# AFTA = Another Futile Trade Area?

***Prof. Mohamed Ariff bin Abdul Kareem***
*(B.A. Hons., M. Ec., Ph.D.)*
Fakulti Ekonomi dan Pentadbiran

**SYARAHAN PERDANA**
Universiti Malaya
Kuala Lumpur
3 February 1994

# A F T A = Another Futile Trade Area ?

Mohamed Ariff

The importance of international trade can scarcely be exaggerated. It is hard to imagine a world in which nations cannot trade with one another. Mankind could not have made much progress, had there been no international trade. In the absence of trade relations, every country will have to be self-sufficient, consuming goods and services produced domestically at whatever cost. Simply put, the world would have been a much poorer planet, had countries adopted autarkism as a way of life.

Trade is indeed a necessity. God Almighty, in His infinite wisdom, has distributed the worldly resources unevenly across the globe, thereby compelling the inhabitants of the planet earth in different parts of the world to reach out to one another. Indeed, international trade is a superb manifestation of human interdependence, symbolising unity in diversity.

Traditional trade theory tells us that economic welfare will be maximised when each country concentrates on the production of those goods which can be produced relatively cheaply at home, exchanging them for goods which can be produced relatively cheaply abroad. International division of labour thus forms the basis of trade relations among nations.

To be sure, theories that attempt to identify the y ingredients of comparative cost advantage are many. eedless to say, no single theory can adequately explain ıch a complex phenomenon. Regardless, there is consensus mong trade theorists that some trade is better than no rade. Free traders have gone further to argue that barriers o trade would only serve to bring about a malallocation of scarce resources and that trade must remain free to ensure efficiency.

Admittedly, the doctrine of free trade seems too idealistic to take roots in an imperfect world. Even the countries which had championed the cause of free trade -- England in the nineteenth century and the United States of America in the early and mid twentieth century -- have strayed away from it. Good economics and shrewd politics seldom mix. More often than not, politics overrides economics. Nonetheless, free trade still remains an ideal worth cherishing, a dream worth chasing.

The primary objective of GATT (General Agreement on Tariffs and Trade) is freer trade, not free trade. But, free trade may well be the end result, should GATT or its successor WTO (World Trade Organisation) succeed in making trade freer and freer all the time. GATT has promoted freer trade by serving as framework for multilateral trade negotiations. Thus far, GATT has mounted fairly successfully eight rounds of trade negotiations, the Uruguay Round being the latest and most ambitious of all.

It is important to underline the fact that multilateralism constitutes the cornerstone of the GATT system. GATT sets and regulates the code of international trade conduct, adopting a multilateral approach based on the golden principle of non-discrimination. It requires that trade barriers, if any, are transparent and that trade concessions and restrictions are applied without discrimination.

To date, 117 countries hold membership in GATT, subscribing to the MFN (most-favoured-nations) principle, and yet many of them have apparently deserted multilateralism in favour of regionalism, judging by the growing number of regional groupings all over the world. Multilateralism and regionalism are fundamentally inconsistent, as the latter necessarily entails discrimination against non-members to the extent that membership privileges are not extended to others who are kept out.

The proliferation of regional groupings under the very nose of GATT, which is committed to uphold multilateralism, is not hard to elucidate. An important explanation is that the GATT system itself has unwittingly condoned regionalism. Article XXIV of GATT permits preferential trading arrangements within regional groupings in the belief that partial trade liberalisation is better than none and that intra-regional trade concessions will bring countries closer to the free trade ideal. Arthur Dunkel, former Secretary General of GATT, has gone as far as to assert that regionalism and multilateralism are "two sides of the same coin".

A more important explanation is that economic regionalism has spuriously gained much intellectual respectability through theoretical literature. The theory of customs union unveiled by Jacob Viner in 1950 has given rise to the notion that regional trading arrangements can confer net benefits, if the positive "trade creation" effect outweighs the negative "trade diversion" effect. Trade creation is positive, because it enables a country to source a product more cheaply from a partner through trade than to produce it domestically. Trade diversion is negative, because it amounts to shifting the source of imports from a more efficient third country to a less efficient partner. Seen in these terms, a regional grouping will make economic sense if trade creation exceeds trade diversion.

It was subsequently pointed out in theoretical discourses by Meade [1955], Gehrels [1956-7] and Lipsey [1956-7] that we must also take the consumption effect into account and that this can be positive where consumers benefit from preferential tariff cuts. Accordingly, positive consumption effect emanating from regional arrangements is looked upon as a plus factor.

What is more, there are theoretical postulates which de-emphasise the negative aspect of trade diversion. It is argued that trade diversion is essentially a short-run phenomenon and that economies of scale can ensure lower cost of production in partner countries in the long run [Balassa, 1962]. In a similar vein, Lipsey [1960] has argued that trade diversion is not necessarily bad, as long as consumers learn to switch from expensive items to cheaper ones.

Upon close scrutiny, however, it does appear that the prima facie case in favour of regional groupings is much weaker than what textbook models suggest. Theoretical support for regional arrangements is based on the premise that the first-best free trade option is politically not feasible and the second-best thing to do is to liberalise trade within regional blocs. What has been sadly overlooked is the fact that a country has the option of reducing its tariffs unilaterally in a non-discriminatory fashion. As Cooper and Massell [1965] have demonstrated, a non-discriminatory or non-preferential tariff reduction will enable a country to enjoy trade creation without suffering any trade diversion.

This means that unilateral tariff reductions will allow a tariff-cutting country to obtain its imports from the most efficient sources thereby maximising its gains, whereas preferential tariff reductions under regional arrangements will shift the sources of imports to regional partners. In other words, it does pay to reduce one's tariffs even if the rest of the world will not do likewise.

It must be stressed at this juncture, to avoid any misinterpretation, that this is no argument in favour of total elimination of all tariffs. The need for selective and temporary tariff protection on infant industry grounds is duly recognised. The argument here is that when it is time for tariff reduction, it must be implemented vis-a-vis all countries in a non-preferential manner.

Thus, unilateral trade liberalisation clearly represents a better option than the so-called second-best alternative. The issue is not whether the net effect of a customs union arrangement is positive or negative as posed by Viner, but how this net gain will compare with the gain from unilateral tariff cuts. Without a doubt, the static gains from the latter are larger, because the latter entails only trade creation without an iota of trade diversion.

Besides, the proposition that trade diversion will disappear in the long run, thanks to scale economies, is no more than an interesting theoretical possibility. Production cost is unlikely to fall across the board as low as that of the most efficient producer outside the regional bloc.

Moreover, Lipsey's argument that trade diversion may not reduce economic welfare, if consumers substitute cheaper products for expensive ones, does not invalidate Viner's categorisation of trade diversion as bad. We need to make a clear distinction between inter-country substitution and inter-commodity substitution. Trade diversion refers to the former, while Lipsey's point relates to the latter. What all this amounts to saying is that the adverse consequences of trade diversion may be offset partially or completely by inter-commodity substitution.

The presumptuous notion that "the higher the degree of regional integration, the better" is wrong. Integration schemes of customs union or economic union variety are, by design, more discriminatory than those aimed at looser forms of regional cooperation. Closely knit groupings are, by definition, highly inward-looking and trade-diverting.

Admittedly, the preceding analysis ignores the dynamic effects, about which there is no consensus among trade theorists. While several economists including Scitovsky [1958] and Balassa [1962] have stressed the importance of positive dynamic effects, several others including Johnson [1957] and Kindleberger [1959] have expressed serious doubts. In any case, it is extremely difficult to capture and predict the dynamic effects through economic analysis.

While the theoretical support for regional groupings is thus vigorously questionable, empirical evidence also casts serious doubts. About 60 per cent of the developing countries belong to regional groupings of some sort. All major groupings [Appendix 1] have mounted regional programs for promoting intra-regional trade. Some ve resorted to preferential trading arrangements, as in e case of Latin American Integration Association (LAIA), eferential Trading Area of Eastern and South African ates (PTA), and the Association of Southeast Asian Nations SEAN), while some others have opted for common market rangements with common external tariffs and freer factor vements as in the case of West African Economic Community WAEC), Central African Customs and Economic Union (CACEU), nd Central American Common Market (CACM).

