

THE ANGKOR AGENDA

REPORT OF THE HIGH-LEVEL TASK FORCE ON THE AFTA-CER FREE TRADE AREA

Executive Summary

1. The challenges facing ASEAN and CER today are many and varied. A great wave of globalization is sweeping the world today, leading to the growing integration of previously segmented national markets. Side by side with the increasing globalization of world markets there has been a veritable explosion of regional integration arrangements (RIAs) from the decade of the nineties to the present. Market-opening at both the multilateral and regional levels increases the pressure on domestic industries and firms to become *competitive* or else be resigned to extinction. Such a pressure is becoming even more intense with the increasing challenge for global markets and investment opportunities offered by newly emerging economies, such as China and India. Unfortunately, the recent Asian crisis has only served to expose the vulnerabilities of the ASEAN countries, highlighting the need for deep structural and institutional reforms in both their public and private sectors. More than ever before, ASEAN and CER have become acutely aware of the necessity of improving the region's competitive strength, if it is to sustain dynamic growth and maintain its significance as an economic and political force as well.

2. We, the members of the High-Level Task Force, after a fairly long period of study and consultations, have concluded that *establishing a free trade area between AFTA and CER* is not only *feasible* but also *advisable* if both ASEAN and CER are at least to keep pace with the rapidly changing world of today.

3. We believe that an AFTA-CER FTA makes for both good politics and economics. On the political side, the proposed FTA will strengthen the bargaining position of both regional groups as they negotiate both regionally and multilaterally in areas of common interest to them. It will send a strong signal to the rest of the world of the region's commitment to policy reform, enhancing its position of stability as a credible trade partner and host to foreign investments. It also prepares the countries in the region to undertake even bolder economic reforms and confront the challenges of other countries and regional groupings in the future.

4. On the economic front, the lowering of trade barriers as well as creating more opportunities for trade facilitation will enlarge the market to double its current size through a combined GDP of around US\$ 1 trillion. An empirical study by the Centre for International Economics using computable general equilibrium techniques has shown that the proposed FTA will bring about a net discounted benefit of about US\$ 48 billion in additional GDP to the region up to the year 2020, of which more than half is expected to be reaped by ASEAN countries. The welfare gains to consumers in terms of lower prices of goods

and a greater variety of products to choose from will be even greater. The creation of such an integrated market will sharpen competitiveness as industries and firms achieve economies of scale and of scope and are stimulated by increased competition to adopt productivity-improving measures. As industry location becomes determined along the lines of competitive advantages, industrial growth is spurred, inducing investments from countries both inside and outside the region. The study also showed an FTA would lead to increased productivity and consequently increased investment in the order of US\$ 39 billion into the region over the period. In turn, such foreign direct investments bring with them not only capital inputs but more importantly, access to new technology, management techniques, marketing networks and input sources. The net outcome should enhance economic development of member countries through greater employment, growth of SMEs, and development of exporting industries, thereby uplifting the welfare of peoples in the region.

5. However, we are aware of the fact that market-opening, while growth-enhancing, brings with it attendant costs. Preferential reduction of trade barriers tends to bring with it some diversion of trade from more efficient non-members to less efficient member countries as well as some loss of tariff revenue. Adjustment to a more liberalized environment will inevitably entail short-run costs, mainly in the form of displacement of workers and rationalization of industries and firms in some member countries. Nonetheless, while there is likely to be short-term dislocations in some areas, the net long-term impact of an FTA will be positive.

6. We are well aware of these adjustment costs and of the fact that the expected gains from liberalization are not easily achieved. For this reason, we strongly suggest that at the individual country level policy makers carefully study the nature of the short-run adjustment costs as well as the sectors likely to be most vulnerable to trade liberalization. In no uncertain terms, we recommend that the necessary measures be adopted to ease, if not eliminate some of the burden of adjustment. We think that human resource development and skills training are a particularly appropriate tool to achieve this end.

7. We are likewise conscious of the fact that countries in the region are not equally in a position to take the most advantage of the regional market expansion resulting from the proposed AFTA-CER FTA. This is due to the different levels of development and the existence of a wide range of non-tariff barriers. For this reason, we propose that development assistance in the form of capacity-building measures and technical assistance be provided to countries in the region to improve their export competitiveness as well as their market access particularly to the CER countries. Among others, we think that assistance should take the form of developing, strengthening, and diversifying product and export bases of member countries, technical skill-formation, meeting the requirements of markets (e.g. testing and quarantine measures).

8. Capacity-building and technical assistance measures, however, may not be enough to address market-access problems. The countries in the proposed FTA should commit to include in the negotiations the issues of non-tariff measures (anti-dumping, standards and conformance, price undertakings,

import licensing, labelling, import quota and sanitary and phytosanitary (SPS) measures) that tend to inhibit trade. We, the members of the AFTA-CER Task Force, note the concern of the ASEAN countries with regard to the SPS policies of CER countries. We welcome the proposed capacity-building initiatives in this area and recommend that CER countries address the required standards, the processes and procedures adopted in administering their SPS and quarantine measures.

9. To be beneficial to all members, we believe that the proposed AFTA-CER FTA should be guided by the following principles:

- (a) The AFTA-CER FTA would represent a separate arrangement which would be comprehensive, covering all goods, services, and investments, and would lead to the elimination of all forms of tariff and non-tariff barriers to trade in goods and services. AFTA and CER would maintain their respective identities;
- (b) The AFTA-CER FTA should be mutually beneficial to each group and to all member countries of the respective groups;
- (c) The pace of liberalization within the AFTA-CER FTA should proceed faster than that agreed within APEC, i.e. 2010 for developed economies and 2020 for developing economies;
- (d) Subject to new arrangements that may be achieved within AFTA, the AFTA-CER FTA would not normally go beyond the pace of liberalization which AFTA has already agreed for ASEAN members, i.e. elimination of tariffs for manufactured goods by 2010 for ASEAN-6 and 2015 for the four newer members, with some flexibility. CER would progressively reduce tariffs for ASEAN from the conclusion of negotiations, reaching free trade by 2005;
- (e) The AFTA-CER FTA would be open to inclusion of new issues not currently covered by the AFTA or CER Agreements. In these cases, members of either group could decide to exclude themselves temporarily from the agreement;
- (f) The AFTA-CER FTA would comprise both developed and developing countries with different needs and levels of development. Hence, the structural adjustment and flexibility needed should also be recognized. The proposed FTA should provide development assistance in the form of capacity-building measures and technical assistance and the adoption of a longer time-frame for the newer members of ASEAN;
- (g) The AFTA-CER FTA would be open to accession by any other country or regional grouping that shares the common principles and underlying objectives of the FTA;

