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ENHANCING THE BENEFITS OF ASEAN ECONOMIC INTEGRATION

By Steve Magiera¹

Introduction

Regional free trade agreements (FTAs) are proliferating worldwide, and now most countries are members of at least one such agreement. Countries form trade agreements because they expect expanded commercial ties to improve national welfare. As was the case with ASEAN, there can be important political reasons for bringing countries together commercially. Finally, FTAs now are also being used to gain a competitive edge in attracting investment.

The benefits of an FTA are the result of several factors. First and foremost, lower tariffs for members of a trading bloc cause production to shift to lower cost producers within the bloc. This results in lower prices to consumers. Second, regional trade agreements lead to expanded internal markets, which can result in scale economies for production, greater knowledge and technology transfers, and greater investment. All of these factors lead to lower prices, higher productivity, higher wages, greater employment, and a generally higher level of development for members of the trading bloc.

For free trade agreements to work effectively, trade must occur seamlessly across borders. Tariffs, non-tariff barriers, customs inefficiencies, divergent product standards, and poorly integrated regional logistics all cause markets to remain fragmented and result in low levels of trade. The incentive to invest and trade is also affected by the competitiveness and general business climate of the trading bloc. No matter what the size of markets, investments are unlikely to occur if markets lack competitive infrastructures or if the legal and regulatory climate is not conducive to investment. What investment does occur will likely be concentrated in low-valued assembly of consumer products.

There are many ways to reduce costs and improve the competitiveness of a trading bloc. Examples are trade facilitation measures involving streamlined customs procedures, the harmonization of licensing schemes and product standards, and the elimination of redundant inspection requirements. Other cost reductions can be achieved by improving the transport and telecommunications infrastructure, and by expanding the coverage of free trade to include services.² The cost of complying with government regulations can be reduced and greater certainty can be provided investors through improved legal and regulatory environments. Finally, countries often pursue the deepening of the free trade area through the harmonization of international trade policies (customs union), allowing the free movement of labor and capital (common market), and the harmonization of monetary and fiscal policies (full economic union).

¹ The author is an International Trade Economist with the Partnership for Economic Growth (PEG), a United States Agency for International Development (USAID)-funded Project with the Government of Indonesia. This paper was tabled by Indonesia as a non-paper at the Special Meeting of ASEAN Economic Ministers (AEM), Jakarta, 23 July 2003. The views expressed in this report are those of the author and not necessarily those of USAID, the U.S. Government or the Government of Indonesia.

² Services now account for 50 percent of the GNP in some countries and are critically important to national competitiveness.

Trends in the Share of Intra-ASEAN Trade

The share of intra-ASEAN in total ASEAN trade rose from 21.1 percent in 1993 to a peak of 25 percent in 1995 and 1996, but has since fallen back to 23 percent in 2001 (Table 1). As a result, the share of intra-ASEAN trade has changed little over the past eight years. ASEAN's low and declining share of intra trade is sometimes compared with the shares of other regional groupings (NAFTA, EU, and Mercosur) which have been increasing during the past few years. This has led some to question whether ASEAN is contributing to the development of the region.

Table 1: Share of Intra-ASEAN Exports in Total Exports (Percent)

Year	1993	1994	1995	1996	1997	1998	1999	2000	2001
Share	21.1	23.7	23.7	25.0	24.9	21.9	21.9	23.2	22.8

Source: ASEAN Secretariat

Although the low level of intra-ASEAN trade is a matter of concern, it might be well to note that there are many factors that cause fragmentation of markets and low trade volumes. Many of these factors are either beyond the immediate control of policy makers or require a long-term commitment of investment funds.

- **Asian Financial Crisis.** The decline in the share of intra-ASEAN trade since 1997 may have been due to the collapse of ASEAN financial institutions and increased country risk. Lines of credit between importers and exporters within ASEAN were affected more by the financial crisis than lines of credit between ASEAN traders and those in developed countries.
- **Resource Endowments.** ASEAN countries tend to have similar resource endowments which makes trade between them less likely to occur.
- **Limited Demand for High End Products.** Most ASEAN countries wish to move up the value chain into higher valued products. Often, the demand for these products is concentrated not in ASEAN, but in the high-income industrialized countries. The penetration of these markets by ASEAN producers is sign of success, even though this leads to lower intra-ASEAN trade. As one example, electrical equipment and computer machinery account for 50 percent of all ASEAN trade and are ASEAN's most important export products, but are ranked 40th in terms of intra-ASEAN trade.
- **Transport and other Infrastructure Bottlenecks.** The margin of support afforded by AFTA is diluted by high transport costs. Much trade between ASEAN countries requires a land link and a sea link with port infrastructure in between. By way of comparison, only a road link is necessary for trade between most countries of the European Union.

