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AFTA: Effect on Malaysian Economy

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ABSTRACT

The Global Economy has changed in very significant ways during the past several decades and these changes are deeply rooted in the cross boarder trade among countries. These transformations lead countries to the formation of new Regional Blocs. Countries belonging to particular regional bloc promotes free flow of capital, cheap labor and other products, in order to strengthen there economy by signing Free Trade Agreements (FTAs). The main purpose of signing FTA is to increase there cross boarder trade by lowering taxes on there exports and imports so that consumers can get products at the cheaper price. But every coin has a flipped side; signing FTA does not guarantee that the signatories will get benefit of it; the intentions of governments might be different. The main purpose of this paper is to provide an overview of the effect of Asean Free Trade Agreement (AFTA) on Malaysian Economy.

Keywords : AFTA, Cross boarder trade, FTA, Global Economy and Regional Bloc.

INTRODUCTION

Trade is as old as humanity, or nearly so. Archaeological sites demonstrate that ancient peoples traded objects such as rare stones and shells across fairly long distances even in prehistoric times (Guisepi, 2000). Over the centuries, the volume of trade has expanded exponentially, driven in large part by advancement in transportation and communication technologies. Steamships replaced sailing ships; railroads succeeded canal barges; the telegraph supplanted the Pony Express. Today, in a world of container ships, jumbo jets, and the Internet, goods and many services are delivered faster and more cheaply than ever before. Advancement in these technologies has made our environment a globe one which led to Globalization. One of the most basic issues discussed in the academic circles for a

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few recent decades, is the issue of Globalization. Globalization in its literal sense is the process of globalizing, transformation of some things or phenomena into global ones. It can be described as a process by which the people of the world are unified into a single society and function together. This process is a combination of economic, technological, sociocultural and political forces (Croucher, 2004). Scholte (2000) further define globalization, 'a process of removing government-imposed restrictions on movements between countries in order to create an "open", "borderless" world economy'.

The term of globalization has only become commonplace in the last three decades, and academic commentators who employed the term as late as the 1970s accurately recognized the novelty of doing so (Modelski, 1972). In the 19th century it was sometimes called "*The First Era of Globalization*" a period characterized by rapid growth in international trade and investment, between the European imperial powers, their colonies, and, later, the United States. It was in this period that areas of sub-saharan Africa and the Island Pacific were incorporated into the world system. With growing flows of trade and capital investment there is the possibility of moving beyond an international economy, (where 'the principle entities are national economies') to a 'stronger' version - the globalize economy in which, 'distinct national economies are subsumed and rearticulated into the system by international processes and transactions' (Hirst and Thompson, 1996, p. 3). Globalization is very often used to refer to economic globalization that is integration of national economies into the international economy through trade, foreign direct investment, capital flows, migration, and the spread of technology (Bhagwati, 2004).

REGIONALISM:

The fundamental purpose of any regional effort is to link communities which share a common geographical locations and characteristics. A region represents a collection of societies which share a linked fate due to their interconnection, and which are all impacted by the region's challenges and opportunities. The motivating force behind the renewed interest in regionalism is emerging from several sources.

First the globalization of the economy. International trade agreements like NAFTA and the development of a European Community all demonstrate reduced economic competitiveness on a country-by-country basis, and increased competitiveness on a region-by-region basis.

A second challenge consists of achieving sustainable development. Around the world, population pressures are pushing against environmental capacity. Increasingly, we are trying to balance economic growth, with environmental preservation and social equity. Part of the solution requires acting regionally. After all, water basins, air shed, and commuter shed are all regions.

Finally, the US and several other countries are undergoing a devolution revolution. More of the policy making and service delivery functions mandated by federal and state governments are being directed to the local level. Many of these--transportation, air and water quality planning, and an increasing amount of social services planning--are required to be carried out at on a regional basis. Others are becoming regional on a voluntary basis.

Reasons for Regionalism

Regionalism in East Asia is motivated by several factors. The first is to reduce the risks of financial contagion and unusual exchange rate instability, the damaging effects of which were made clear by the Asian financial crisis. The crisis showed that rapid depreciation of one country's currency could adversely affect the export competitiveness of other countries, especially neighbours producing the same products for the same export markets. The crisis initially propelled countries to explore options for monetary cooperation and macroeconomic policy coordination, but, by highlighting the economic interdependence of the region, it has also given rise to proposals for regional cooperation in trade and investment.

A second key reason for the new trend is the perceived need by other economies of the region for stronger cooperation with China, both as a growing import market and as a rising competitor in export markets. Over the decade 1990-2000, China experienced an average real rate of growth of 10 percent a year and its exports quadrupled from some US$62 billion to US$250 billion. Meanwhile, investment flows to China increased dramatically from some US$3 billion to more than US$40 billion.