The track record of developing country groupings n general is not impressive. Empirical studies have shown hat trade diversion exceeded trade creation in Latin merican Free Trade Association (LAFTA), with net negative tatic welfare effects [George, et al., 1977] and that trade iversion was the major source of growth of intra-LAFTA rade [Langhammer and Hiemenz, 1990]. There has not been much trade expansion within Latin American Integration Association, despite preferential tariff cuts, presumably due to overvalued exchange rates [Wogart, 1978; and Marques, 1985]. Central American Common Market, established in 1960, became dormant in the 1970s in the face of military conflicts and adverse external economic conditions. In the Caribbean Community or the CARICOM, comprising 13 states, intra-regional imports account for a tiny proportion of the total [UNCTAD, 1988]. In the African groupings, extra-regional imports are being replaced more readily by domestic production than by intra-regional imports, which suggests

hat neither trade creation nor trade diversion is really
nportant.

The African continent houses the largest number of neffective, aborted or dormant regional groupings. East frican Community (EAC) was dissolved in 1977, West African conomic Community is barely alive, Economic Community of est African States (ECOWAS) is weak, Central African ustoms and Economic Union remains sedated, and the referential Trading Area of Eastern and South African tates is crawling. Nevertheless, the spirit of regionalism s strong in Africa, as reflected in the Lagos Plan of ction launched by the Organisation of African Unity which nvisages a massive Free Trade Area, enveloping all African ountries by the year 2000.

The story is not very different in other Third World groupings. In South America, the Andean Pact was weakened by the withdrawal of Chile in 1976; LAFTA has folded up and was replaced by LAIA in 1980. In Central America, military conflicts and civil wars have brought its common market scheme to a grinding halt. The Caribbean Community survives, thanks mainly to the US-Caribbean Basin Initiative which provides freer market access in the US for Caribbean manufactures. Regional groupings in the Middle-East are in a pathetic shape, to say the least. Ambitious plans like the proposed Arab Common Market and the Maghreb Customs Union have remained no more than wild dreams. Closer home in Asia, ASEAN and SAARC (South Asian Association r Regional Cooperation) have made their presence felt rough much rhetorics and little substance.

Where developed countries are involved, regional oupings seem to have fared much better. The European onomic Community, established in 1957 with six members s grown bigger and stronger, now representing a grouping 12 members and constituting a Single European Market nce 1992. North American Free Trade Area (NAFTA), mprising the United States, Canada and Mexico, has come to existence, after the agreement was signed in 1992 and tified in 1993. To complete this broad-brush survey, ference must also be made to the somewhat loosely ructured European Free Trade Area (EFTA) which has merged th the EC to form European Economic Area (EEA) with effect om 1 January 1994, Central European Free Trade Area EFTA) established by four Central European countries in 92 with a timetable running up to the year 2001, and oser Economic Relations (CER) Agreement between Australia d New Zealand. Although the last-mentioned has partaken of e character of a bilateral rather than regional rangement, it is linked with the South Pacific islands der the South Pacific Regional Trade and Economic operation Agreement (SPARTECA).

As alluded to earlier, all regional groupings are scriminatory to the extent that members enjoy preferential reatment, even if no new barriers are erected against the rest of the world. There is little doubt that such preferences will divert trade from third countries, although the degree of trade diversion may vary among groupings depending on the situations before and after group formations. Thus, for example, nearly three-fourths of the trade between the US and Canada was duty-free prior to free trade agreement. Even before NAFTA, one-half of the Mexican exports to the United States was already duty-free, while a substantial proportion of the other half was smuggled through the porous US-Mexico border. All these mean that trade diversion under NAFTA will not be as serious as it would have been otherwise.

All this, however, does not mean that trade diversion is a non-issue. Far from it. Geographical proximity, reduced transaction costs, lower tariffs, restrictive rules of origin, and tough regional content requirements all tend to favour trade with regional partners at the expense of third countries. To this we must add, at least in passing, investment diversion which regional groupings give rise to. For, direct foreign investment tends to flow into regional blocs in order to secure a foothold in the protected regional market, again at the expense of third countries.

Thus, quite paradoxically, the so-called Free Trade Areas have nothing to do with the free trade ideal. The advocates of Free Trade Areas are certainly no free traders. None of the regional groupings is truly GATT-consistent. Surprisingly, GATT is yet to scrutinise the conformity of any of these groupings to Article XXIV. A regional grouping can legitimately be described as GATT-consistent, only if it has a program to bring down the barriers against non-members as well, which in reality is not the case. Johnson [1967] was right when he equated economic regionalism with "internationalisation of protection". Article XXIV of GATT is tantamount to legitimising group protectionism or admitting protectionist forces into the GATT order through the backdoor.

Strictly speaking, no region can be optimally defined as a self-contained economic entity. The world is too small to be fragmented into autarkic blocs. It, indeed, is in the interest of humanity that the world remain intact as a single trading bloc -- which is what the GATT system is all about.

All regional groupings are thus clearly sub-optimal by definition. In other words, ironical as it may sound, there is hardly anything "economic" about regional economic groupings. Economic groupings are formed primarily for geopolitical and security reasons, with economic cooperation functioning as a means rather than an end. For open economies especially, economic regionalism entails losses. These losses may be considered a price worth paying for security and stability, but that is a political, not an economic, decision.

It is a well-known fact that the European ommunity (EC) -- now called the European Union (EU) is riven by political considerations. The European Free Trade rea or EFTA has come about as a defensive cooperation among he five north European non-members of EC. It is an open ecret that NAFTA was formed as a countervailing force gainst the EC. The story is pretty much the same for Third orld groupings, especially ASEAN. The primary purpose of SEAN is political. ASEAN is a historical accident, a reature hatched in the heat of the Cold War.

Once regional groupings are already in place, here is always a tendency for them to widen and deepen. or, the bigger the grouping the better in terms of ncreased geopolitical clout and visibility, while a more losely knit grouping tends to develop stronger muscles and njoy greater bargaining power than a loosely structured egional entity. All this may make much political sense, but n economic terms closely integrated large groupings tend to istort trade more than loosely knit small ones.

Viewed from this angle, developed country roupings seem far more dangerous than developing country ounterparts. The latter, unlike the former, consist of ountries which play only a minor role in the international rade arena, and their ability to distort world trade is ccordingly limited. The Third World groupings are less armful also because they do not work as well as their developed country cousins.

The capacity of EEA and NAFTA to cause trade distortions is particularly enormous in terms of their size, clout and power. EEA which represents the biggest economic bloc with a market of 372 million people is awesomely matched by NAFTA which constitutes a market of 360 million people. The volume of trade they are capable of diverting from the rest of the world is likely to dwarf that all other groupings can possibly do together. Trade diversion represents only one of the many ways in which EEA and NAFTA can inflict damage on world trade. A trade war between the two can be devastating, with many developing countries getting caught in the crossfire.

More worrisome is the implication of economic regionalism for the GATT system. Already there are signs that the commitment of the major players in these blocs to the multilateral trading system is waning. No wonder the Uruguay Round dragged on for seven long years, quite unlike the previous rounds which were concluded in much shorter time. The rising tide of regionalism thus tends to undermine the GATT process. This "attention diversion" is no less serious than trade diversion or investment diversion.

The argument that regionalism and globalism are compatible is not convincing. To make this argument more persuasive, a new term "open regionalism" has been coined. It is contended that outward-looking regional groupings, where extra-regional trade plays an important role, tend to practise open regionalism. This concept of "open regionalism" is misleading, because "openness" is inconsistent with special privileges accorded to members of the club which is not open to all. The term "open regionalism" would make economic sense only if it implies that concessions given to members will be subsequently extended to others as well or that membership is open to all. Seen in this light, open regionalism is really anti-regionalism! Thus, the argument about the compatibility of open regionalism and globalism is almost tautological.

The thesis presented here is that regional trading arrangements are inherently inferior to the multilateral trading system, and that unilateral trade liberalisation is more beneficial than preferential trade concessions. This contains a strong message for ASEAN which has recently launched AFTA or the ASEAN Free Trade Area [Appendix 2].