Governments should also be careful about the policies prescribed for expanding intra-ASEAN trade. Policies that erect barriers between ASEAN and foreign countries may lead to expanded intra-regional trade, but are also likely to lower economic growth within ASEAN. This would be the case if the restrictions cause importers to shift purchases from low cost foreign producers to high cost ASEAN producers, or exporters to shift sales from highly profitable foreign markets to less profitable ASEAN markets. The policy prescription for low trade volumes should therefore focus not on restricting markets, but on making them work more effectively.

The ASEAN Vision: Whither ASEAN?

ASEAN has surpassed several milestones and introduced a number of integration initiatives since its inception in 1967. At their December 1997 Summit in Kuala Lumpur, ASEAN Leaders provided an umbrella for these initiatives by proclaiming ASEAN Vision 2020. The Leaders' Vision includes:

“the creation of a stable prosperous and highly competitive ASEAN economic region in which there is free flow of goods, services and investment, freer flow of capital, equitable economic development and reduced poverty and socio-economic disparities.”

ASEAN Leaders initiated steps to fulfil this Vision at their Ha Noi Summit in December 1998 when they approved the Ha Noi Declaration and the Ha Noi Plan of Action (HPA). These contain a series of directives that are to be carried out between 1999 and 2004. Next year will conclude the five-year implementation period for the HPA.

At the ASEAN summit in Brunei Darussalam in November 2001, Leaders placed continued emphasis on their Vision by requesting a Roadmap and milestones for the realization of Vision 2020. The Roadmap is to identify ways to address gaps in the Ha Noi Plan of Action and is to look beyond trade liberalization to other forms of integration, such as customs and standards. The Roadmap covers all of ASEAN's current activities: AFTA, services, investment, standards, customs, industrial cooperation, e-ASEAN, ICT, SMEs, IPR, transport services and the energy network development.

Finally, ASEAN has received recommendations from ISEAS, ASEAN ISIS and McKinsey for the formation of an ASEAN Economic Community (AEC). These proposals differ in their detail, but would in any case lead to the formation of an ASEAN market involving the free flow of goods, services, investment, capital, and certain types of labor. The High Level Task Force on ASEAN Economic Integration is now examining the proposals and is drawing up a concrete plan of action.

The full implementation of all ASEAN agreements (e.g. AFTA, AIA, and AFAS) would bring ASEAN considerably closer to a full common market. One of the first issues facing Ministers, therefore, is whether to recommend “declaration” of a common market by endorsing proposals to form the ASEAN Economic Community. Alternatively, Ministers might decide to recommend the further consolidation and deepening of existing ASEAN initiatives under the themes such as:

- Enhancing the Benefits of the ASEAN Economic Integration
- Bringing Global Competitiveness to ASEAN

Consolidation could also involve new framework agreements, such as a “Business Facilitation Framework” which would include work already begun on customs, rules of origin, and transport, or a “Single ASEAN Market for ICT” which would include many of the ASEAN ICT initiatives now in progress.

Lowering the Cost of Cross Border Trade

The word “globalization” has taken on numerous and sometimes politicized meanings in recent years. In the case of a Free Trade Agreement, the meaning can be illustrated quite clearly. At one time, investors might have searched for one least-cost location to be used in the production of a final product. Now, investors search for several least-cost locations that will be used in the production of components for the final product. The multiple sourcing of inputs implies that the transaction cost of getting components into the production line is a critical factor in investment decisions. With shortened product cycles and modern just-in-time inventory techniques, the speed at which components and final products must reach market has also become ever more important. Where it once might take three months to fill an overseas order for a garment, a competitive producer today must be able to fill an order in less than 18 days.

The combined size of the ASEAN market is sometimes compared favorably to those of China and India. A key difference, however, is that raw materials and components must often cross borders in order to take advantage of ASEAN’s size. These borders represent an artificial barrier to trade. Unless cross border trade can be made as seamless as possible, investors are unlikely to view ASEAN’s large market as an inducement to invest.