(h) The provisions of CER and AFTA are different. Neither is an appropriate base model for an AFTA-CER FTA. However, elements of either CER or AFTA may be incorporated in the proposed AFTA-CER FTA agreement; and

(i) AFTA and CER will continue to exist as functioning agreements.

10. The importance of the related modalities is emphasized and these are detailed in section 4 of the main report.

11. In view of the above, we strongly suggest that the Economic Ministers from both AFTA and CER undertake the necessary steps toward the establishment of the proposed AFTA-CER FTA at the earliest possible time.

12. In a world of constant flux, to stand still is to fall back. ASEAN and CER must take this decisive step. They must seize this unique opportunity to move forward.

SECTION 1

THE CHALLENGES FACING ASEAN AND CER

Globalization And International Competitiveness

- 1.1 At the dawn of the third millennium, the world stands witness to the growing integration of previously segmented national markets. This has been the fruit of technological changes and sharp declines in transport cost, and more so in the cost of transmitting ideas around the globe. But perhaps even more importantly, nations have persistently made an effort at the national and international levels to reduce barriers to trade in goods and services, and to free movements of peoples, capital and technology across national borders. They have agreed upon rules and created institutions that have made it more difficult to raise barriers against each other. As a consequence, output growth has accelerated, standards of living have risen, and more people are now enjoying the fruits of development.
- 1.2 ASEAN and CER have benefited greatly from the continued liberalization of the world trading system. It has been for both a continuing source of dynamism for its economies and peoples. And far from remaining passive recipients of the benefits of open global markets, both regional groupings have labored actively to keep it open through their own efforts at unilateral and regional trade liberalization, as well as through their active participation in multilateral trade negotiations. However, such market-opening at both the multilateral and regional levels has intensified competition to an unprecedented degree, requiring domestic industries and firms to become *globally competitive*, or else be resigned to eventual extinction.
- 1.3 In addition to the increasingly globalizing environment, newly emerging economies, such as China and India, have begun to contest global markets with increasing success. Their economic size, growth potential, and abundant labor make them not only attractive markets for goods but also effective export bases, rendering them strong competitors for foreign direct investments. Clearly, countries in the region are challenged to improve their competitiveness as well as their locational advantages, if only to retain their share of markets and capital flows.

The Asian Crisis

- 1.4 Before 1997 the economies of East Asia had been eliciting accolades from all over the world for their stunning growth performance. However, the ensuing crisis broke their growth momentum and exposed the vulnerabilities of the countries in the region, and this at a

time of intensifying competition all around. And even as the most hard-hit economies of Asia, namely Thailand, Indonesia, South Korea, Malaysia and Philippines, are now widely judged to be recovering from the regional crisis, the crisis has made plain the general weaknesses of these countries' financial systems, their weak capital and technological bases and the frailty of the governance structures of both their public and corporate sectors, weaknesses that call, among others, for deep structural and institutional reforms. It is, of course, to the credit of these Asian nations that in spite of the crisis, they have retained their strong commitment to an open trading system. Collectively refusing to succumb to increased protectionism, AFTA has even accelerated the momentum of liberalization from 2003 to 2002. But while the crisis may well prove to be merely a temporary stumble, its long-term implications, especially in its social dimensions, will have to be confronted decisively, to prevent them from undermining the gains of economic recovery. ASEAN must regain the competitiveness and attractiveness to investment which the Asian crisis had eroded.

The Rise Of The 'New' Regionalism

- 1.5 Against the backdrop of increasing globalization of world markets and regional challenges, ASEAN and CER are likewise confronted by a veritable explosion of regional integration arrangements (RIAs) that have emerged as complements, if not alternatives, to multilateralism. Eighty-two such RIAs are said to have gone into force since 1990, in contrast to only seventy-five of them established during the four decades between 1950 and 1990. At present, almost all developed and developing countries are members of at least one such regional arrangement, or are in the process of becoming one.
- 1.6 While regional integration schemes have been formed in the past, the present regionalism can be said to be 'new' in several respects. First, while past regional blocs have been characterized by a tendency toward 'inward-orientation', especially those formed by developing countries espousing import-substituting policies, the more recent ones tend to be outward-oriented and hence, more supportive of an open world trading system. Second, although all have a common objective of intra-regional trade liberalization, there is a growing realization that barriers to a meaningful integration of markets lie beyond the traditional realm of trade policy. Current regional schemes incorporate 'deep integration' arrangements, such as those relating to trade facilitation, investment policy, competition policy, intellectual property rights, among others. Third, while regional blocs of the past tended to be drawn exclusively along North-North and South-South lines, the more recent ones include both developed and developing economies, such as those of NAFTA, the EU Enlargement, and more recently the EU-Mexico free trade area. Fourth, even as new regional blocs are being formed, inter-bloc arrangements are taking place, linking previously existing regional schemes, *within* and *across* continents. The creation of a Free Trade