To cynics, ASEAN is an acronym for "Ad hoc Strategic Entity of Ambiguous Nature". But, ambiguity has been a source of strength, not weakness, for ASEAN. This has meant that ASEAN could blend easily with the changing environment without losing its identity, practising flexibility and pragmatism par excellence. The ASEAN economies are outward-looking and trade-dependent, and their manufactured exports are driven largely by foreign direct investments. ASEAN has wisely avoided regional integration schemes that would have rendered it inward-looking. Critics have often lamented that the ASEAN cooperation schemes have not worked. Thank Goodness that some of these schemes could not take-off. Had they materialised, the ASEAN countries would have paid dearly for their regionalism.

It is not difficult to explain why regional trade cooperation has failed in ASEAN. A simplistic argument would be that there is too little complementarity in the production structure within the region to permit much intra-regional trade. A plausible technical explanation would be that the product coverage was too narrow or the tariff cuts were too shallow or demand was too price-inelastic. A more palpable reason is that the program has been implemented in a half-hearted fashion, judging by the numerous complaints of the ASEAN businessmen about cumbersome customs procedures and other formalities they have to go through. Bluntly put, the scheme has not worked because it was not meant to work in the first place!

At the Bali Summit in 1976, ASEAN opted for Preferential Trading Arrangement. In the first round, tariffs were reduced by 10-30 per cent on just 71 products. The number of items had increased to some 15,000, with tariff concessions of 20 to 30 per cent by 1991 without much impact on intra-ASEAN trade. Most of the items included in the list were either unimportant or irrelevant.

In recent years, however, intra-ASEAN trade has increased, thanks not to trade cooperation but to unilateral trade liberalisation by the ASEAN countries [Ariff, 1991]. Credit for the expansion of intra-industry trade within ASEAN, in particular, should go mainly to the multinational corporations which are quietly integrating the region through their investment networks. Thus, anonymous market forces are contributing much more to ASEAN integration than formal regional cooperation schemes.

AFTA represents the latest and most ambitious regional economic scheme ever mounted by ASEAN. Under AFTA, all tariffs are to be slashed down to 0-5 per cent within 15 years and all non-tariff barriers are to be dismantled among the ASEAN countries within 8 years beginning from 1 January 1993.

Trade liberalisation within AFTA is planned to proceed along two lines. Under the "Normal Track", tariffs of over 20 per cent will be reduced to 0-5 per cent in 15 years, while tariffs of 20 per cent or less will be cut down to 0-5 per cent in 10 years. Tariffs above 20 per cent are to be scaled down in two stages: to 20 per cent within 5 to 8 years in stage one, and to 0-5 per cent in the next 7 years in stage two. Under the "Fast Track", tariffs of over 20 per cent will be reduced to 0-5 per cent within 10 years, while tariffs of 20 per cent or less will be reduced to 0-5 per cent within 7 years. Thus, in effect, there are four tracks [Chart 1]. Accelerated tariff reduction will take place on Fast Track I for tariffs of 20 per cent or less and on Fast Track II for tariffs of over 20 per cent. All other items will be placed on Normal Track I for tariffs of 20 per cent and below and on Normal Track II for tariffs exceeding 20 per cent.

These tariff reductions will be based on the CEPT (Common Effective Preferential Tariff) formula. The CEPT scheme differs from the previous item-by-item approach, as its design is basically sectoral, hence more comprehensive in terms of product coverage. It is also noteworthy that CEPT will equalise the tariff rates of the ASEAN countries.

Fifteen products of considerable commercial importance have been identified for accelerated tariff reduction under the CEPT scheme [Appendix 3]. These products account for roughly US$ 9.3 billion or 37 per cent of total intra-ASEAN trade [Kumar, 1992].

The AFTA proposal is not impractical, and in fact one may expect it to take off smoothly, now that tariffs in the ASEAN countries have been falling in recent years in the wake of liberal policy reforms. Average nominal tariffs of Brunei and Singapore have always been negligible, while the average nominal tariffs of the other four ASEAN countries (ASEAN-4) range from 16 per cent in Malaysia to 44 per cent in Thailand [Chart 2]. The corresponding tariff rates for CEPT products average 16 per cent, well below the 20 per cent threshold level, although this average conceals considerable intra-commodity variations [Table 1].

It is pertinent to note that the "real" tariff rates may well be considerably lower than the "official" tariff rates, due to extensive circumvention of trade barriers, as shown in the "underpricing" of imported goods in the market place which do not fully reflect official customs duties, especially in Thailand.

Tariffs, however, do not tell the whole story. Non-tariff measures such as quotas, customs procedures, import licensing, and health and safety standards, also constitute barriers to intra-regional trade flows. Accordingly, AFTA calls for an immediate removal of all quantitative restrictions, and demands that all other forms of non-tariff barriers be phased out in 8 years.

All this looks deceptively neat on paper. Be that as it may, we must not underestimate the difficulties of operationalising the AFTA scheme. One of these relates to the question of "rules of origin" for determining the eligibility of products for preferential treatment. It is not easy to ascertain the origin of a product nowadays, given the ever increasing internationalisation of production processes. There are cost implications, too, since extensive documentation involved in enforcing the regional content rules will raise transaction costs. Besides, a strict enforcement of minimum regional content may have a dampening effect on intra-regional trade flows. However, it is heartening to note in this context that AFTA has adopted a

40 per cent minimum cumulative ASEAN content, which is less restrictive than the 50 per cent or higher regional content adopted by the EC or NAFTA.

Regardless, the rules of origin cannot preclude indirect trade deflection, i.e., the possibility of a member country exporting its own products to a partner country, capitalising on preferential market access, and replacing them at home with cheaper imports from third countries. In this case, the exporting country would gain at the expense of its AFTA partner.

The diversity of the tariff structure among the ASEAN countries will give rise to equity problems. Low-tariff countries are clearly at an advantage over the high-tariff ones in that the former have nothing much to offer by way of tariff reduction, but stand to gain substantially from the tariff cuts offered by the latter.

AFTA gains, if any, are likely to be distributed unevenly among the ASEAN countries. It would appear that Singapore, being the most developed member which also accounts for the bulk of intra-ASEAN trade [Chart 3], would gain most. This may well be an overstatement. For it is unlikely that a small city-state economy with a high degree of specialisation will be able to make dents on many fronts. Malaysia's share of intra-ASEAN trade is roughly one-quarter which pales in comparison with Singapore's one-half, but this trade is more important to Malaysia than to Singapore

[Chart 4]. It is also of relevance to note that Malaysia is the biggest exporter of CEPT products, contributing about 60 per cent of the total [Chart 5], while its share of CEPT imports is only 20 per cent.

This, however, does not necessarily mean that Malaysia will gain most from the AFTA exercise. Two other observations are in order: (a) Singapore, the biggest importer of CEPT products [Chart 6], is unlikely to increase these imports under AFTA, as its initial tariffs are already low; and (b) it is difficult to assess the impact of AFTA on Singapore's imports, since most of them are re-exported not only to other ASEAN countries but also elsewhere. Besides, it is wrong to associate "gains" with exports and "losses" with imports. To be sure, importing countries would also benefit from cheaper imports.

ASEAN is yet to work out the technical details of the AFTA machinery. Formulating workable rules of origin is no easy task. There is also a need to harmonise tariff classification and nomenclature. Trade liberalisation within AFTA will proceed smoothly only if all countries work on a common digit-level in the harmonised standard classification.

There are no provisions in the AFTA Agreement for dispute settlement. Disagreements on the interpretation of rules relating to regional content, fairness of competition, anti-dumping, etc. are bound to arise once AFTA is in full swing. The private sector, the role of which is crucial for the success of AFTA, will not participate actively unless a dispute settlement mechanism is in place. A formal dispute settlement machinery for ASEAN is almost unthinkable, as it is accustomed to an informal, casual approach that is hardly amenable to any legalistic framework. The present arrangement requires all trade disputes to be referred to the AFTA Council which is made up of the economic ministers of member countries.

