<td>37.2</td>
<td>197.8</td>
<td>27.3</td>
<td>355.2</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>4.2</td>
<td>20.5</td>
<td>4.6</td>
<td>20.5</td>
<td>8.6</td>
<td>58.3</td>
</tr>
<tr>
<td>Fertilizers</td>
<td>94.2</td>
<td>38.4</td>
<td>49.7</td>
<td>9.8</td>
<td>2.7</td>
<td>194.9</td>
</tr>
<tr>
<td>Plastics</td>
<td>37.1</td>
<td>43.5</td>
<td>2.5</td>
<td>349.6</td>
<td>25.3</td>
<td>458.0</td>
</tr>
<tr>
<td>Leather</td>
<td>2.1</td>
<td>3.1</td>
<td>0.2</td>
<td>2.8</td>
<td>7.4</td>
<td>15.7</td>
</tr>
<tr>
<td>Rubber</td>
<td>11.5</td>
<td>34.1</td>
<td>2.2</td>
<td>20.8</td>
<td>25.6</td>
<td>94.3</td>
</tr>
<tr>
<td>Cement</td>
<td>35.6</td>
<td>41.6</td>
<td>0.0</td>
<td>12.8</td>
<td>0.7</td>
<td>90.7</td>
</tr>
<tr>
<td>Glass, Ceramics</td>
<td>20.5</td>
<td>44.4</td>
<td>5.0</td>
<td>19.2</td>
<td>13.3</td>
<td>102.4</td>
</tr>
<tr>
<td>Gems, Jewell</td>
<td>15.5</td>
<td>0.2</td>
<td>0.4</td>
<td>9.2</td>
<td>10.9</td>
<td>36.2</td>
</tr>
<tr>
<td>Electronics</td>
<td>39.0</td>
<td>2872.0</td>
<td>149.8</td>
<td>878.9</td>
<td>874.1</td>
<td>4814.3</td>
</tr>
<tr>
<td>Furniture</td>
<td>11.1</td>
<td>53.1</td>
<td>0.9</td>
<td>1.5</td>
<td>7.8</td>
<td>74.5</td>
</tr>
</tbody>
</table>

Source: Kumar (1992)

1.54 PRODUCTS COVERED UNDER CEPT

There are 4 categories of CEPT products (Appendix 1).
i) Inclusion List (IL)

Products in IL covers manufactured and processed and some unprocessed agricultural products. Goods in this list have to undergo immediate liberalization, and ASEAN-6 has completed transferring these products into IL in 2000. Reduced tariff rates were achieved either using Fast Track or Normal Track and by 2003, reached 0-5 percent. Vietnam and Cambodia have a time frame until 2006 and 2010 respectively to complete the tariff reduction. Lao PDR and Myanmar have a time frame until 2008 to meet the deadline.

ii) Temporary Exclusion Lists (TEL)

Products under TEL are temporarily excluded from the CEPT Scheme. By 2000, all the products on this list were transferred into IL and tariffs were reduced to 0-5 percent by 2003, except for new ASEAN members.

iii) Sensitive Lists (SL) and Highly Sensitive List (HSL)

This list covers unprocessed products such as wine, poultry, tropical fruits tobacco, tea, coffee and vegetables. They are given a longer time frame to be transferred into IL. Tariffs are to be reduced to 0-5 percent by 2010. HSL, which includes unprocessed agricultural products, will be phased into the CEPT Scheme no later than 2005 with the ending rate to be decided by each member country (not above 20 percent) by 2010. Malaysia has placed rice in this list.

iv) General Exception List (GEL)

GEL contains lists of products that are permanently exempted from the CEPT Scheme for reasons of protecting national security, public morals, human, animal and plant life and health, environmental, articles of artistic, historic and archaeological values. Malaysia has excluded 63 tariff lines, basically products under HS17 (sugar), HS22 (liquor) and HS24 (arms and weapons).
1.55 **CRITERIA FOR CEPT**

The tariff reduction / elimination is granted only if the following CEPT requirements are met:

i) **Principle Of Reciprocity**

CEPT concession are granted on a reciprocal basis whereby member country can enjoy lower tariff only if they also offer tariff reduction for the same products and comply with the local content requirement. Products must also be wholly obtained or produced within ASEAN. The tariff rate for these IL products must be 20 percent or less.

ii) **Rules of origin**

CEPT rules of origin are essential to ensure that tariff preference benefit the ASEAN countries only. A product must be eligible for tariff concession if at least 40 percent of its content originates from any ASEAN member state. The 40 percent local content refers to both single and cumulative content. In AFTA, the Rules of Origin is based on value-added with the maximum level set at 40 percent of the value of products at FOB (Free On Board).