Area of the Americas (FTAA) has been proposed to include all the countries in the entire Western Hemisphere, with the exception of Cuba. The whole of Western Europe is already linked under the European Economic Area (EU and the EFTA) while EU is currently in the process of enlargement into Eastern Europe and the Mediterranean. The proposal for a Transatlantic Free Trade Area envisions linkage between the two western continents, while at a more modest level, MERCOSUR has begun regional integration talks with EU. In Asia, the AFTA (ASEAN Free Trade Area) has added four more to its six members, with the inclusion of the transition economies: Cambodia, Lao PDR, Myanmar, and Vietnam. The APEC (Asia Pacific Economic Cooperation) involves twenty-one economies belonging to four continents: Asia, Oceania, North and South Americas. In the meantime, hub-and-spoke arrangements are in the works: the Mexico-EU, Singapore-New Zealand, as well individual countries from across continents: Chile-South Korea, Chile-Singapore. And fifth, while East Asian economies have traditionally not been part of any formal RIA (except for membership in APEC), talks are underway on the possibility of eventually forming a free trade area between Japan and South Korea. There are regular consultations between ASEAN and the three East Asian countries (ASEAN plus three) that may well evolve into some form of regional arrangement in the future. Such a veritable explosion of RIAs around the world has certainly contributed to intensify even more the degree of competition in the global economy.

- 1.7 All the above global and regional developments cannot but have a profound influence on the present and future course of events in ASEAN and CER countries. The increasingly globalized environment, the emergence of new competitors for markets and capital flows, the Asian crisis, the rise of new and deeper forms of regional integration arrangements will shape the geo-politico-economic configuration of the world and of the region in the new millennium. More than ever before, ASEAN and CER have become acutely aware of the urgency of improving the region's *competitive strength*, if it is to sustain dynamic growth and maintain its significance as an economic and political force in the world. Such global and regional challenges require a decisive and immediate response on the part of both AFTA and CER.

SECTION 2

AFTA-CER FREE TRADE AREA : A RESPONSE TO THE CHALLENGE

- 2.1 After a fairly long period of study and consultations, the members of the High Level Task Force have concluded that *establishing a free trade area between AFTA and CER* is not only *feasible* but also *advisable* if both ASEAN and CER are at least to keep pace with the rapidly changing world of today. In the following sections will be discussed the major reasons why the members of the Task Force think the AFTA-CER FTA is an *appropriate response* to the global and regional challenges facing both regional groups. On the whole, the members believe that the AFTA-CER FTA makes for both good politics and economics.

THE POLITICAL GAINS

- 2.2 **Bargaining Power** The proposed FTA will strengthen the bargaining position of both the ASEAN and the CER as they negotiate both regionally and multilaterally in areas of common interest to them. The use of regional integration to strengthen the bargaining power of members against a perceived stronger negotiating partner is based on the belief that there is strength in numbers. A prime example is the EEC whose formation is believed to have been partly motivated by the desire to increase the member countries' bargaining power against the US. Although not a formal RIA, the Cairns Group made up of developed and developing country agricultural exporters¹ led by Australia was considered very influential in negotiations, an influence that is said to have been responsible for the US' maintaining its pressure on the EU.
- 2.3 The increasing reluctance of some developed countries to keep the momentum of opening their markets to developing country exports is an important source of concern for ASEAN. After having negotiated downwards most of their tariffs, developed countries are seen to be increasingly relying on technical barriers and other forms of non-tariff measures, especially contingent protection – anti-dumping, countervailing duties, etc. – to block trade, particularly, of agricultural products and other simple manufactures of interest to ASEAN. This means an even greater need for ASEAN to align itself with countries with greater economic and political clout than its own, such as the CER countries, and which have similar common areas of interest e.g. agriculture) to keep regional and world markets open. An AFTA-CER bloc would definitely *be of significance*, given the political and

¹ The Cairns Group is made up of Argentina, Australia, Brazil, Canada, Chile, Colombia, Fiji, Indonesia, Malaysia, New Zealand, Paraguay, the Philippines, South Africa, Thailand, and Uruguay.

economic size of twelve developed and developing countries in membership.

- 2.4 Moreover, the world trading system is being organized into numerous and interlocking regional blocs. Existing regional groups are striking up integration agreements with others within and across continents. And even in East Asia which up till recently resisted the formation of RIAs, there is current talk of a free trade area between Japan and South Korea. The joining of two existing regional blocs such as AFTA and CER will certainly strengthen the two groups' bargaining power in a world that is becoming simultaneously multilateralized and regionalized.
- 2.5 **Signaling the Region's Policy Credibility and Commitment to Reform** As a regional arrangement, the proposed FTA will serve as a *signaling device*. It will send a strong signal to the rest of the world of the region's, and of each member country's, strong commitment to policy reform including trade liberalization, thus enhancing its position of stability as a credible trade partner. Such a commitment also signals to current and prospective investing firms the advantages of locating their long-term investments in an area committed to open markets and stable macroeconomic regimes.
- 2.6 Once a government has decided to undertake a policy reform, a major difficulty confronting policy makers is that of preventing the policy reform from being watered-down or worse, being reversed. This problem can be confounded by a government's lack of a track record of reform, so that its credibility to keep the reform on course may be low in the eyes of both domestic and foreign observers. As a result, the desired outcome of the reform may not materialize, increasing even more the pressure on the policy makers to reverse it. For instance, macroeconomic reform or trade liberalization policy may be initially beset by adjustment difficulties and can be stymied by lobbying of well-entrenched sectors. By 'locking-in' the policy reform especially with regard to trade liberalization, the proposed FTA reduces the temptation of governments to backtrack from it by raising the cost of reneging, given the commitment it has made to other member countries. In this sense, the regional arrangement serves also as a *commitment device*, ensuring achievement of the required policy reform. This seems to have been the case with Mexico, which used its commitment to NAFTA to secure a radical liberalization of the economy in the face of deep political divisions that such liberalization entailed² (Tornell and Esquivel, 1995). In a similar vein, prospective members of the EU understand that 'democracy' is one of the key elements of the *acquis communautaire* necessary for membership in the regional group. Likewise, MERCOSUR is said to have sent a strong signal to Paraguay

