

AFTA and Foreign Direct Investment¹

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As one of the fastest growing groups of economies in the world, the Association of Southeast Asian Nations (ASEAN) has benefited greatly from extensive interaction with the international marketplace and financial markets. Accompanying the group's average 5.5 percent growth during the 1980s was an instrumental expansion of foreign direct investment (FDI) inflows. The rapid rise in capital flows following the 1985 Plaza Accord helped to stimulate ASEAN exports and to boost economic growth. Today, however, a steady source of capital is no longer assured and there is growing competition for resources from the economies in transition in Europe and Asia. The nations in Southeast Asia are being compelled to rise to the occasion.

In ASEAN, there is much hope that the formation of a free trade area (AFTA) will have a positive influence on the flows of FDI to the region. This impact, of course, will depend on the structure of AFTA, as well as the commitment of each of the participants. If a genuine free trade area in ASEAN is no more than an illusion, then its intended effects are unlikely to materialize. ASEAN cannot afford to paper over weak economic cooperation programs as it did in the past if it wants to continue attracting foreign investors to the region.

This paper examines AFTA to see if it is an illusion, or if it represents a requisite mechanism established by the ASEAN countries that may indeed stimulate the flow of FDI to the region. In doing so, we first briefly review ASEAN economic cooperation and the factors influencing the formation of AFTA. Then we examine the mechanics of AFTA and the impact that it may have on FDI in the region.

EVOLUTION OF AFTA

The founding of ASEAN in 1967 to ostensibly deepen economic interaction in the region did not result in the apparition of economic cooperation between the five states² until the early 1980s. Yet the group's members thrived economically, thanks in large part to the stability which accompanied the ASEAN spirit. For the five countries with conflicting territorial claims and other interests,³ ASEAN has provided a peaceful backdrop to a business climate which is conducive to growth.

The 1980s witnessed the establishment of the Preferential Trading Arrangements (PTA), the ASEAN Industrial Complementation (AIC) Scheme, the ASEAN Industrial Projects (AIPs), and the ASEAN Industrial Joint Venture (AIJV) Scheme. These attempts at economic cooperation through a combination of market sharing and resource pooling mechanisms, however, were plagued by a common set of problems which limited their effectiveness. First, as a consequence of the excessive bureaucratic procedures at both the ASEAN and national levels, delays of a year or more for approvals weakened the attraction of the various schemes. Second, there was a general lack of commitment to implement these schemes. ASEAN initiatives were not followed up with thorough promotion efforts, and information was not extensively disseminated to all the parties who stood to benefit from the cooperation. Third, there was an absence of private sector involvement in the decision-making process at a regional level. Although the ASEAN Chambers of Commerce and Industry (CCI) has been active in pursuing the interests of the private sector, it has run up against the interests of national bureaucracies. Finally, a dearth of political will was the most important factor impeding genuine economic cooperation in ASEAN. Government leaders were more concerned with the costs associated with cooperation than the spillover of benefits and were, therefore, reluctant to pursue

greater cooperation.⁴

One of the schemes of particular relevance to this discussion is the AIC. This mechanism was designed to stimulate intra-industry trade by liberalizing ASEAN trade in intermediate products for goods whose final production takes place in an ASEAN country. In conceiving this scheme, the ASEAN leaders hoped to create the right conditions (e.g., a large market so that firms may gain from economies of scale) to attract FDI to the region so that such products as an ASEAN car could be developed. The AIC, however, was not championed by any party until it was modified in 1989 to incorporate an intra-firm "brand-to-brand" concept. In this form, the AIC scheme allows the private sector a larger role in determining the location of various production processes. Previously, the ASEAN governments were responsible for negotiating which processes would take place in each country. Inevitable conflicts arose over which countries would receive the higher value-added processes. Under the "brand-to-brand" variation, private automobile companies make proposals for AIC privileges (a minimum 50 percent margin of preference on tariffs) based on their own market calculations, thus dislodging many of the political rivalries involved in government-to-government negotiations.⁵

The "brand-to-brand" complementation (BBC) scheme, which is strikingly similar to a proposal made by the Ford Motor Company in 1971 (tabled because it was too ambitious at the time), illustrates the evolution of ASEAN government officials' political will to liberalize intra-ASEAN trade. Yet the BBC has, to date, been confined to the automobile sector and is not far reaching. The emergence of AFTA, therefore, must be a manifestation of the continuing evolution of the political will which first rejected the Ford proposal and later saw the establishment of BBC.