A major drawback of AFTA is that not all members will be moving in tandem. There has been much horse trading with respect to content, timing and pace of tariff reductions. Malaysia and Singapore have begun to implement both the fast-track and normal-track programs in 1993, with Brunei coming aboard in 1994. Indonesia is scheduled to join the Fast Track in 1995 and the Normal Track in 1998, while Thailand will do likewise in 1995 and 1999, respectively. The Philippines will hit the trail in 1996 on both the fast and normal tracks.

A saving grace, however, is that all of the ASEAN countries are committed to the program of reducing all tariffs to 0-5 per cent by the year 2008. In other words, all of them will reach the finishing line at about the same time, even though they have decided to join the tracks at different times and to move at different speeds.

The spanner in the works seems to be the exclusion list. This list consists of items which are considered too "sensitive" to be exposed to regional competition. The irony of it all is that many of the items in the exclusion list carry low tariffs of less than 20 per cent. The number of items under "temporary exclusion" ranges from zero in the case of Singapore to 1,654 in the case of Indonesia [Table 2]. Temporary exclusion means that these products will be either placed in the Normal Track after the eighth year or put in the Fast Track at a later date.

In addition to the temporary exclusion list, there are items which are to be "permanently" excluded. These comprise not only of such items of security importance as guns and ammunitions under General Exception, but also of raw agricultural products.

In logic, "exclusion" means that everything else is included. But, this is not the case with AFTA. Strange as it may sound, AFTA is squeezed not only by the exclusion list but also by an "inclusion list". The number of items in the inclusion list ranges from 4,451 put up by the Philippines to 7,355 offered by Malaysia [Table 2]. Without exception, the number of items in the Normal Track exceeds that in the Fast Track for all countries. Overall, only 37 per cent of the items in the inclusion list belong to the Fast Track.

It is of interest to note that about 72 per cent of the items for accelerated liberalisation are in Fast

Track I, with tariff rates of 20 per cent or less. Likewise, low-tariff items dominate the normal track, with Normal Track I accounting for 78 per cent.

Even if we assume that AFTA can come to fruition on 1 January 2008 as planned, intra-ASEAN trade is unlikely to take on a significantly higher profile than it presently does. It better not. The ASEAN countries have always been open economies with strong extra-regional linkages. They have benefited greatly from the open multilateral trading system through their global trade and investment connections. It is not in the interest of the ASEAN countries to deviate from this path. If the past experience is anything to go by, preferential tariff reductions may not lead to any significant changes in the profile of intra-ASEAN trade flows. As a matter of fact, the share of intra-ASEAN trade declined from 18.6 to 17.4 per cent during the period 1985-1990, in spite of trade cooperation, although it grew in absolute terms at the rate of 14.7 per cent per annum [Ariff, 1993].

In any case, the share of intra-regional trade is not a good measure of the success of regional economic cooperation. For it does not necessarily mean that the higher the ratio the better. To be sure, the intra-ASEAN trade share can be raised substantially through deep preferential tariff cuts and prohibitively high external tariffs, but at very high costs to the member countries.

This, however, will make no economic sense. It would be better for the ASEAN countries to liberalise trade as much as possible, even on a preferential basis, but allowing market forces to determine the level of intra-ASEAN trade. The ASEAN countries will have to pay a very heavy price, if they were to set high intra-regional trade targets and work on it religiously through policy interventions.

In discussing intra-ASEAN trade, we need to exercise some caution. The role of Singapore as an entrepot tends to distort the picture somewhat. A large proportion of Singapore's exports to the ASEAN neighbours are really re-exports of products from outside the region. By the same token, a significant share of Singapore's imports from its ASEAN partners are re-exported to third countries. It is in this sense that trade statistics seem to overstate the importance of intra-ASEAN trade, especially since Singapore accounts for the lion's share of intra-regional trade. If Singapore is excluded, intra-ASEAN exports would only represent much less than one-tenth of total ASEAN exports (8.4 per cent in 1991).

Seen from another angle, however, it does appear that intra-ASEAN trade may well be substantially larger than what trade statistics would suggest. This is so because trade statistics do not capture the thriving "illegal" trade flows among the ASEAN countries. Illegal trade links are particularly strong between Mindanao and Sabah, between Cebu and Singapore, between Peninsular Malaysia and Southern

Thailand, and between Singapore and Java. Given the secret nature of the entire operation, it is extremely difficult to quantify its extent. Nonetheless, it does seem that it is embarrassingly large. It is so embarrassingly large that Singapore does not publish statistics relating to its trade with Indonesia. It is quite obvious that Singapore's figures will not tally with that of Indonesia, with a huge margin of discrepancy.

It may well be argued that there is nothing wrong with all this. In economics, legality is a non-issue. What is illegal today can be rendered legal tomorrow or the other way around by an act of parliament. Illegal activities may be viewed as market responses to unrealistic rules and regulations. Illegal trade has a useful role to play, as it can help allocate resources optimally by circumventing policy barriers which defy economic logic. This is why economists prefer to brand it as "informal trade" or as "cross-border transactions" rather than as "illegal trade", to make it more palatable.

It is perhaps no exaggeration to state that "informal" trade may have contributed more significantly to regional cohesion within ASEAN than formal cooperation. Informal trade seems to be integrating the ASEAN region in a borderless fashion, while the formally orchestrated trade cooperation scheme seems to have paid just lip service, judging by the fact that only 2.6 per cent of the items in the preferential trade list or 19.0 per cent in value terms was actually utilised in the formal intra-ASEAN trade as of 1987 [Pangestu, et. al., 1991]. This line of reasoning would lead us to the inescapable conclusion that it will pay the ASEAN countries to simply legalise this cross-border trade. Viewed in these terms, AFTA is clearly a move in the direct direction.

Under AFTA, we can expect intra-ASEAN trade to rise sharply in absolute terms, simply because what was left out by trade statistics previously will be recorded in the future, once such trade flows are legalised. But, this will amount to a one-shot increase only. In addition, AFTA can have a stimulating effect on intra-ASEAN trade, if it results in lower prices and higher incomes.

All this notwithstanding, the percentage share of intra-ASEAN trade in total ASEAN trade is unlikely to increase markedly, given the high degree of economic openness of its members and the lack of complementarity of the ASEAN economies -- which is not a bad thing. As alluded to earlier, economic openness exposes domestic industries to external competition so that they have no choice but to remain efficient and competitive. Complementarity is not necessarily a good thing. Of course, it would be politically easier for complementary economies to cooperate with one another, because regional imports will not threaten domestic industries, but it will not make much economic sense. Perfect complementarity would mean pure trade diversion with virtually no trade creation.

The main reason why regional cooperation in many groupings, including ASEAN, has not been very successful is that preferential market access is given mostly to those products which do not compete with domestic products. The search for complementarity has led to the exclusion of too many important items from trade cooperation.

ASEAN is advised in no uncertain terms not to aim at a high intra-regional trade ratio, quite unlike the EC where it accounts for a hefty 58 per cent of total EC trade. Such a high ratio of intra-regional trade will have serious cost implications for the open economies of ASEAN.

AFTA is very un-ASEAN in a variety of ways. AFTA is by no means a new idea, as the free trade area option was considered and rejected by the architects of ASEAN some 25 years ago, albeit for the wrong reasons. AFTA cannot jive well with the informal and casual approach that ASEAN has nurtured and perpetuated over the years. Besides, as is well known, the ASEAN countries compete with one another in the world market, and it is unnatural for competitors to cooperate among themselves.

Be all that as it may, AFTA is not a big deal, judging by the product coverage of the inclusion list, the size of the exclusion list, the mechanism of trade liberalisation and the long-drawn timetable. And, it pales in comparison with NAFTA which is a comprehensive package with liberalisation stretching beyond merchandise trade to services trade and investment regulations, and regional protection extending beyond trade to environment and intellectual property rights, with all technical details worked out well in advance.

Having said this, we must hasten to add that it is not in the interest of the ASEAN countries to emulate NAFTA or any other grouping for that matter. The NAFTA Agreement exceeds 2000 pages, compared with the AFTA Agreement of just 12 pages. Detailed rules and guidelines themselves can become formidable barriers to intra-regional trade flows. It is sometimes virtuous to be ambiguous, as it permits flexibility. And, ASEAN knows it only too well.