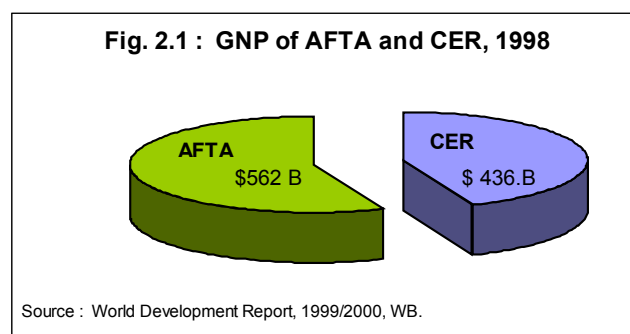
² A dissenting view is expressed by Panagariya (1996) who raised the possibility that such causal relationship usually attributed to NAFTA might in fact be reverse, that is, it is likely that the perceived credibility of Mexico's reforms was what led the US to sign NAFTA in the first place.

coup leaders in April 1996 that adherence to republican institutions was a prerequisite to remain in the bloc. An AFTA-CER FTA would then serve to bolster member countries' commitment to policy reform and will send a signal of such commitment to the world.

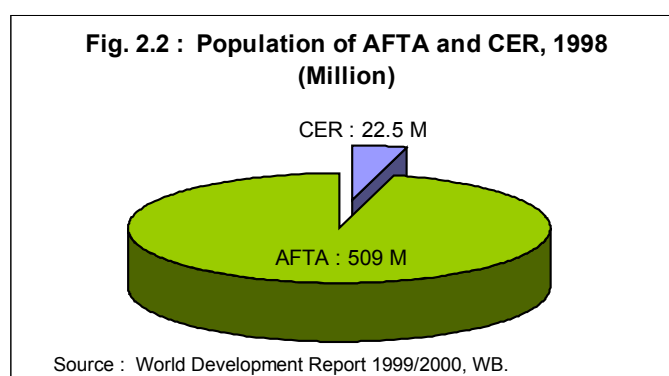
- 2.7 **Preparation for Bolder Reforms and Future Challenges**
Membership in the proposed FTA prepares the countries in the region to undertake even bolder policy reforms and confront the challenges of other countries and regional groupings in the future. Country experiences have shown that the first steps to certain policy reforms are often the most difficult to take. There are many reasons why this may be so: the fears – whether imagined or real – of adjustment costs may be magnified, lobby groups opposing the reform may wield strong political clout, certain constituencies may be lost, or policy makers may lack the confidence necessary to achieve the expected beneficial effects of the reform. The fact that policy reform in an FTA is circumscribed within a limited number of member-countries helps to overcome the initial difficulties of undertaking the reform. In the proposed FTA, market-opening will be limited to extending AFTA concessions to only two additional CER countries. This will constitute a unique experience for ASEAN countries of 'testing the waters' of regional bloc-formation with developed-country trading partners.
- 2.8 Ultimately, the increased competitiveness as well as other gains from such limited liberalization will increase the confidence of member-country governments in undertaking future policy reforms and even liberalization on a wider scale. This had been the experience of New Zealand when it first opened wide its market to a bigger, more developed partner-country like Australia. The positive experience from liberalization had created for New Zealand a wellspring of confidence that allows it currently to embark upon bolder moves for policy reform. Joining the enlarged AFTA-CER FTA will therefore prepare member countries to undertake greater market-opening to the world, and even to consider the formation of regional trading arrangements with more countries and regional groups at some future time.
- 2.9 In the light of the anti-trade liberalization sentiment which marred the Seattle WTO ministerial conference, an AFTA-CER would send a positive signal and re-energize trade liberalization initiatives not only in the Asia Pacific region but also in the entire world. The great danger to the WTO is if the forces opposing further global liberalization were to discourage political leaders from mounting a serious effort to restart another round of multilateral trade negotiations. A decision to proceed with an AFTA-CER FTA, coming less than a year after the debacle in Seattle, would be a convincing affirmation of confidence in the benefits of liberalization and globalization. We are convinced that an AFTA-CER FTA would act like a spur to the member economies to achieve the Bogor targets within the designated time frame, if not earlier.

THE ECONOMIC GAINS

- 2.10 **Market Enlargement** An FTA enlarges the market size faced by producers by pooling together the markets of the member economies. Combining the markets of AFTA and CER countries (Fig. 2.1) easily doubles the market size of the bloc to a combined total GNP of around US\$ 1 trillion³.



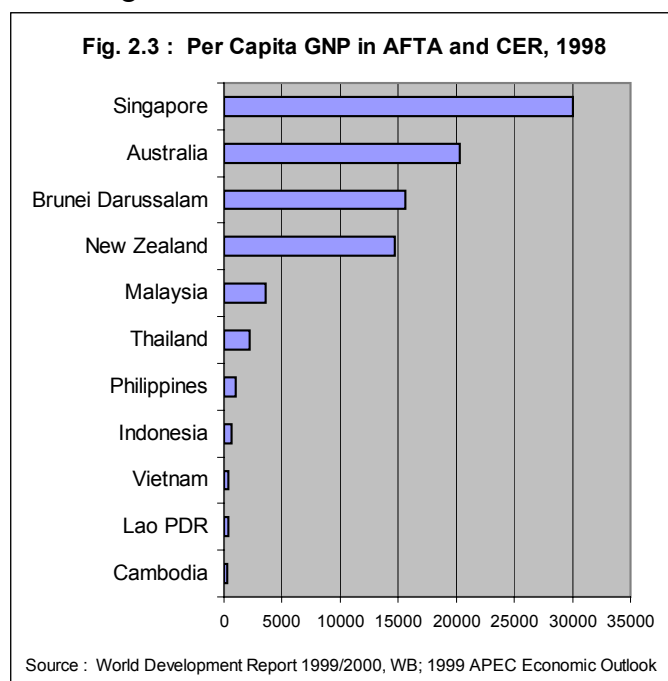
- 2.11 There has been apprehension among AFTA member countries that because of the small populations of the CER countries – in fact minuscule relative to the combined population of ASEAN (Fig. 2.2) – the CER will reap most of the gains from the FTA. However, such thinking assumes that the purchasing power of each member of the population is roughly the same in the two regions. One should consider the size of ‘effective demand’ in each bloc rather than the absolute size of the population, because of the difference in levels of development, and hence of per capita purchasing power, across countries in the two regions.