A third factor is the interest of business communities in getting preferential access to foreign markets, especially when these are imperfectly competitive markets in which some form of establishment is required. There are significant benefits from being the first movers in such an environment. The greater tradability of many services and the growth of foreign direct investment have contributed to this focus in policymaking.

Other factors include the move by many economies, especially the more developed in the region, to lower their average tariffs; the growing recognition of the value of harmonizing standards and regulations, if these are not to impede trade; and the higher concentration of trade among regional partners, especially in East Asia. These changes have affected countries' assessment of the costs and benefits of entering into preferential agreements. Some countries are also seeking to forge new agreements as a defensive response to arrangements being created elsewhere. Agreements on economic cooperation offer opportunities to build a sense of community or to repair past tensions between neighbouring economies. Membership of regional trading arrangements and informal economic cooperation forums provides occasions for numerous meetings between senior officials, ministers, and leaders, and it has been seen as a crucial component of the community building that has taken place in the region, especially in ASEAN. Table 1, shows statistics of various Regional Blocs.

Table 1:
Regional Bloc Statistics

Most active regional blocs								
Regional bloc	**Area** km²	sq mi	**Population**	**GDP** ($US) in millions (PPP)	in millions (nominal)	per capita (PPP)	per capita (nominal)	**Member states**
GAFTA	9,421,946	3,637,834	280,727,416	1,341,298	N/A	4,778	N/A	(16+1)3
AU	29,797,500	11,504,879	897,548,804	1,515,000	1,131,850	1,896	1,261	53
ASEAN	4,497,493	1,736,000	566,500,000	737,480	1,173,000	5,541	2,041	10
CACM	422,614	163,172	37,816,598	159,536	84,792	4,219	2,242	5
CARICOM	462,344	178,512	14,565,083	64,219	24,020	4,409	1,649	(14+1)3
CCASG / GCC	2,285,844	882,569	35,869,438	536,223	717,800	14,949	20,011	6
CEFTA	298,148	115,116	28,929,682	222,041	122,001	7,675	4,217	(7+1)3
EU	4,324,782	1,669,808	497,000,000	14,953,000	16,574,000	28,213	33,482	27
EurAsEC	20,789,100	8,026,720	208,067,618	1,689,137	1,125,528	8,118	5,409	6
EFTA	529,600	204,480	12,660,623	567,500	743,300	44,828	60,000	4
GUAM	810,506	312,938	63,764,600	456,173	106,469	7,154	1,670	4
NAFTA	21,783,850	8,410,792	445,000,000	15,857,000	15,723,000	35,491	35,564	3
PARTA	528,151	203,920	7,810,905	23,074	N/A	2,954	N/A	(14+2)3
SAARC	5,136,740	1,983,306	1,467,255,669	4,074,031	N/A	2,777	N/A	8
Unasur / Unasul	17,339,153	6,694,684	370,158,470	2,868,430	N/A	7,749	N/A	12

Source: CIA World Factbook 2005, IMF WEO Database.

ASSOCIATION OF SOUTH EAST ASIAN NATIONS (ASEAN)

ASEAN is a geo-political and economic organization of 10 countries located in Southeast Asia, which was formed on August 8, 1967 by Brunei, Cambodia, Indonesia, Lao, Malaysia, Myanmar, The Philippines, Singapore, Thailand and Viet Nam. Its aims include the acceleration of economic growth, social progress, cultural development among its members, and the promotion of regional peace. ASEAN is an alliance consisting of the Philippines, Malaysia, and Thailand that was formed in 1961. It was established on August 8, 1967. The five foreign ministers - Adam Malik of Indonesia, Narciso R. Ramos of the Philippines, Abdul Razak of Malaysia, S. Rajaratnam of Singapore, and Thanat Khoman of Thailand - are considered as the organization's Founding Fathers. Table 2; below show some key statistics of ASEAN signatories.

Table 2:
ASEAN key statistics

Countries	Total land area	Total population	Population density Persons per	Annual population growth	GDP at current prices	GDP domestic product per capita at current prices		Foreign direct investments inflow	
	Km	, 000.	km	percent	US$ million	US$ million	US$ PPP	US$ Million	US$ million
	2006	2006	2006	2006	2006	2006	2006	2005	2006
Brunei Darussalam	5,765	383	66	3.5	11,551.0	30,159.2	25,215.6	288.5	433.5
Cambodia	181,035	14,167	78	2.1	7,256.5	512.2	3,365.3	381.2	483.2
Indonesia	1,890,754	222,192	118	1.5	364,400.1	1,640.0	4,353.3	8,336.0	5,556.2
Lao PDR	236,800	5,747	24	2.2	3,521.8	612.8	2,509.3	27.7	187.4
Malaysia	330,252	26,640	81	2.0	156,924.2	5,890.5	12,471.7	3,964.8	6,059.7
Myanmar	676,577	57,289	85	2.3	11,950.3	208.6	2060.1	235.9	143.0
Philippines	300,000	87,099	290	2.1	118,083.0	1,355.7	5,370.3	1,854.0	2,345.0
Singapore	704	4,484	6,369	3.3	132,273.4	29,499.6	32,975.5	15,001.9	24,055.4
Thailand	512,120	62,829	122	0.7	206,645.1	3,289.0	9,625.0	8,957.0	10,756.1
Viet Nam	329,315	84,156	256	1.2	60,965.2	724.4	3,403.5	2,020.8	2,360.0
ASEAN	4,464,322	564,986	127	1.6	1,073,570.5	1,900.2	5,303.1	41,067.8	52,379.5