Various internal and external factors have affected this will to proceed with the free trade area. First, the emerging shape of the international economic environment is affecting the outlook of ASEAN officials *vis-a-vis* regional economic cooperation. The development of economic blocs in Europe and North America has heightened the apprehensions of ASEAN leaders over the possible diversion of trade and investment from the region. Furthermore, the delays in the completion of the Uruguay Round of talks illustrate how the international economic environment is being shaped largely by the OECD countries. As the ASEAN countries are relatively trade-dependent, they need to bolster their bargaining power to assure that their interests are not ignored. AFTA is a means not only of strengthening the cohesion of the group, but also of enhancing the dynamism of each individual economy. As the heads of state stated in the Singapore Declaration of 1992: "ASEAN shall constantly seek to safeguard its collective interests in response to the formation of large and powerful economic groupings among the developed countries, in particular through the promotion of an open international economic regime and by stimulating economic cooperation in the region." In this way, ASEAN leaders hope to show the world that they are a force to be reckoned with.

Second, ASEAN leaders have been compelled to adopt economic reforms as a result of hardships suffered from external circumstances in the 1980s. General liberalization policies, as well as the adoption of outward-oriented industrialization strategies based on multilateral trade under the GATT, have strengthened the economies in ASEAN. Cooperation within ASEAN, in the form of AFTA, is seen as a first step in the process of reducing tariff and non-tariff barriers on a most favored nation (MFN) basis. This gradualist approach allows for domestic industries to be subjected to greater competition from within ASEAN before being exposed to the rigors of the international marketplace.

Third, the growth strategies adopted by the ASEAN governments in the 1990s have been based on attracting additional FDI to the region following the apparent successes of the investments made in the 1980s. In light of the competition from Indochina, China, Eastern Europe, and Mexico for increasingly scarce capital, an effort has been made to maintain these inflows. But investment incentives are not enough to make or break investment decisions, thus AFTA was seen as a more appropriate vehicle to improve the investment environment. If it is broad-based enough, AFTA will undoubtedly be attractive to foreign investors who are looking to gain from economies of scale by producing for the region or by manufacturing truly regional products for export. Officials involved in the negotiations leading up to the summit meeting in Singapore admit that this capability of attracting foreign investment was one of the most compelling arguments for AFTA.

Finally, the introduction of international production networks is beginning to affect the way business is done in ASEAN. Technological advances, which have lowered the costs of transportation and improved the telecommunications networks, have resulted in production being based in different locations as a result of increasingly smaller cost differentials and greater efficiency. During the investment boom in the late 1980s, the ASEAN countries were exposed to these new technologies. Taking advantage of these new technologies to develop production networks can help ASEAN businesses lower their costs of production and become more competitive. The enthusiasm among foreign automobile manufacturers for the BBC scheme suggests that a more diverse production base including all six ASEAN economies will be attractive to firms producing on a global scale. A broad-based AFTA will eliminate the barriers to intra-firm trade and trade in intermediate inputs, and improve the atmosphere needed to facilitate intra-regional production networks.

The formation of AFTA, which reflects these changes, is designed to lower all barriers to intra-ASEAN trade in manufactured goods (with at least 40 percent ASEAN content) to a maximum of 5 percent by the year 2008. The Common Effective Preferential Tariff (CEPT) scheme, which categorizes products on a broad sectoral basis (e.g., HS 6-digit level), is to be conducted at two speeds. At the January 1992 Singapore Summit, the ASEAN leaders agreed to accelerate the reduction of tariffs on 15 items to show their commitment to AFTA. These so-called "fast track" items include:

- vegetable oils
- cement
- chemicals
- pharmaceuticals
- fertilizer
- plastics
- rubber products
- leather products
- pulp
- textiles
- ceramic and glass products
- gems and jewelry
- copper cathodes
- electronics
- wooden and rattan furniture

Tariffs on the remaining items are to be reduced according to an agreed schedule (see [Table 1a](#), [Table 1b](#), [Table 1c](#) and [Table 1d](#)).