- 2.12 One can have an idea of the size of ‘effective demand’ from the per capita incomes of countries in ASEAN countries relative to those in CER (Fig.2.3). The only two countries in ASEAN with capita incomes

³ GNP figures exclude those of Brunei Darussalam and Myanmar. The data are in US dollars, converted using current exchange rates (World Bank Development Report). GNP in PPP dollars is almost triple AFTA’s total GNP in 1998, that is, at PPP \$1,588 billion.

currently comparable with those in CER also happen to have the smallest populations. Singapore, which exceeded the per capita incomes of both Australia and New Zealand in 1998 has a population of only 3.9 million. Brunei Darussalam whose per capita income exceeded that of New Zealand but not that of Australia has the smallest population in ASEAN of 0.314 million. On the other hand, except for Malaysia and Thailand, all the other ASEAN countries have per capita incomes equal to or less than 5 percent that of Australia and less than 10 percent that of New Zealand. One can then surmise that the *actual* number of people in ASEAN whose per capita incomes approximate those of Australia and New Zealand cannot be very much larger than the combined population of the two CER countries of 22.5 million. Thus the aggregate size of effective demand in the ten ASEAN countries cannot be said to be much larger than that of CER countries, although the market potential of ASEAN is enormous over time and with sustained growth.



- 2.13 The above intuition is borne out by the relative size of aggregate economic gains from the AFTA-CER FTA estimated using computable general equilibrium (CGE) techniques by the Centre for International Economics (CIE; see Appendix D). Economic modeling has shown that the proposed FTA will bring about a net discounted benefit of about US\$ 48 billion in additional GDP to the region by 2020 (on a discounted basis). Of this additional GDP, more than half (or US\$ 25.6 billion) will be reaped by ASEAN countries.
- 2.14 **Trade Creation** The reduction of protective barriers against imports from other member economies in an FTA causes trade to be *created* among them. This is the classic static effect of a regional trading arrangement. Trade creation translates above all into welfare gains for consumers who then pay lower prices for a bigger volume of both

imported goods and their domestic substitutes, with a greater variety of goods to choose from. This consumption welfare effect can be substantial but is all too often forgotten in the debate on trade liberalization. In the final analysis, it is the consumers who benefit the most from market-opening.

- 2.15 The CIE study has shown that the changes in real household consumption – which is indicative of changes in welfare from trade liberalization – resulting from the AFTA-CER FTA even exceeds the changes in real GDP cited above. The estimates indicate that the impact of the proposed FTA on the real welfare of ASEAN (5) is typically around an additional 1% to 2% above what it would otherwise be by 2005, compared with the real GDP gains which constitute only about a third of one percentage deviation above baseline by 2010. The results, therefore, show that real welfare gains by consumers not only rise faster but also occur sooner than production gains.
- 2.16 **Efficiency and Enhanced Competitiveness** With market enlargement producers are able to overcome the limits of the domestic market. They are thus able to exploit the benefits of economies of both scale and scope. Market-opening also induces greater competition among firms in member countries and breaks up monopoly power that may have been entrenched by protection in domestic markets. Firms are then stimulated to look for and adopt cost-cutting techniques as well as new, best-practice technologies, leading to productivity improvements and enhanced competitiveness. In turn all these translate into lower production costs, lower prices and better quality/variety of goods for consumers, leading to even greater expansion in demand and more trade among members.
- 2.17 **Industry Relocation** With the removal of barriers to trade and eventually to capital flows within the region, a more efficient pattern of production will emerge, drawn along lines of comparative and competitive advantages. The AFTA-CER FTA will comprise member countries lying along a spectrum of factor endowments and economic development. Production rationalization can thus take place in consideration of such differences in factor supplies as well as in effective demand across member countries, spurring growth in agriculture, manufacturing, and services. As a result, the proposed FTA can have profound implications on investment activity in the region.
- 2.18 **Increased FDI** An AFTA-CER will increase FDI flows to member countries. An expanded AFTA-CER market will attract the attention of non-member country investors who will position themselves to ensure access to the regional market, that expands not only from the pooling of member country markets but also from the productivity and income gains in each member economy. Moreover, the efficiency gains from trade liberalization as well as terms of trade improvements raise the return on capital in the region, thereby attracting funds where they can earn the highest returns. In addition, efficiency-seeking investors will

take advantage of the range of differences in factor costs and skill availability in the region to better splice up and assign the different parts of the value-added chain in flexible manufacturing. For instance, there is a considerable intra-industry trade between Australia and a number of ASEAN countries in machinery (non-electrical, electrical and electronic). Liberalization of still protected sectors can expand the possibilities for trade and investments in parts and components and for the creation of production networks in the region. These are areas that can attract investment flows from both member and non-member countries.

- 2.19 The induced relocation of industry will also bring with it movements of capital within AFTA-CER, in response to changing relative prices and returns from trade. While AFTA and CER countries are generally importers rather than exporters of direct investment capital, there is likely to be a lift in intra-regional capital flows, albeit from the current low base. For instance, the increased integration in markets accompanying an FTA is likely to lift the currently low share of Australian outward FDI going to AFTA as Australian-based companies look to increase their presence in AFTA markets, including those in which AFTA countries are clearly competitive in global markets. Conversely a number of firms in the more affluent ASEAN countries will find their way into CER in terms of greenfield investments, joint ventures, or mergers and acquisitions. The inducement of intra-bloc investments can also be expected to take place through information exchange. Australian and New Zealand investment overseas have been traditionally confined to areas already familiar to CER, namely the UK, the Netherlands, and the US. Through increased trade facilitation and economic interaction, the FTA will open up avenues for greater exchange between the two regions and thus propel intra-bloc investments.
- 2.20 Overall, the more comprehensive the coverage of the free trade area, that is, the more liberalization takes place beyond goods trade and into services and investments, the greater will be the movements of investment capital. The resulting increases in FDI will, in turn, bring not only capital inputs but, more importantly, access to new technology, input sources, production and management techniques, financial expertise and global marketing networks. This will also further boost trade, wealth and living standards as new and growing business networks, within the AFTA-CER region and beyond, take advantage of emerging technologies and market opportunities. And the establishment of the proposed FTA will on the whole contribute to greater investment flows by improving the environment for it. By injecting greater credibility in the government's willingness and ability to pursue sound policies (Schiff and Winters, 1998), in particular, through the region's commitment to policy reform, investing countries can be expected to be more attracted than they would otherwise be to the region.