In all fairness, AFTA should be judged not by the input but by its output. Without a doubt, AFTA represents the most important trade initiative that ASEAN has ever taken since its establishment in 1967. AFTA can trigger dramatic changes in the structure of production and trade in the ASEAN countries. AFTA can serve as a "training ground" for the ASEAN businessmen who will learn to compete in the regional market before they could compete in the world market. Once ASEAN becomes commercially borderless under AFTA, a new pattern of production with each member discovering its own niches is likely to emerge, rendering ASEAN products competitive internationally. AFTA will then benefit not only its members but also its neighbours, trading partners and foreign investors. Seen in these terms, the bottomline of AFTA is really competition, not cooperation.

However, trade liberalisation alone will not ensure all this. To be effective, trade liberalisation must be accompanied by a liberalisation of investment regulations in all of the ASEAN countries so that ASEAN investments are accorded "national treatment" in the member countries. Indeed, trade and investment are interrelated, as borne out by the fact that the ASEAN countries' main trading partners are also their major sources of foreign investments. The fact that the bulk of the intra-ASEAN trade is conducted by Singapore and Malaysia may be attributed in no small measure to the strong investment linkages that exist between the two countries.

To realise the full potentials of AFTA, ASEAN will need to widen the product coverage, shorten the process and ensure that AFTA is not strangulated by unnecessary red tapes and complex rules. In the same vein, a harmonisation of tariff classifications, customs procedures and investment incentives would be helpful. If ASEAN is really serious about AFTA, it must do away with the "inclusion list" so that what is not excluded is automatically included, and ensure that the "exclusion list" is short and time-bound. All tariffs should be reduced to zero eventually, and it does not make economic sense to reduce it to 0-5 per cent.

Customs revenue based on such low tariff rates may not even meet the cost of tariff collection and administration.

The 15-year AFTA timetable is too long. The chances are that AFTA will be overtaken by world events by the year 2008. Tariff cuts under the GATT system may reduce the ASEAN preferential margins so that AFTA may become redundant or irrelevant before it reaches the deadline. Quite paradoxically, AFTA's success will lie in making itself redundant or irrelevant sooner. AFTA will then have served a useful purpose by paving the way for a total integration of ASEAN with the global economy. This means that tariff concessions within AFTA need to be extended to non-members later on. In other words, AFTA should be seen as an exercise in "minilateralism", i.e., a step towards full-fledged multilateralism.

Two other possibilities, though remote, cannot be entirely ruled out. Should AFTA falter and fall short of our great expectations, ASEAN will lose its credibility and join the ranks of numerous ineffective regional groupings. Should it evolve into a trade bloc, it will strap itself to a low-level equilibrium. In either case, ASEAN will have lost a golden opportunity to scale greater heights, with AFTA being epitomised as an acronym for "Another Futile Trade Area".

All said and done, in the final analysis, it is ASEAN, not AFTA, that is really important. The end of the Cold War and the retreat of communism have not made ASEAN redundant or irrelevant. Peace in Southeast Asia cannot be taken for granted. ASEAN is needed now more than ever to avoid arms race, defuse tensions and avert military conflicts in the region. ASEAN can contribute significantly to geopolitical stability and security so that its members could concentrate on their economic pursuits. The ASEAN economies do not need AFTA, as they can perform pretty well on their own. But, the strength of ASEAN now hinges critically on AFTA. For AFTA can serve as a glue that would not let ASEAN fall apart. ASEAN's image will be severely tarnished, should AFTA fail. AFTA must succeed for the sake of ASEAN.

# REFERENCES

Ariff, M., "ASEAN Economic Cooperation at the Crossroads: Options for the 1990s", paper presented to the ADIPA Conference on "The Changing World Community: Development Consequences and Adjustments", Macao, 8-11 October 1991.

_______ "AFTA: An Outward-Looking Free Trade Agreement", Economic Brief, No.14, East-West Center, Honolulu, 1993.

Balassa, B., The Theory of Economic Integration, London, 1962.

Cooper, C.A., and Massell, B.F., "A New Look at the Customs Union Theory", Economic Journal, Vol. 75, 1965.

Gehrels, F., "Customs Unions from a Single Country Viewpoint", Review of Economic Studies, 1956-7.

George, R., et. al., "Short-Run Trade Effects of the LAFTA", Kyklos, Vol. 30, 1977.

Johnson, H.G., "The Criteria of Economic Advantage", Bulletin of the Oxford University Institute of Statistics, February 1957.

_______ Economic Policies towards Less Developed Countries, Washington, D.C., 1967.

Kindleberger, C.P., "The United States and European Regional Economic Integration", Social Science, October 1959.

Kumar, S., "The ASEAN Free Trade Area -- Issues for Policy", paper presented at the ASEAN Roundtable, Institute of Southeast Asian Studies, Singapore, 3-5 September, 1992.

Langhammer, R.J., and Hiemenz, U., Regional Integration among Developing Countries, Tubingen, 1990.

Lipsey, R.G., "Mr. Gehrels on Customs Unions", Review of Economic Studies, 1956-7.

_______ "The Theory of Customs Unions: A General Survey", Economic Journal, September 1960.

Marques, J.S., "Trade Liberalization, Tariff Redundancy and Inflation: A Methodological Exploration Applied to Argentina", Weltwirtschaftliches Archiv, Vol.121, 1985.

Table 1
Average Unweighted Tariff by Product (percentage)

| | Indonesia | Malaysia | Philippines | Thailand | Average |
|---|---|---|---|---|---|
| Pulp | 9 | 3 | 7 | 5 | 6 |
| Textiles | 19 | 6 | 26 | 30 | 20 |
| Vegetable oils | 13 | 1 | 21 | 10 | 11 |
| Chemicals | 4 | 0 | 7 | 10 | 5 |
| Pharmaceuticals | 5 | 0 | 9 | 8 | 5 |
| Fertilizers | 0 | 0 | 3 | 0 | 1 |
| Plastics | 15 | 13 | 17 | 25 | 18 |
| Leather | 3 | 9 | 19 | 24 | 14 |
| Rubber | 9 | 8 | 23 | 22 | 15 |
| Cement | 15 | 55 | 30 | 5 | 26 |
| Glass & Ceramics | 20 | 15 | 20 | 18 | 18 |
| Gems | 11 | 5 | 24 | 0 | 10 |
| Electronics | 24 | 15 | 18 | 25 | 21 |
| Furniture | 50 | 24 | 33 | 80 | 47 |
| Total | 14 | 11 | 19 | 19 | 16 |

Source: Kumar (1992).