Sources: ASEAN Finance and Macro-economic Surveillance unit Database and ASEAN Statistical Yearbook 2006
ASEAN Trade Database as of 18 July 2007
IMF World Economic Outlook Database as of October 2007

Fundamental Principles of ASEAN

ASEAN Member Countries have adopted the following fundamental principles in their relations with one another, as contained in the Treaty of Amity and Cooperation in Southeast Asia (TAC):

- mutual respect for the independence, sovereignty, equality, territorial integrity, and national identity of all nations
- the right of every State to lead its national existence free from external interference, subversion or coercion
- non-interference in the internal affairs of one another
- settlement of differences or disputes by peaceful manner

- renunciation of the threat or use of force; and
- Effective cooperation among themselves.

(Source: http://www.aseansec.org/64.htm)

ASEAN economic growth from 2000 to 2005 shows positive signs in regional economic increase.

Table: 3

	Anual growth, y-o-y,%				
Country	**2001**	**2002**	**2003**	**2004**	**2005**
Indonesia	3.4	3.7	4.0	5.1	5.5
Malaysia	0.3	4.1	4.5	7	6
Philippines	4.5	4.4	4.2	6.1	5.3
Singapore	(2.4)	2.2	0.8	8.4	5
Thailand	2.1	5.4	6.4	6.5	6.5
Brunei	3.0	3.2	4.0	1.1	2.2
Cambodia	5.7	5.5	5.2	6.0	4.0
Lao PDR	10.5	5.5	5.1	3.6	3.3
Myanmar	6.9	7.0	7.3	7.6	7.0
Vietnam	6.9	7.0	7.3	7.6	7.0
ASEAN	3.3	4.5	4.7	6.1	5.7

Source: MATRADE

Most of the Southeast Asian region is now a free trade area. Accounting for over 96 percent of all ASEAN trade, the first six signatories of the Common Effective Preferential Tariff scheme for the ASEAN Free Trade Area (AFTA) have reduced their tariffs on intra-regional trade to no more than five percent for almost all products in the Inclusion List or removed them altogether. AFTA was established in January 1992 to eliminate tariff barriers among the Southeast Asian countries with a view to integrating the ASEAN economies into a single production base and creating a regional market of 500 million people. The Agreement on the Common Effective Preferential Tariff (CEPT) Scheme for AFTA requires that tariff rates imposed on a wide range of products traded within the region be reduced to no more than five percent. Quantitative restrictions and other non-tariff barriers are to be eliminated. Although originally scheduled to be realized by 2008, the target of a free trade area in ASEAN was continuously moved forward.

It planned to reduce tariffs to zero to 5% in 15 years among the six nations through a “common effective preferential tariff”. Why the 5% option? To help some member countries cover the administrative costs of government in handling trade. The Philippines set its bottom at 3% and Indonesia at that time targeted 5%. A mid-phase target of 20% tariffs within 5 to 8 years was also set. The agreement included all manufactured products including capital goods and processed agricultural products. The major exclusion was basic agriculture or unprocessed agricultural products. The elimination of tariffs and non-tariff barriers among the ASEAN members has served as a catalyst for greater efficiency in production and long-term competitiveness. Moreover, the reduction of barriers to intraregional trade gives ASEAN consumers a wider choice of better quality consumer products. By the beginning of 2002, only 3.8 percent of products in the CEPT Inclusion List of the first six signatories, or 1,683 items out of 44,060, would have tariffs above five percent. The current average tariff on goods traded under the AFTA scheme is about 3.8 percent. In the light of their later accession to the CEPT Agreement, Vietnam is expected to realize AFTA in 2006, Laos and Myanmar in 2008, and Cambodia in 2010. The first signatories to the CEPT scheme are Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore and Thailand.

IMPACT OF AFTA ON MALAYSIAN ECONOMY

AFTA has a potential to produce a wealth of benefits, but faces a rocky road ahead. It was signed to benefits the Malaysian consumers and local companies in the domestics market but the real situation is some what different. There is a low rate of tax imposed on the raw material of the products, to encourage the free flow of products and make them cheaper, but due to the enforcement of taxes on the consumers, products prices are indirectly increasing. Prices suppose to be decreased as it was predicted, but consumer products are still expensive. There is also an increase in intra-ASEAN competition from lower cost producers. Turning ASEAN region into single market will damage these producers in terms of competition and giving benefit to larger organization.