- 2.21 The CIE study estimated that the AFTA-CER FTA economies will experience a capital inflow as a result of the proposed FTA. These positive flows are found to be significant, especially for AFTA which receives an extra capital inflow amounting to US\$ 30 billion over the decade to 2010 (in discounted terms). CER countries, on the other hand, can expect an extra capital inflow of US\$ 7.7 billion. Thus, an increased capital inflow of close to US\$ 38 billion into the region can be expected over the period. These inflows originate principally from outside the region, especially from US, Japan, and Europe.
- 2.22 **Improved Growth Potentials** The net outcome of all the income and welfare gains from the proposed FTA will be to enhance the growth potentials of the region and of each member economy in particular. Market-enlargement, improved market access, trade facilitation will all lead to the development of export industries. Moreover, as trade liberalization takes place, the original bias of the protective structure against exports, especially manufactured ones, will be reduced, if not eliminated, boosting exports even more. Such export-expansion effect has been among the most consistent empirical findings of a large number of empirical studies on liberalization, particularly among developing countries (Michael, Choksi, and Papageorgiou, 1990). Overall growth as well as export development lead to greater employment creation, again an empirically documented finding in experiences of liberalizing countries. Yet another area, unfortunately often overlooked, where liberalization impacts positively on the growth of a sector, is that of small-and-medium enterprises (SMEs). Typically protection policy as well as other incentives are biased in favor of large firms, which have a greater political and economic clout than small firms. Hence, market-opening will generally favor the development of SMEs, unleashing their potentials for growth.

THE ECONOMIC COSTS

- 2.23 **Trade Diversion** Nevertheless, the policy reforms required by the proposed FTA, while generally enhancing growth, bring with it attendant costs. In particular, the preferential reduction of trade barriers among members of the FTA can bring with it some diversion of trade from more efficient nonmembers to less efficient member economies. Theoretically, this can lead to static welfare loss if the trade diversion effect is larger than that of trade creation.
- 2.24 However, this effect need not occur. Or, at the very least, it could be minimized (IBRD, 1999) depending on the architecture of the FTA. First, if the tariff against nonmembers is kept low enough, trade need not be diverted even if the tariff were cut against members. Second, if the partner country's pre-union trade barriers are low, then its costs and prices would not differ much from those of nonmembers. A cut in the tariff against imports from the partner country will not lead to much loss of welfare through trade diversion. Third, trade diversion effects

are mitigated if products are not perfect substitutes or if there are trade barriers other than tariffs, such as transport cost. If goods are less than perfect substitutes, removing the tariff against imports from partner countries will not cause all imports to be diverted from nonmembers. Or, if transport costs are important trade barriers, removing tariffs against distant members will not cause trade to be diverted from nonmembers nearby whose supply costs tend to be lower. This makes trade diversion less likely to occur in RIAs among countries that are geographically close to one other ('natural trading partners': Wonnacott and Lutz 1989; Summers 1991).

- 2.25 What is the empirical evidence of trade diversion being more important than trade creation in RIAs currently in force? Soloaga and Winters (1999) using an 'improved' gravity model on nine RIAs in the nineties confirmed trade diversion only for EU and EFTA, although a decline in extra-bloc and a rise in intra-bloc trade is evident for NAFTA. On the other hand, they found no evidence of trade diversion for CACM, the Andean Pact, and MERCOSUR, and ASEAN.
- 2.26 **Decline in Tariff Revenue** The reduction in tariff barriers against partner countries following the formation of an FTA may lead to some loss in government revenue in some member countries. This occurs as tariff revenue previously collected from imports (from nonmembers) declines as imports are diverted to members receiving preferential treatment at low or zero tariffs.
- 2.27 Under the proposed FTA, some ASEAN countries, because of the remaining gap between their MFN and AFTA tariff rates, can expect some decline in tariff revenue on imports that originate from CER. However, this does not constitute real economic losses because it simply amounts to a redistribution of welfare to consumers who now pay a lower price for the imported goods. Moreover it would be small because existing trade flows are small, and would also be partly offset through extra revenues from increased economic growth due to the FTA. On the side of CER, as well as for Singapore, the loss of tariff revenue will be inconsequential, because their MFN tariffs are already zero or close to zero for most products.
- 2.28 On the other hand, country experiences in trade liberalization have shown that governments experiencing some decline in tariff revenue were stimulated to search for alternative sources of revenues, which in the end proved more efficient sources than trade taxes. An example cited by Fukase and Martin (1999) was that of Cambodia which used to receive 56 percent of its total tax revenue from customs duties prior to joining AFTA, two thirds of which were levies on imports from ASEAN. However membership in ASEAN gave the Cambodian government the impetus to introduce a value added tax in 1999. This has likewise been the experience of other ASEAN countries in the wake of liberalization. The Task Force members from the original ASEAN

countries attest to the tax policy reforms undertaken in their respective countries in response to some revenue losses from trade liberalization.