**Table 2**

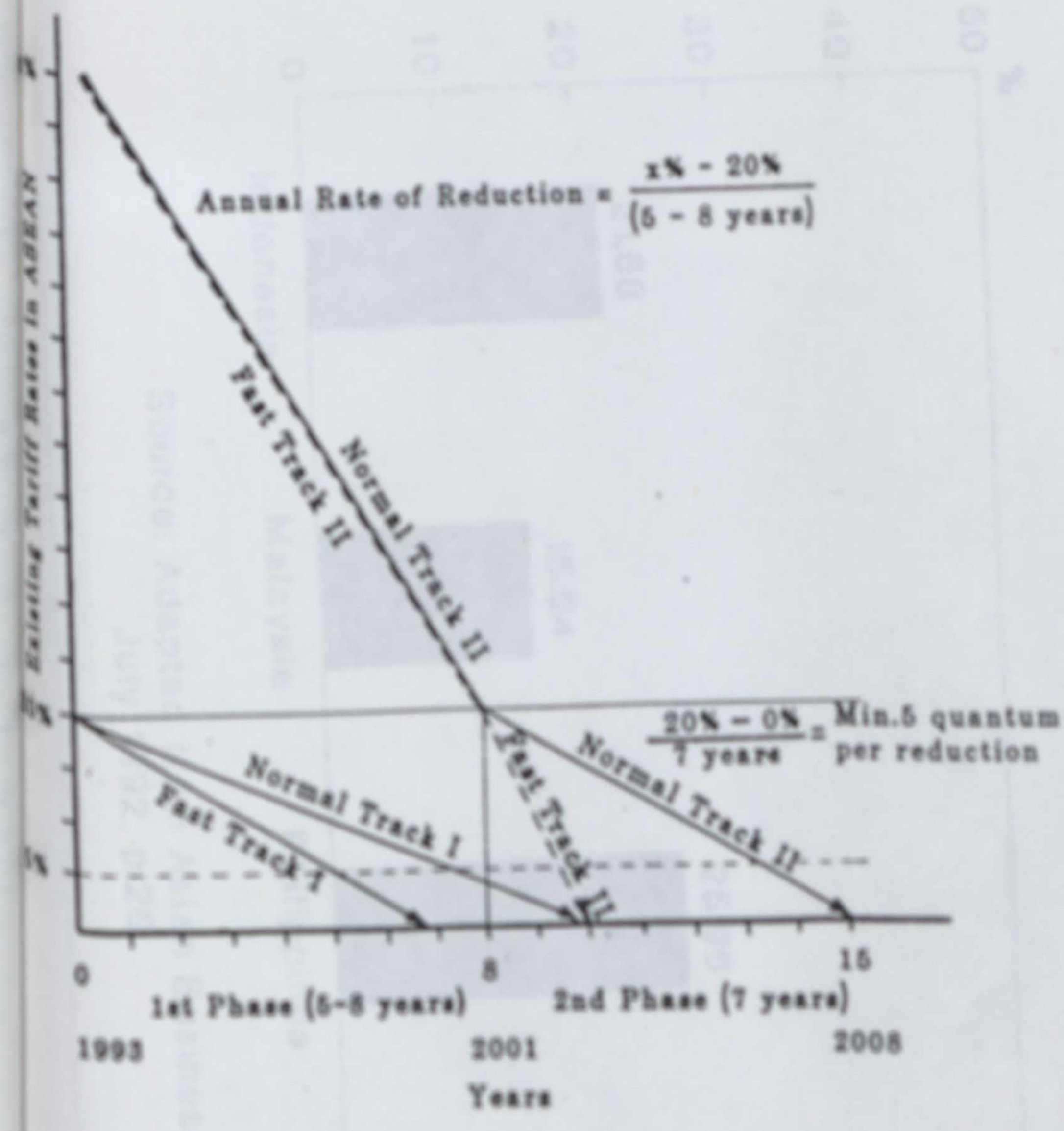
**AFTA: Accelerated Tariff Reduction, Normal Tariff Reduction and Exclusion List**

| Country | HS Digit Level | Inclusion | | | | Exclusion | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Accelerated Tariff Reduction Program (ATRP) | Normal Rate Reduction Program (NTRP) | Sub-Total | % (f)/(k) | Temporary | General Exception | Unprocessed Agricultural Products | Total |
| (b) | (c) | (d) | (e) | (f) | (g) | (h) | (i) | (j) | (k) |
| Brunei Darussalam | 9 | 2,472 | 3,498 | 5,970 | 92.66% | 208 | 243 | 22 | 6,443 |
| Indonesia | 9 | 2,816 | 4,539 | 7,355 | 78.39% | 1,654 | 50 | 324 | 9,383 |
| Malaysia | 9 | 3,166 | 5,611 | 8,777 | 88.25% | 627 | – | 541 | 9,945 |
| Philippines | 8 | 1,033 | 3,418 | 4,451 | 79.61% | 714 | 28 | 398 | 5,591 |
| Singapore | 9 | 2,205 | 3,517 | 5,722 | 97.95% | Nil | 120 | Nil | 5,842 |
| Thailand | 6 | 1,736 | 2,777 | 4,513 | – | 118* | 26 | 390 | – |

* At HS 10-digit level.