The formula in computing single country 40 percent local content is as follows:

\[
40 \text{ percent} = \frac{\text{Material Cost} + \text{Direct Labour Cost} + \text{Direct Overheads} + \text{Profit}}{\text{Country Content} \times \text{FOB}} \times 100 \text{ percent}
\]

iii) **Documentary requirements - FORM D**

Products of both exporting and importing ASEAN countries claiming for CEPT preferences must provide a Combined Declaration form and a Certificate of Origin (FORM D).
1.56 PROGRESS OF CEPT IMPLEMENTATION.

As of 1st January 2003, 98.8 percent of the total tariff lines for ASEAN-6 are already in the IL of the CEPT Scheme for tariff concessions. Of this, 99.6 percent have duties between 0-5 percent. It covers all products except those in GEL. The new members have offered 72.2 percent of their products in the CEPT Scheme, out of which 55.7 percent are at duties between 0-5 percent. The combined average tariff for ASEAN-10 is 3.21 percent while for ASEAN-6 is 2.38 percent (Table 1.2).

Table 1.2

Average CEPT Rates

<table>
<thead>
<tr>
<th>YEAR</th>
<th>ASEAN-6</th>
<th>NEW MEMBERS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>12.76</td>
<td>-</td>
</tr>
<tr>
<td>2001</td>
<td>3.22</td>
<td>7.17</td>
</tr>
<tr>
<td>2002</td>
<td>2.93</td>
<td>6.67</td>
</tr>
<tr>
<td>2003</td>
<td>2.38</td>
<td>6.08</td>
</tr>
<tr>
<td>2006</td>
<td>-</td>
<td>4.08</td>
</tr>
<tr>
<td>2008</td>
<td>-</td>
<td>3.31</td>
</tr>
<tr>
<td>2010</td>
<td>-</td>
<td>4.62</td>
</tr>
</tbody>
</table>

Source: ASEAN Secretariat

1.6 CEPT SCHEME FOR MALAYSIA

In 2003, Malaysia transferred 10,116 products into the IL since 1993. This constitutes 97.32 percent of Malaysia’s total tariff lines, of which 99.26 percent are already
at tariff of between 0-5 percent (Table 1.3). Malaysia has achieved 60.3 percent of its tariff lines at zero tariffs. The average tariff rates are shown in Appendix 2.

**Table 1.3**

**Status Of Products At Tariff 0-5 percent For Individual ASEAN Country (2003)**

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>PRODUCTS AT 0-5 % IMPORT DUTY (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brunei</td>
<td>99.18</td>
</tr>
<tr>
<td>Indonesia</td>
<td>100</td>
</tr>
<tr>
<td>Malaysia</td>
<td>99.26</td>
</tr>
<tr>
<td>Philippines</td>
<td>98.81</td>
</tr>
<tr>
<td>Singapore</td>
<td>100</td>
</tr>
<tr>
<td>Thailand</td>
<td>99.92</td>
</tr>
</tbody>
</table>

*Source: ASEAN Secretariat.*

There are still 218 tariff lines related to Completely Knocked Down (CKD) and Completely Built Up (CBU) automotive products that will be included in the IL in 2005 at 20 percent. This delay is to allow the domestic auto industry enough time to recover from the shock of 1997’s regional financial crisis. Rice, which is currently in the HSL, will be included in 2005. Malaysia has the right to impose 20 percent import duty on rice in 2010 to protect the local industry. SL and HSL are shown in Appendix 3. Malaysia has excluded permanently items in GEL for safety reasons. GEL as in Appendix 4.
1.7 **NON-TARIFF BARRIERS (NTBs)**

NTBs are measures other than tariff that restricts export and import of products within ASEAN. Among them are complex registration requirements, customs uplifts, and delay in clearance of goods, stringent product standards, custom/import surcharges, technical measures and QRs (quota). The CEPT Scheme can only be realized if NTBs are removed. Malaysia does not maintain QRs on products in the IL.