- 2.29 **Adjustment Costs** Adjustment to a more liberalized environment under the proposed FTA may likewise entail short-run costs, mainly in the form of displacement of workers and rationalization of some industries and firms in some member countries. However, a comprehensive review undertaken by Matusz and Tarr (1999) of more than fifty studies examining trade liberalization experiences in a number of countries revealed that such (short-run) adjustment costs are small relative to the long-run benefits of liberalization. In contrast, the benefits from liberalization grow as the economy grows over the long run. Other studies comparing the magnitude of job-displacement brought about by trade liberalization found that it tended to be even smaller than normal labor turnover. Trade liberalization, by reducing the bias against manufactured exports and by leading to overall growth, was typically accompanied by a net increase in employment.
- 2.30 The CIE analytical model took into account the adjustment costs associated with reallocation of capital from uncompetitive protected industries to more efficient ones in an AFTA-CER FTA. The positive effects on national income as well as on real consumer welfare mentioned earlier were thus *net of adjustment costs*. In short, while there is likely to be short-term dislocations in some areas of the economy, the net long-term impact of the proposed FTA is likely to be positive.
- 2.31 It must be recognized, however, that the adjustment costs, while short-run in nature, have to be addressed effectively in order to ease the burden on the affected sectors and to ensure that the long-run gains may be achieved. Similarly, the expected gains from the liberalization effort can not be realized without effort. On the other hand, the nature and degree of adjustment needed as well as the effort required to achieve the long-run benefits from market-opening are *specific* to each country. For this reason, the members of the Task Force suggest that at the individual country level, policy makers carefully study the nature of the short-run adjustment costs as well as the sectors likely to be most vulnerable to trade liberalization. Necessary measures have to be adopted in order to ease, if not eliminate, some of the burden of adjustment in certain sectors of the population. Those displaced in the process of market-opening will have to be assisted in finding employment in other growth areas of the economy. A particularly appropriate tool to facilitate such transfers is that of human resource development and skills training.
- 2.32 Furthermore, while the proposed AFTA-CER FTA is expected to benefit member-countries through enlargement of the regional market, they are not equally in a position to take the most advantage of the possibilities for growth. This is because member-countries are at different stages of economic development and there exists a wide range of non-tariff

measures that block trade. In recognition of these realities, development assistance in the form of capacity building measures and technical assistance should be provided to member-countries, particularly by the more developed CER countries to the newer members of ASEAN, namely Cambodia, Lao-PDR, Myanmar, and Vietnam. Such development assistance should be directed towards improving the export competitiveness of these countries' industries and firms, as well as their market access especially to the CER countries. Assistance will then be most useful in the fields of developing, strengthening, and diversifying these countries' product and export bases, undertaking technical skill formation, and meeting the requirements of markets (such as testing to conform to standards and to quarantine measures).

- 2.33 However, due to the presence of non-tariff barriers to trade, it may not be sufficient to extend assistance in the form of capacity-building and technical assistance to countries to improve their market access. For this reason, the proposed FTA should commit to include in the negotiations the issues of non-tariff measures that serve to inhibit trade. These measures include anti-dumping, standards and conformance, price undertakings, import-licensing, labeling, import quota and sanitary and phytosanitary (SPS) measures. The ASEAN countries, on various occasions, have expressed their concern for the SPS policies of CER countries. Although the proposed capacity-building initiatives of CER to address such market-access problems are welcome and commendable, the members of the Task Force recommend that CER countries address the required standards, processes and procedures adopted in administering their SPS and quarantine measures.

SECTION 3

PROPOSED ARCHITECTURE OF THE AFTA-CER FTA : THE PRINCIPLES

To ensure that the proposed FTA will be an effective response to the global and regional challenges confronting AFTA and CER today, the members of the Task Force believe that the proposed AFTA-CER FTA should be guided by the following principles:

- 3.1 (a) *The AFTA-CER FTA would represent a separate arrangement which would be comprehensive, covering all goods, services, and investments, and would lead to the elimination of all forms of tariff and non-tariff barriers to trade in goods and services. AFTA and CER would maintain their respective identities.*
- 3.2 With regard to type of regional integration arrangement, the choice is reduced to that between forming a customs union (CU) or a free trade area (FTA)⁴. Given the still disparate degrees of country-level protection among members as well as the need for long adjustment periods before tariffs can be reduced to zero in all member-economies, it appears more feasible to adopt an FTA over a CU. Moreover, formation of an FTA instead of a CU tends to reduce the loss of national autonomy because the latter requires a common external policy. It also reduces the adjustment costs associated with having to adopt a common schedule against nonmembers and eliminates possible disputes arising from the distribution among member-countries of the revenue from common external tariffs.
- 3.3 A way to ensure that the FTA will be trade-creating and, hence, will lead to efficiency gains for members is for it to be as *comprehensive* as possible. This is because if the FTA excludes certain sectors, especially major ones, trade creation cannot occur in these sectors. Sectors that are excluded from the FTA are able to avoid competition from more efficient partner-country sectors. Sourcing will continue to take place from less-efficient member-country firms and the benefits from specialization among member countries is not realized. Comprehensiveness is also compromised when a substantial number of exemptions are granted to certain product areas. For instance, under NAFTA, long-phase-in periods are allowed to apply for certain agricultural goods. Sugar is a case in point. Mexico's tariff-quota access for sugar into the US is limited to 25,000 tons annually during

⁴ A free trade area (FTA) aims to eliminate all tariff and non-tariff restrictions on imports among member countries, but each country retains its own set of tariffs and quantitative restrictions against nonmembers. Customs unions (CUs), like FTAs, aim to eliminate all trade barriers among members, but differ from the latter in that member countries adopt a common set of trade barriers against nonmembers.

the first six years of NAFTA, and unlimited access is set to become available only after 15 years. Thus, the GATT-WTO under Art. XXIV requires that FTAs cover ‘substantially all trade’⁵. In the same vein, the WTO requires FTAs to comply with the GATS V articles on services, given the increasing importance of services in the economy, the sector’s close relationship with trade, and the usual high levels of protection and regulation of the sector. Opening it up to competition will help break up market power and induce domestic firms to introduce cost-efficient techniques and new technologies. On the other hand, limitations to investments will reduce the possibilities for industry relocation according to member-country comparative and competitive strengths as well as limit not only flows of direct investments but also of technology and skills.