Chart 1

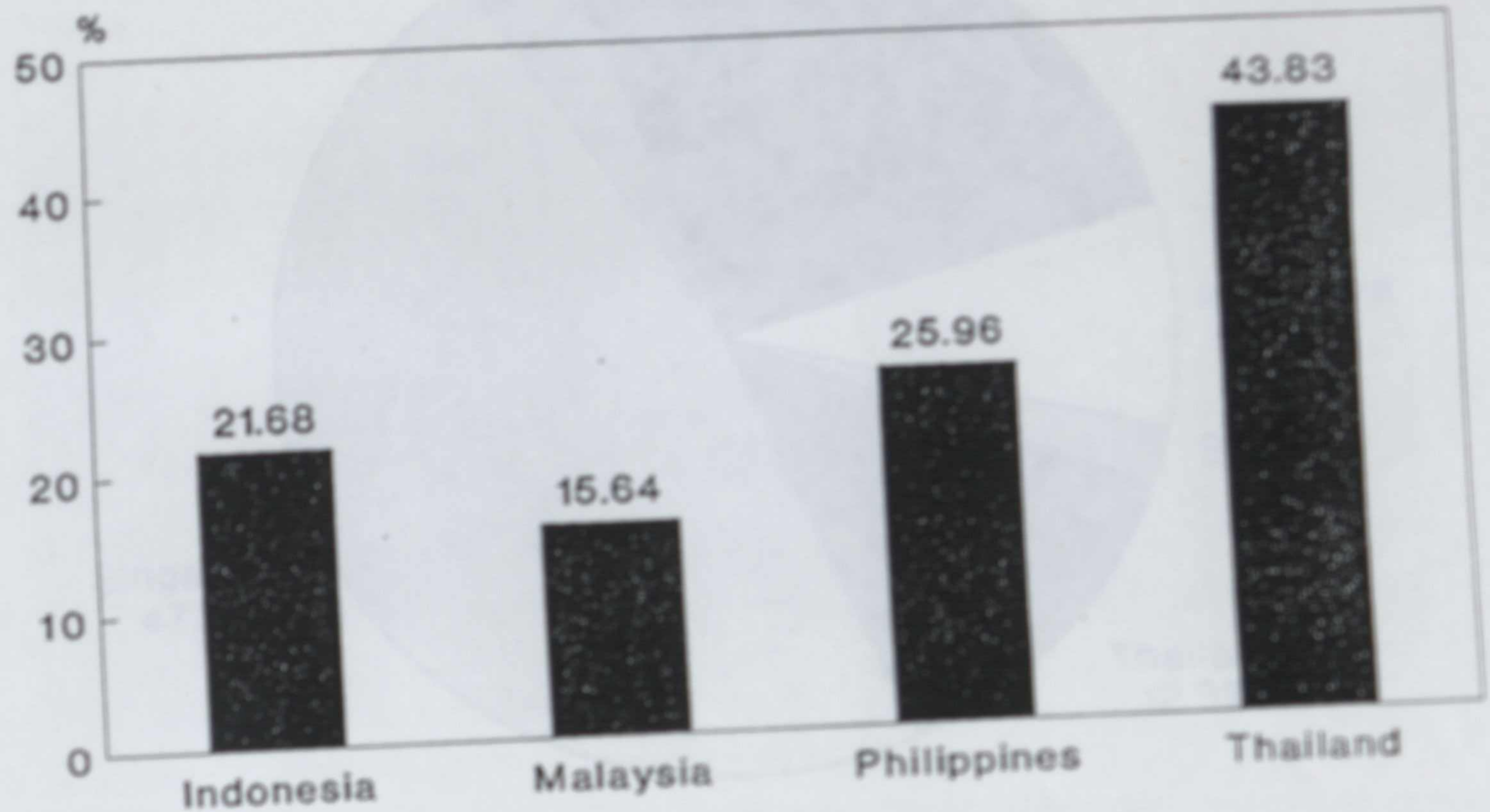
## CEPT SCHEDULE OF TARIFF REDUCTION




Note: x-the existing tariff of individual member states

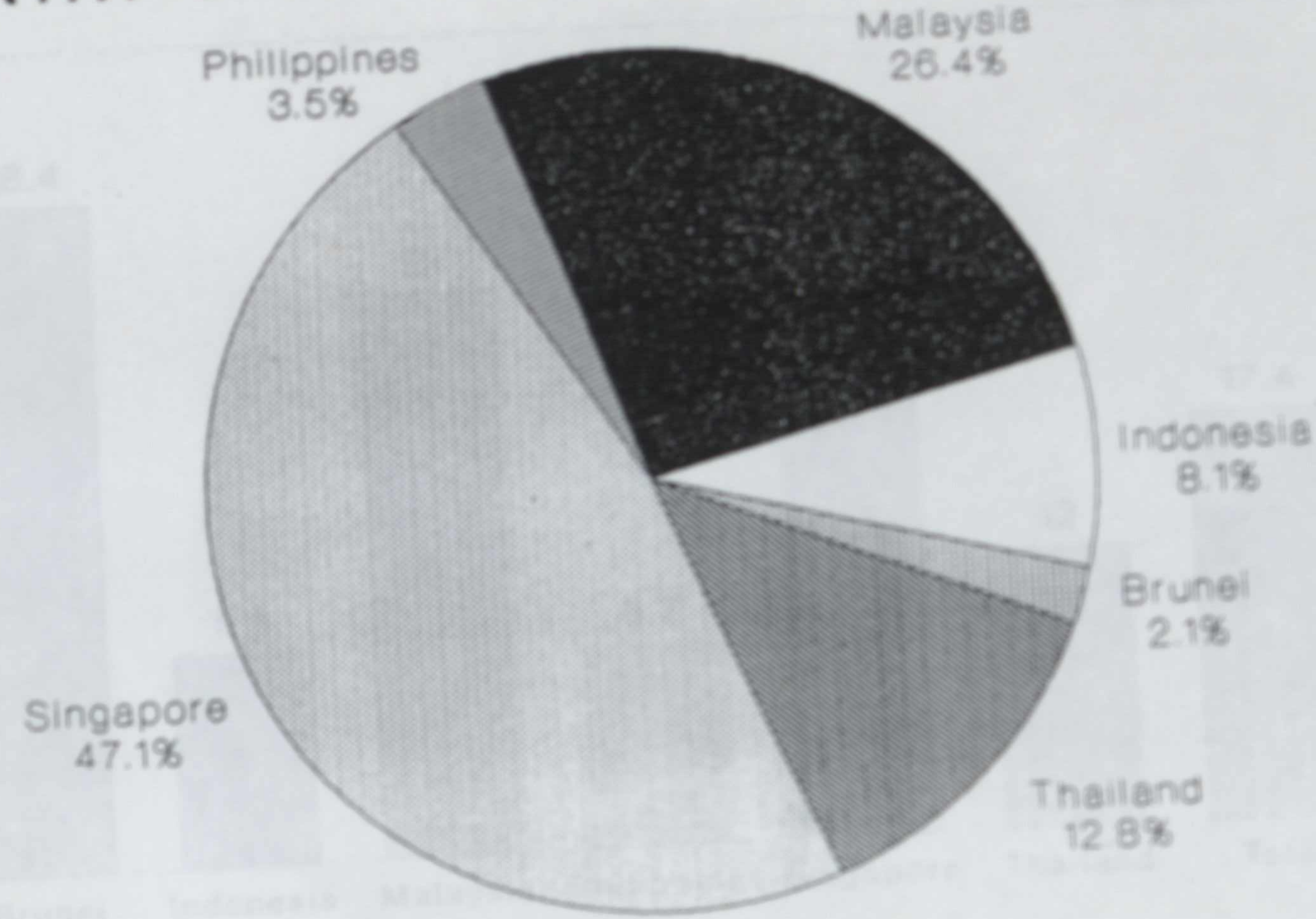
## Chart 2

### OVERALL AVERAGE TARIFFS IN ASEAN




Source: Adapted from Asian Business,
July 1992, p.26

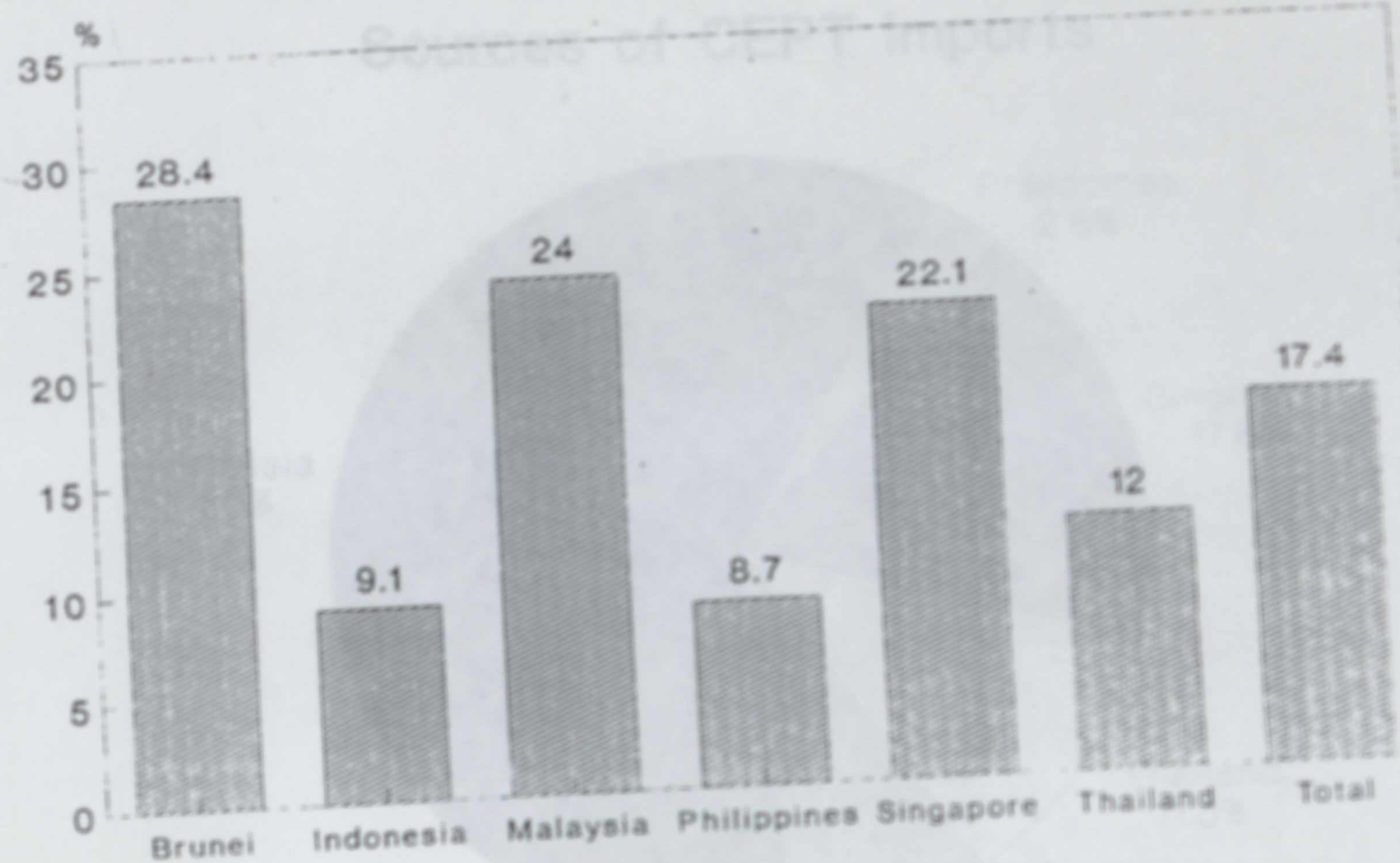
CHART 3
COUNTRY SHARE OF INTRA-ASEAN TRADE 1990