1.8 **TRADE FACILITATION MEASURES**

To complement efforts in tariff reduction under AFTA, ASEAN has also undertaken various trade facilitation measures.

1.81 **CUSTOMS COOPERATION**

Aimed at facilitating the smooth flow of goods across region, the agreement on Customs Cooperation was signed in 1997 to simplify and harmonize the customs aspect of trade in goods.

i) **ASEAN Harmonized Tariff Nomenclature**

The Harmonized Commodity Description and Coding System (HS) for customs classifications, which will be implemented sometime this year, are to harmonize classification of products by individual customs authorities.

ii) **Harmonized Valuation Of Goods**

The ASEAN-6 has implemented the World Trade Organization Valuation Agreement to ensure uniformity and predictability in the implementation of custom valuation under WTO.

iii) **Green Lane System**

Under this scheme, the clearance of goods at customs checkpoints will be faster and goods from ASEAN countries will only be checked randomly.
1.82 STANDARDS AND CONFORMANCE

i) Mutual Recognition Arrangements

The framework was signed in 1998 and the development of standards and conformity assessment among ASEAN members will allow products tested in one ASEAN country to be sold in other ASEAN nations, once registration process in any one of the ASEAN countries takes place.

ii) Standards Harmonization

The Standard Harmonization, which started with 20 products groups that are largely traded in ASEAN, will reduce costs of production for the industries.

1.9 OTHER DEVELOPMENTS IN AFTA

The creation of several schemes such as the AFTA-Plus, ASEAN Industrial Cooperation (AICO) and ASEAN Investment Area (AIA) were aimed to complement and create more opportunities for trade and investment in the region.

1.91 AFTA-Plus

Launched in 1995, AFTA-Plus expands the scope of AFTA and deals with issues such as Trade-Related Investment Policies (TRIMs) and Trade-Related Intellectual Property Rights (TRIPs) (Naya and Imada, 1992). The measures contained within AFTA-Plus include the harmonization of standards and customs procedures, macroeconomic consultations, reciprocal recognition of tests and certification of products, and promotion of venture capital. AFTA-Plus is therefore a key part of the strategy to make AFTA internationally competitive.
1.92 ASEAN DISPUTE SETTLEMENT MECHANISM (DSM)

Adopted in November 1996, it is similar to the WTO’s dispute settlement mechanism. All economic agreements between member countries are covered under the DSM. It provides a better way of settling dispute regarding ASEAN economic agreements through the Protocol on Notification procedures, aimed at warning of measures that would have an adverse effect on concessions granted under such agreements.

1.93 ASEAN INDUSTRIAL COOPERATION (AICO)

AICO was signed on the 27th April 1996 and is an important feature of ASEAN cooperation. It is designed to encourage technology-based investments in ASEAN. AICO products will enjoy immediate benefit of the CEPT tariff rates of 0-5 percent and it is applicable for imports of intermediate products and/or raw material inputs for production. The basis of AICO is different components produced in different ASEAN countries can be assembled in any one of those countries. Many American firms have indicated their interest in the scheme. In fact, as at July 2002, there were 98 approved AICO ventures, which had an estimated annual transaction value of US$1.09 billion.

1.94 ASEAN INVESTMENT AREA (AIA)

Endorsed in December 1995, the ultimate aim of AIA is to substantially increase the flow of investment into ASEAN from both ASEAN and non-ASEAN sources. The AIA is another complement to AFTA. It plays a vital role to encourage FDI flows in the region, which means all investors from ASEAN states will be granted national treatment. The AIA is also set to remove barriers to investment in ASEAN countries by other ASEAN countries by 2010. The same privilege will be granted to non-ASEAN countries by 2020.