The effectiveness of AFTA depends in large part on the commitment of each of the six countries to reduce their tariffs, and to do so in a coordinated manner. Although the CEPT agreement is not a legally-binding document, none of the countries is willing to contravene it for fear of the economic consequences of such an action. Nevertheless, to make it more palatable, the agreement allows each country to compile a list of goods to be excluded from the tariff reductions. Such exclusion lists are hardly a new concept to ASEAN, and have repeatedly undermined the effectiveness of other market sharing efforts (e.g., PTA). This so-called "six-minus-X" mechanism can go both ways, however, as it permits individual countries to participate in cooperation schemes at either a slower or a faster rate than the other members.

AFTA: A YEAR AND A HALF LATER

Over a year after it was established, and only several months since it commenced, AFTA remains somewhat of an enigma in many circles. As a consequence of the uncharacteristic circumstances in which a consensus on ASEAN cooperation emerged before any thorough research could be conducted on it, there remains much uncertainty. Nevertheless, the governments in each of the countries profess to be fully supportive of the initiative. This is important in that adherence to a consistent policy will be valuable to the business sector. After all, the private sector does not wait for new policies to be handed to them. Rather

they anticipate changes and react to them in a manner most advantageous to them. Thus, if the scope of the sectors included in AFTA is guaranteed to be wide enough, foreign investors who are attracted to the region would begin establishing their production bases prior to 2008, when AFTA is to be fully implemented.

While guarantees are ostensibly given by state officials, the transforming political pressures in ASEAN, particularly in Indonesia and Thailand, have cast some doubt on commitments to AFTA. The present government in Thailand, for example, is not as insulated from domestic interest groups as was the Anand interim cabinet which proposed the free trade area. In their efforts to hold a fragile coalition government together, the prime minister and his economic ministers have been susceptible to interest group politics with regard to AFTA as support from as broad a group as possible is necessary for the coalition to remain in office. Hence strong industrialists who will be adversely affected by liberalization of intra-ASEAN trade have had some successes in influencing Thailand's position on AFTA. The palm oil and petrochemical industries, for instance, have been able to attain a temporary reprieve from the unrestrained competition from their ASEAN counterparts.

The new cabinet in Indonesia raises additional concerns about this country's continued commitment to AFTA. The new team of economic officials in which well known advocates of trade liberalization (e.g., Radius Prawiro and Johannes Sumarlin) have been replaced by individuals less inclined toward free trade could very well undermine the benefits of Indonesia's program of tariff reductions. This is not necessarily the result of local private sector pressure, however; in certain industries (e.g., textiles) the private sector is supportive of AFTA while the state enterprises call for continued protection. Nevertheless, if President Suharto's behavior over the past 25 years is any indication, when the economic circumstances dictate, the president will react expediently.⁶ And, in the case of AFTA, he is convinced of the benefits that may accrue in the form of increased (or at least sustained) flows of FDI.

A high degree of timely participation by each of the ASEAN countries will be the key to the formation of an effective AFTA which is more than a paper tiger. Two indicators available at present illustrate this level of participation: the exclusion lists and the tariff reduction schedules. A quick look at the individual exclusion lists shown in [Table 2](#), reveals that Indonesia and the Philippines exclude the highest number of items: 1,708 and 1,179, respectively.⁷ Aside from Singapore (whose list was unavailable), Thailand has the smallest number of exclusions, with only 117 items listed at the HS 10-digit level. Malaysia, one of the countries taking the lead in pushing AFTA, has a surprisingly large list of 648 items. Many of these commodities, however, are subject to tariffs of only 5 percent or less. Thus Kuala Lumpur's exclusions should not have as much of a negative impact on trade liberalization under AFTA, as might be expected at first glance.

The tariff reduction schedules adopted by each of the ASEAN countries are also raising questions and concern among the private sector throughout the region. As can be seen in [Table 1a](#), [Table 1b](#), [Table 1c](#) and [Table 1d](#), while indeed programs have been adopted for the reduction of tariffs, concrete actions generally will not take place in Indonesia, the Philippines, and Thailand for several years. In Thailand, for instance, goods in the normal track with existing tariffs between 21 and 25 percent, will not be subject to rate reductions until the end of the century. Tariffs on normal track goods with rates presently between 26 and 30 percent will not be brought down to 25 percent until 1998, and Thailand's fast track tariff rate reductions are also delayed until 1995. Similarly, tariff reductions in the Philippines in both the fast and normal tracks will not commence until 1996. In Indonesia, tariff reductions will commence in 1995 for fast track items, and between 1996 and 1998 for normal track commodities.