The cost of complying with custom and other import procedures can be 2 to 5 percent of the value of merchandise trade. The cost of complying with rules of origin might raise this another couple of percent. Thus, lowering the cost of cross boarder trade can be an extremely effective way to integrate markets and facilitate trade.

Rules of Origin. While 20-25 percent of ASEAN trade is between ASEAN members, far less of that trade actually makes use AFTA tariff concessions. It is estimated that less than 5% of intra-ASEAN trade, or about 1% of total ASEAN trade, falls under the CEPT. The low level of AFTA usage indicates that the benefits of participating in AFTA are small relative to costs. These benefits are measured by the margin of preference afforded trade within ASEAN compared with trade between ASEAN and other countries. Low benefits reflect the fact that many ASEAN countries have lowered MFN rates along with their AFTA rates.³

The cost of participating in the CEPT is directly related to the monies spent on collecting, managing, and storing the information needed to comply with ASEAN rules of origin. Rules of origin are the criteria used to determine the “nationality” of a product when the product’s raw materials or components are produced in countries outside ASEAN. Rules of origin also prevent countries from qualifying for ASEAN tariff preferences when they transship goods that are produced overseas through an ASEAN country.

Rules of origin can be exceedingly complex and costly to comply with. These costs increase exponentially when a company must comply with differing rules in many trading blocs. As a result, rules of origin can have a major impact on investment and trade. In some case, the costs

³ If the benefits of participating in AFTA are indeed small, ASEAN could move quickly to a customs union with AFTA tariff rates that are close to MFN rates.

of compliance with rules of origin may exceed the benefits of favorable tariff treatment.⁴

The ASEAN Task Force on CEPT-AFTA rules of origin has had detailed discussions to improve the value added calculations in ASEAN's rules, to develop a new Operational Certificate Procedure on Rules of Origin, and to consider other requests for rules changes. The Task Force should make every effort to keep rules compliance as simple and least costly as possible. For example, there are now proposals for changing ASEAN's value added rule for certain products. While there may be merits to this in individual cases, it would be preferable to limit exceptions and instead develop broad based rule changes that will reduce the overall cost of participation in the CEPT.

As the number of FTAs negotiated by ASEAN and its members proliferate, ASEAN should also make every effort to harmonize the rules of origin in these agreements. Harmonization would allow greater business predictability, allow sourcing by common rules, reduce the tremendous cost of compliance with multiple rules, and prevent the shifting of production on the basis of differing rules.

Customs Procedures. Although slowed by human resource and financial constraints, ASEAN is taking numerous steps to streamline and modernize its customs procedures. An ASEAN harmonized system of tariff codes has been negotiated and will be implemented this year. Six members are now applying WTO valuation procedures and will introduce post clearance audits. An ASEAN Customs Valuation Guide is now being prepared, and members have agreed to the simplification and harmonization of customs procedures in line with the Kyoto Convention. ASEAN might wish to formalize these various activities under a Framework Agreement on Business Facilitation. A similar framework is contained in the Agreement on Free Trade of the Americas.

Lowering the Cost of Rules Compliance

- Lower ASEAN's value added threshold of 40 percent to 35 percent. This should benefit ASEAN's unless developed members who have less vertically integrated production processes and lower wages;
- Consider replacing ASEAN's value added rule with substantial transformation, as is now under consideration on a product basis;
- Ensure that inputs produced in several ASEAN countries can easily be counted as ASEAN local content;
- Harmonize methods of calculating value added across ASEAN countries;
- Harmonize rules of origin in ASEAN Free Trade Agreements.

Framework Agreement on Business Facilitation

- Temporary Importation by Business Travelers
- Express Shipments
- Simplified Procedures for Low Value Shipments
- Compatible EDI Systems and Common Data
- Harmonized Commodity Descriptions/Coding
- Customs Information and Guide.
- Codes of Conduct for Customs Officials
- Risk Analysis/Shipment Targeting

⁴ These costs equal about 3 percent of product prices in ALADI: Latin American Integration Association.

Infrastructure

Transport and communications infrastructure provide key backbone services that directly impact trade-related transactions costs. Thus, these services are critical to the efficient delivery of goods and to the competitiveness of the ASEAN region. Many transport and communications services are also demanded by households as final consumption items.

ASEAN Ministers have made some commitments for these services under the ASEAN Framework Agreement on Services (AFAS), but progress has been slow. Because of the importance of these services to competitiveness, the HLTF recommends that consideration be given to various initiatives to fast track these sectors.