Source: Based on IMF, Directions of Trade Statistics, 1991

Chart 4

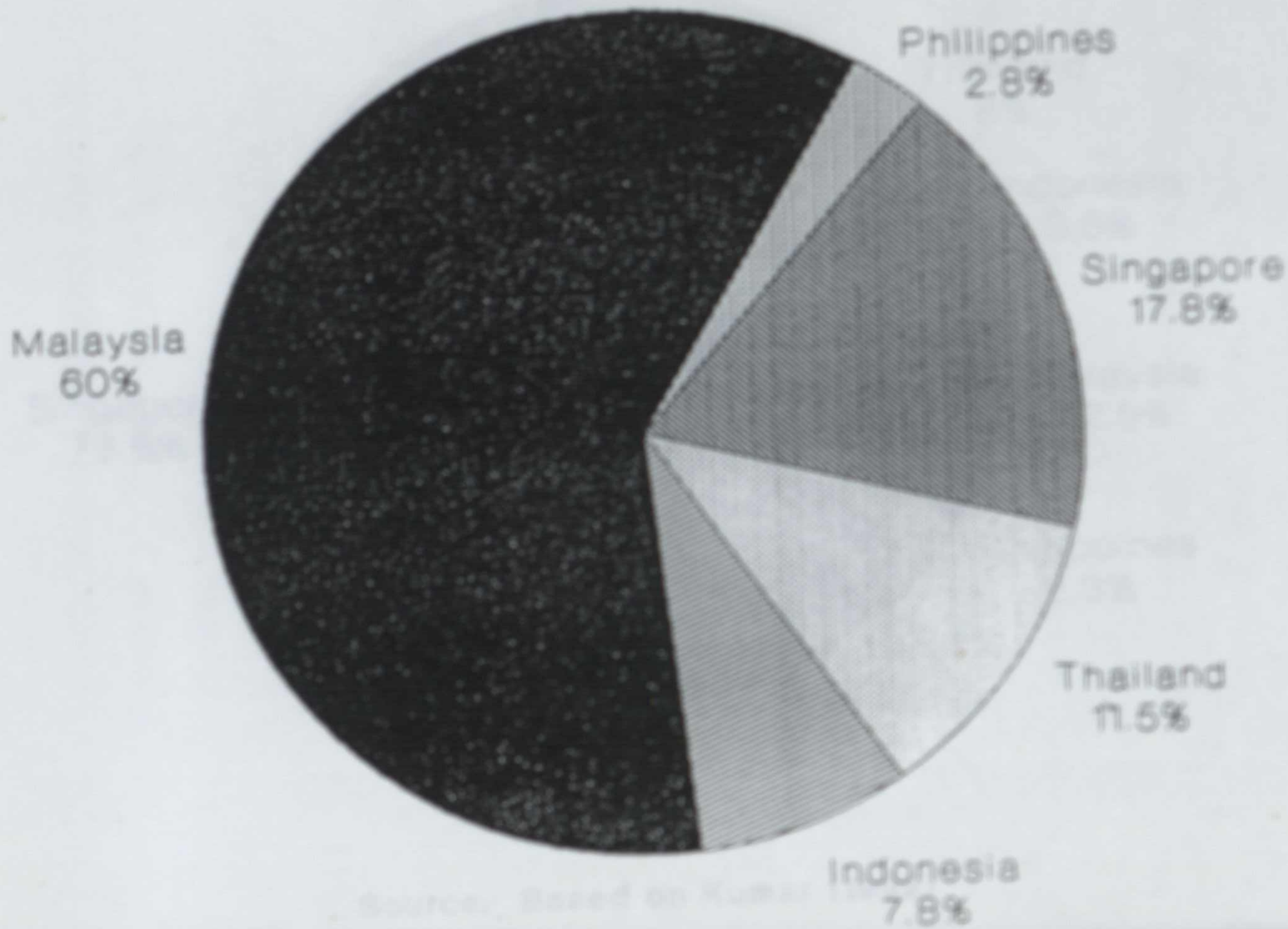
RATIO OF ASEAN TRADE TO TOTAL TRADE:1990




Source: Based on IMF, Direction of Trade Statistics, 1991

Chart 5

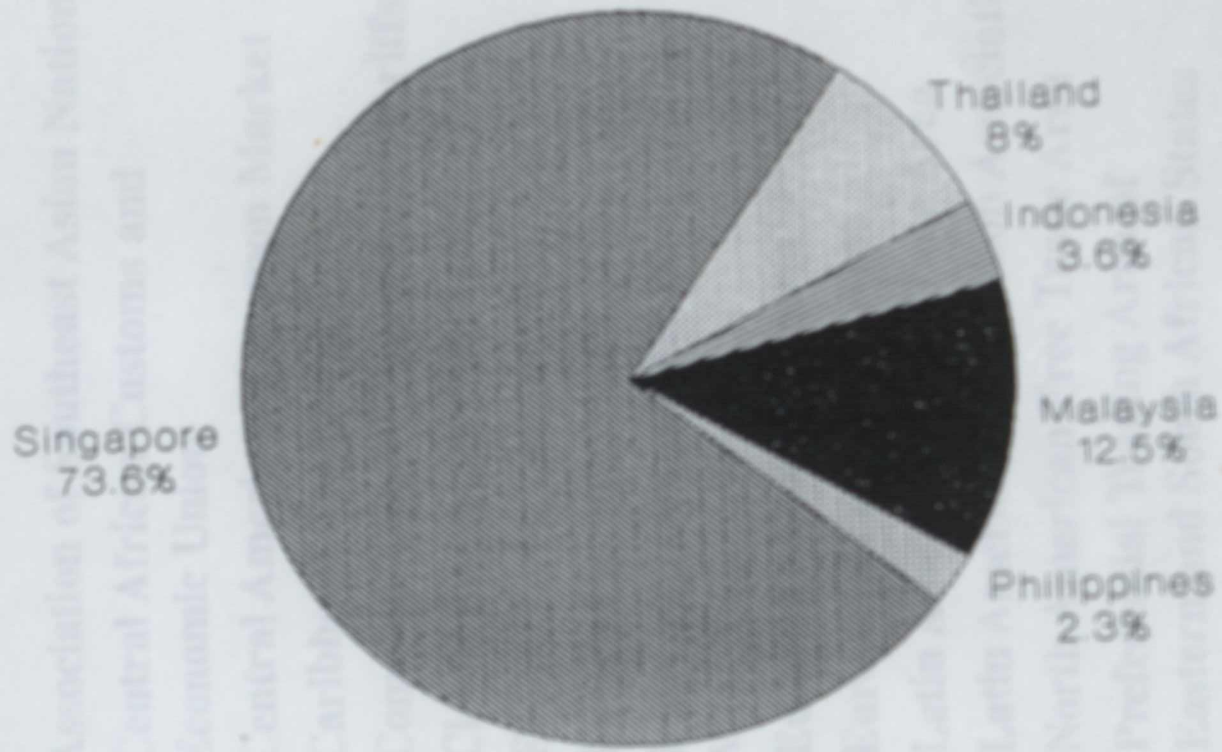
## Sources of CEPT Imports




*Source: Based on Kumar (1992)*

Chart 6

## Country Share of CEPT Imports




Source: Based on Kumar (1992)

# MAJOR REGIONAL GROUPINGS

| | | |
|---|---|---|
| EAN | – | Association of Southeast Asian Nations |
| CEU | – | Central African Customs and Economic Union |
| CM | – | Central American Common Market |
| RICOM | – | Caribbean Community |
| PT | – | Common Elective Preferential Tariffs |
| R | – | Closer Economic Relations |
| C | – | East African Community |
| | – | European Community |
| OWAS | – | Economic Community of West African States |
| A | – | European Economic Area |
| TA | – | European Free Trade Area |
| FTA | – | Latin American Free Trade Area |
| IA | – | Latin American Integration Association |
| FTA | – | North American Free Trade Area |
| A | – | Preferential Trading Area of Eastern and South African States |
| ARC | – | South Asian Association for Regional Cooperation |
| ARTECA | – | South Pacific Regional Trade and Economic Cooperation Agreement |
| AEC | – | West African Economic Community |

# APPENDIX 2


N. KOREA
Beijing
S. KOREA
JAPAN
Tokyo
CHINA
HONG
KONG
TAIWAN
BURMA
LAOS
Pacific
Ocean
VIETNAM
THAILAND
PHILIPPINES
Manila
Bangkok
KAMPUCHEA
BRUNEI
Bandar
Seri
Begawan
MALAYSIA
Kuala Lumpur
SINGAPORE
equator
INDONESIA
Djakarta
AUSTRALIA

# CEPT PRODUCTS FOR ACCELERATED TARIFF REDUCTION

1. Vegetable Oils
2. Cement
3. Chemicals
4. Pharmaceuticals
5. Fertiliser
6. Plastics
7. Rubber Products
8. Leather Products
9. Pulp
10. Textiles
11. Ceramic & Glass Products
12. Gems & Jewelry
13. Copper Cathodes
14. Electronics
15. Wooden & Rattan Furnitures