These circumstances raise hazards that may affect the leading role taken by Malaysia.⁸ Malaysian businessmen have expressed concern that, by taking immediate action to lower tariff rates for intra-ASEAN trade, the Malaysian government may be placing them at a disadvantage *vis-a-vis* their Indonesian and Thai counterparts. Before they can benefit in the long run from their stronger competitiveness, these businesses must first surmount the short run competition which remains protected in other parts of ASEAN. Although thus far it has not proven to be the case, this situation could jeopardize enthusiasm in Kuala

Lumpur for AFTA if Malaysian business interests become disgruntled about what they perceive to be non-mutual sacrifices made for ASEAN.

Seen in a different light, however, the delays in Indonesia, the Philippines, and Thailand may actually ensure AFTA's success. Given the speed at which the CEPT agreement was drafted and accepted, ASEAN officials were caught off guard with respect to the impact that a free trade area may have on specific sectors. Moreover, having already accepted that certain sectors would be hurt, the ASEAN governments lacked strategies to ease the adjustment process. The buffer built into the official tariff reduction program allows time for programs of adjustment assistance to be formulated and implemented. Thailand, for example, is in the process of studying various means of assisting companies hurt by the elimination of ASEAN, to adopt more efficient production techniques or to develop new product lines. Discussions between government officials, academics, and members of the private sector have been held to consider combining a national adjustment fund with other devices, possibly a mechanism of accelerating the depreciation of capital in affected sectors. This, however, is a time-consuming process, the outcome of which would be late in coming if Thailand had already begun its tariff cuts.

The delays in tariff reductions need not necessarily be interpreted as lack of commitment to AFTA. Rather they allow the ASEAN governments more time to prepare for the cuts when they do occur, and to consolidate private sector support, thus strengthening the likelihood that backpedaling in the future will be prevented. With more credible assurances that the national governments will adhere to their set-forth plans, the business climate could become more conducive to foreign investors.

AFTA'S EFFECT ON FDI

Given that one of the *raisons d'être* of AFTA is to create a large market of 330 million people with a combined GDP of over US\$300 billion, to attract foreign investment, one would expect that the national governments would create as attractive an ASEAN market as possible. In particular, the exclusion lists should reflect their strategies to attract FDI. If, however, the individual exclusion lists include many sectors which ASEAN countries want to attract investment to, then one of the primary purposes of forming the AFTA will be undermined. In this section we examine the exclusion lists to roughly see how AFTA may affect the attraction of FDI to the ASEAN countries.

First we must determine what types of investment the ASEAN countries are trying to attract. The list of activities eligible for investment promotion under Thailand's Board of Investment (BOI) gives a good indication of the types of sectors which the ASEAN governments are targeting. These include:

- Agriculture and agricultural products
- Minerals, metals, and ceramics
- Light industry
- Manufacture of metal products, machinery, and transport equipment
- Electronics and electrical industry
- Chemical industry, paper and plastics
- Services and public utilities

Although the CEPT agreement does not include non-processed agricultural products or services, all of the other products listed here fall under the AFTA scheme.

Now we turn to the exclusion lists presented in [Table 2](#) to see how many items in each sector are affected. This table classifies the excluded goods into their HS 2-digit classifications, with the number appearing in each column representing the number of items in each sector which are excluded. The figure above each country heading describes how detailed the exclusions are (i.e., down to the HS 9-digit level for Brunei). Finally, the asterisk (*) under each code heading indicates that this sector includes goods in the fast track.

Indonesia, Malaysia, the Philippines, and Thailand all exclude items in the manufactured agricultural products sector (HS 02-24). While the Philippines and Indonesia have the most commodities on the list,

with 251 and 181, respectively, Thailand only excludes 27 items. Significantly, Indonesia, the Philippines, and Thailand each excludes a number of vegetable oils which are part of the fast track.