Free flows of man power also harm the labour of rich countries like Malaysia, Singapore and Indonesia. Comparatively Viet Nam, Laos and Cambodia have cheap labour as compare to other ASEAN countries. Companies in rich countries can hire cheaper labour from these countries, leaving the local Malaysian labour unemployed. This will increase the unemployment rate in the long-run in Malaysia.

A recent survey done by "Doing Business" of International Finance Corporation, in 178 countries of the world clearly shows that Malaysia is protecting its investors. The survey ranked Malaysia 3rd in Protecting its Investors and ranked 2nd in Getting Credit in East Asia region. As shown in Table 4:

Table: 4

Economy	Protecting Investor	Ease of Doing Business	Starting a Business	Getting Credit	Trading Across Borders	Closing a Business
Singapore	1	1	1	3	1	1
Malaysia	3	4	11	2	3	7
Thailand	6	3	5	4	10	5
Indonesia	10	20	24	8	6	18
Cambodia	12	22	23	24	21	21
Brunei	17	12	19	12	5	4
Philippines	19	21	22	12	11	19
Vietnam	21	18	16	5	12	15
Lao PDR	24	23	13	20	23	12

Source: International Finance Corporation, The World Bank Group (www.doingbusiness.org/economyrankings).

Malaysia is the 3rd highest country in receiving Foreign Direct Investment (FDI) in the region. In order to bring more FDI, Government has to assure his investors that there investment is secured by investing it in local companies and giving its investors attractive share on there investment, which attracts more direct investment. The cross border taxes are also reduced; now government is imposing taxes on the consumers. As a result of which, whole burden goes to the consumers who are still paying more to buy the products. Every coin has a flip side. AFTA was signed with the idea that it will benefit Malaysian consumers by means of producing and manufacturing cheaper products, but at the present it is not the real case. Prices are still at the peak and increasing. Only Government Sector and Large Organizations appear to have advantage, in term of receiving high taxes and generating more profits leaving consumers who are still buying expensive products.

Impact on Malaysian Industry:

- Increase intra-ASEAN competition from lower cost producers.
- Declined competitiveness of traditional export industries:-
  - High labour cost
  - Lack of resources and expertise
  - Technology obsolescence
- Removal of protection e.g. AP, quota system, monopoly status.
- Complying with 40% local content rule.
- Develop competitive local Small and Medium Industries:-
  - Too focus on domestic market
  - Heavily dependent on single or few buyers
  - Lack of expertise and backward technology
- Sectors that may face strong competition:-
  - automotive-iron and steel
  - ceramic tiles
  - cement
  - Plastic products.

Finally there were the industries and industrial sectors that would be put at a disadvantage by AFTA. A steady stream of the AFTA losers came forward during 1992 and 1993. Thailand's petrochemical industry was one of the first to formally petition its government for exclusion from AFTA, citing from more established producers in Singapore. Other sectors of the Thai economy such as electronic parts and components and plastics products soon followed suit. In the Philippines the textile apparel footwear and iron and steel industries all thought of themselves as being put at a major disadvantage by AFTA. They appealed to their government for protection. In Malaysia even the finance minister Anwar Ibrahim who was very sympathetic to the liberal reformers because expressed concern that recently privatized companies might need protection from more advanced competitors. In particular he noted that with Malaysia developing its own car the Proton Saga, the automobile industry was in need of exemption from AFTA.

CONCLUSION

AFTA was signed to lower trade barriers and increase cross border trade. However there are some disadvantages of this agreement that can harm the business of ASEAN based industries. To overcome these disadvantages ASEAN signatories (government) have to take some steps in order to strength AFTA and minimize its negative aspect. First, Cross-borders mergers and forming of ASEAN multinational enterprises (MNEs) would be beneficial. Second, Innovations are very critical in order to create or reengineer products to meet new market demand and to introduce new processes to improve productivity as well as applying new marketing strategies to expand sales opportunities. Third, Malaysian companies must be willing to invest in new technologies and R&D to gain competitive edge from their ASEAN competitors and maintain the existence of Malaysian products in demand by ASEAN market.

ASEAN companies also have to take some major steps in order to gain market share, profitability and stay ahead of competition through:

1. Maintaining efficiency and productivity,
2. Management of costs and quality,
3. Enhance technology and skills,
4. Restructuring and rationalizing the industries,
5. Consolidation or relocation of business,
6. Producing high value-added products,
7. Undertake product design and development,
8. Establish strategic partnerships and alliances,
9. Merger or takeover,
10. Upgrade marketing as key driver of business and
11. Adopting international standard.

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