Transport. ASEAN has numerous initiatives in the transport sector. Ministers are in the process of finalizing ASEAN agreements on multi-modal transport, the facilitation of inter-state transport, and protocols under the ASEAN agreement on the Facilitation of Goods in Transit. Ministers agreed to launch a regional initiative for the phased liberalization of air service and adopted final offers for the liberalization of air and maritime transport sectors under the AFAS. An ASEAN Memorandum of Understanding on Air Freight Services will allow the designated airlines of each member country to operate limited freight services across ASEAN, and is the first step towards liberalization of airfreight services.

Some ASEAN initiatives, such as the MOU on Air Freight Services and some protocols of the Framework Agreement on the Facilitation of Goods, are targeted at reducing the cost of transport for goods. However, seamless trade requires not only low cost and timely transport, but also that the transport system be integrated with other aspects of the trading system, including trade brokers, customs, and the financial system. With this in mind, ASEAN might conduct a trade and transport facilitation audit for to identify problems in the trading system and determine solutions. The audit would include brokers, traders, carriers, ports, border crossing points, financial agencies, and traders. The solutions would be introduced into a comprehensive framework for trade facilitation that includes not only customs, but also the entire trading system.

ASEAN Trade and Transport Audit

- Forwarders, Brokers, Operators
- Traders
- Carriers
- Ports and Airports
- Border Crossings and Customs
- Finance Institutions

Source: The World Bank Global Facilitation Partnership for Transportation and Trade

Information Communications Technology. ASEAN is already implementing a large number of ICT integration measures. Most ICT-related manufactured products are already covered by the WTO Information Technology Agreements. Mutual Recognition Agreements are also be developed for many of these products. Similarly, ICT services are covered by the WTO Services Agreement and the ASEAN Framework Agreement on Services. When these various agreements are combined, ASEAN might be close to having a framework agreement for a Single ASEAN Market for Information and Communications Technology -- SAMICT.

SAMICT	
In view of the need to achieve global competitiveness, the countries of ASEAN agree that by year 2008, they will create a single ASEAN Market for ICT.	
For ASEAN ICT manufacturing products:	
Tariffs	= Zero
NTBs	= Eliminated
Standards	= Harmonized MRAs
For ASEAN IT Services:	
Investors	= National Treatment 100% Market Access
Professionals	= Free Cross Border Trade
Cyberlaws	= Harmonize MRA for Digital Signatures Payment Standards
Products with ICT	
Mode of supply	= No Restrictions on Trade
For ASEAN Communications Services:	
Investors	= National Treatment 100% Market Access

Dispute Settlement

ASEAN's agreements now extend well beyond tariffs and trade in goods to a variety of other complex legal issues. As a result, there are calls for an improved dispute settlement mechanism which would ensure compliance and the consistent application of ASEAN agreements. This would promote trade and investment by providing the legal certainty that ASEAN members will abide by their agreements.

The current ASEAN Dispute Settlement Mechanism (DSM) is in many ways analogous to the old dispute mechanism of the GATT. This is particularly the case in regards to the adoption of panel rulings. Under Article 7 of the ASEAN Protocol, panel decisions require a majority vote and are non-binding. The same would be true for the ASEAN Compliance Body (ACB), whose findings would be based on a two-thirds vote and are non-binding. The ACB would also be composed of government officials who likely lack independence and whose credibility might therefore be questioned.

The dispute settlement system that was introduced into the WTO following the Uruguay Round is a great improvement over the old GATT system, and is therefore a model that ASEAN might wish to emulate. The WTO system encourages voluntary compliance through monitoring and review, and backs this up with a binding dispute resolution mechanism. The WTO requires adoption of panel reports unless they are disapproved by consensus. ASEAN might consider revisions to the Protocol of Dispute Settlement Mechanism to adopt several aspects of the WTO type model. The ASEAN Compliance Body could be used as an informal mechanism to encourage voluntary compliance with obligations before they go to formal arbitration, but would require independence from national capitals.

Settling Disputes

- Require the adoption of Panel Reports unless there is a consensus to disapprove them;
- Improve the quality of panels and ensure consistency of rulings by providing standing membership;
- Provide for an informal arbitration mechanism to encourage compliance with obligations in a prompt and effective manner.
- The ACB could be used to mediate potential disputes, but would require greater independence.