In the minerals and metals sector (HS 72-81), Indonesia, Malaysia, and Thailand all exclude goods. Although Malaysia excludes the most (113 items), except for a few items, tariffs on these goods range from only 2 to 4 percent. Indonesia and the Philippines each exclude several ceramic products, whose tariffs range from only 5 percent in Indonesia to 50 percent in the Philippines.

The Philippines is the primary offender in the exclusion of light industrial products from its tariff reduction program. Manila is excluding goods from each HS 2-digit textile sector (HS 52-63) except silk and wool. Footwear is also excluded, and present duties in these two broad sectors range from 10 to 50 percent. Exclusions from the other ASEAN countries are insubstantial.

Indonesia, Malaysia, and the Philippines, each exclude machinery products (HS 84). Although Indonesia excludes the largest number of goods in this sector (HS 84), the existing tariff of 71 percent (60 items) of them is zero. This may mean that NTBs are high, and Indonesia is protecting itself from the possibility of future tariffication of these NTBs.

The transport equipment sector (HS 87) interestingly is the most heavily excluded sector. Although ASEAN's BBC scheme is already directed at liberalizing trade in automobiles and automobile parts, Indonesia, Malaysia, the Philippines, and Thailand exclude 181, 160, 55, and 57 items, respectively. This accounts for 48.7 percent of all of Thailand's excluded items, and for 24.7 percent of the goods excluded by Malaysia (see [Table 3](#)). Furthermore, MFN duty rates in this sector are substantially high: 30-100 percent in Thailand, 0-300 percent in Malaysia, and 0-200 percent in Indonesia. It should be noted that under a "six-minus-X" arrangement, Indonesia does not participate in the BBC scheme.

The electronics sector (HS 85) is the one sector which has items excluded by each country. Surprisingly Brunei, often regarded as a duty free market, excludes a wide variety of 146 items--all with MFN duties of 20 percent. Indonesia and Thailand each exclude at least 30 electronics goods from the CEPT tariff reductions. The scope of these exclusions is narrow, however, with lamps and light bulbs making up most of Thailand's exclusions, and with motors accounting for the bulk of Indonesia's electronics exclusions.

Finally, while Malaysia and the Philippines exclude items from the chemicals sector (HS 28 and 29), the Indonesians have the highest number of products on their list (350 items) accounting for 20.5 percent of their exclusions. Only 9 percent (15 of 172) of the tariffs on inorganic chemicals, however, are higher than 5 percent, and only one of these chemicals has a duty rate above 15 percent. Similarly, for the organic chemicals on Indonesia's list, only 12 percent (21 of 178) of the existing tariffs are above 5 percent.

Thus, although the exclusion lists appear to be an overwhelming hindrance to the AFTA goal of attracting FDI, a closer look reveals that the affect should be small. Even in the high-technology electronics sector, the range of goods excluded is narrow enough that the sector as a whole will be subject to tariff reductions. Furthermore, the existing MFN duties on many of the goods are already low. Provided that the tariffication of NTBs for these goods is not excessively high, these exclusions will not have much significance. The one sector which will be significantly affected by almost-across the board exclusions is the automobile sector. Such exclusions will certainly mar the image of AFTA, but nevertheless, given the existing BBC scheme, their impact should be limited.

On the basis of tariff reductions, AFTA's influence on the ASEAN economies is assured to be more than illusory. Although the numerous tariff exclusions are detrimental to the designs of the founders of the free trade area, they will hardly damage it irrevocably. Uncertainty, however, does remain over the elimination of non-tariff barriers (NTBs). Although NTBs are to be addressed in the AFTA framework, with such vague wording as "member states shall eliminate all quantitative restrictions...[and] other non-tariff barriers," the CEPT agreement gives little guidance to how such an ambitious undertaking is to be achieved. Yet NTBs are a real concern as companies consider this to be the most important factor preventing intra-regional trade from expanding much in ASEAN.⁹ While the six ASEAN states are taking great strides to eliminate

tariff barriers within the region, the impact of an ASEAN free trade area on FDI in the region will also depend on how the ASEAN nations handle the existing NTBs. Even so, the sentiment in the private sector is becoming increasingly positive as AFTA begins to take shape.

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