- 3.4 Since there are protection instruments other than tariffs, commitment to liberalization should envision the eventual elimination of all intra-union tariff and non-tariff barriers. The latter includes contingent protection such as anti-dumping and countervailing duties. Some RIAs maintain contingent protection, as can be seen from the 33 anti-dumping cases lodged by Argentina against Brazil within MERCOSUR. Empirical studies (e.g. Messerlin 1990) have shown that even the threat of anti-dumping action can discourage exports from foreign countries. Particularly in the case of agricultural trade, sanitary and phytosanitary standards (SPS) can be used as a non-tariff barrier by importing countries. And even in cases where SPS measures are based on scientific evidence, the implementation of the SPS-related rules and regulations (e.g. unreasonable delays in testing) can also serve to inhibit trade
- 3.5 In order to reduce the potential trade-diverting effects of the FTA, individual member-countries would do well also to keep their protection levels as low as possible against nonmembers. Low protection rates will lessen the possibility of displacement of imports from more efficient nonmembers. This will keep to a minimum the negative impact of the preferential trading arrangement on outsiders. For this reason, one of the provisions of Art. XXIV of the GATT requires that “the duties and other regulations of commerce ... shall not be higher or more restrictive than the corresponding duties and other regulations of commerce... prior to the formation of the free trade area.”
- 3.6 While an FTA is proposed to be established between AFTA and CER, each regional group is expected to maintain its own identity separate from that of the AFTA-CER FTA.
- 3.7 *(b) The AFTA-CER FTA should be mutually beneficial to each group and to all member countries of the respective groups.*

⁵ It must be admitted though that the provision of ‘substantially all trade’ remains ambiguous and can be subject to many interpretations.

Since the members of the proposed FTA are made up of countries at different levels of economic development, there is apprehension that the more developed group, as well as the more developed ones within each group, will benefit at the expense of the less developed ones. Hence, a cardinal principle of the FTA is that it bring mutual gains to both AFTA and CER, as well as to all member countries of the respective groups without exception. The CIE study showed that both AFTA and CER, as a group, as well as every member-country of each group, will reap net gains from the establishment of the AFTA-CER FTA.

- 3.8 (c) *The pace of liberalization within the AFTA-CER FTA should proceed faster than that agreed within APEC, i.e. 2010 for developed economies and 2020 for developing economies.*

The proposed FTA should achieve liberalization goals earlier than that agreed upon under APEC. It will be recalled that under APEC, the expectation is that developed member-countries would achieve liberalization by 2010, ten years earlier than the 2020 deadline for developing member-economies. As will be explained in the succeeding principle, liberalization under the AFTA-CER FTA should proceed at a faster pace than that agreed upon under APEC.

- 3.9 (d) *Subject to new arrangements that may be achieved within AFTA, the AFTA-CER FTA would not normally go beyond the pace of liberalization which AFTA has already agreed for ASEAN members, i.e. elimination of tariffs for manufactured goods by 2010 for ASEAN-6 and 2015 for the four newer members, with some flexibility. CER would progressively reduce tariffs for ASEAN from the conclusion of negotiations, reaching free trade by 2005.*

Under the proposed FTA, ASEAN countries will conform to arrangements, including new ones, that are achieved within AFTA. Hence, the FTA should not set liberalization goals for ASEAN member-countries that will eliminate tariffs for manufactured goods earlier than those agreed upon under AFTA, i.e. 2010 for the six ASEAN members, Brunei Darussalam, Indonesia, Malaysia, Philippines, Thailand, and Singapore, and 2015 for Cambodia, Lao-PDR, Myanmar, and Vietnam (CLMV). Consideration is given to the fact that these four transition economies need more time to adjust to required market-opening policies. Hence, they should be accorded some amount of flexibility and differential deadlines in their liberalization commitments. On the other hand, CER countries, which, except for a few sectors, have generally close-to-zero MFN tariffs, should work towards a progressive reduction of tariffs on ASEAN goods from the conclusion of negotiations. They are expected to achieve free trade at an earlier date of 2005.

- 3.10 (e) *The AFTA-CER FTA would be open to inclusion of new issues not currently covered by the AFTA or CER Agreements. In these cases, members of either group could decide to exclude themselves temporarily from the agreement.*

There are areas not directly related to trade where other regional groupings have reached agreements to achieve a deeper kind of integration, in contrast to 'shallow integration' that is limited to trade issues. Experience has shown that failure to liberalize certain rules and

regulations, such as on foreign investments, or to harmonize certain kinds of legislation related to economic activities that have cross-border effects can hamper the integration of national markets. Such areas include those that are not currently included in either AFTA or CER Agreement (e.g. competition policy for AFTA; investment policy for CER, e-commerce for both) that could be considered for inclusion in the proposed FTA. For the purpose of flexibility, however, members of either AFTA or CER may *temporarily* opt not to take part in the agreement on the new issue. However, the expectation is that at some future date, the member country that has excluded itself will eventually enter into the agreement.

- 3.11 (f) *The AFTA-CER FTA would comprise both developed and developing countries with different needs and levels of development. Hence, the structural adjustment and flexibility needed should also be recognized. The proposed FTA should provide development assistance in the form of capacity-building measures and technical assistance and the adoption of a longer time-frame for the newer members of ASEAN.*

The experience of other regional arrangements has shown that there are advantages to a grouping of North-South countries over one that is limited to developing countries. The reasons are that developing countries gain access to a larger, more affluent market for their products; member-economies take advantage of greater complementarities due to the differences in factor endowments and types of products available (hence greater product choices for consumers); they benefit from greater possibilities for scale and competition effects; and there is a greater probability for FDI from the more developed country-members into the developing members. Likewise there is greater probability that technologies are available in the developed country members that could be transferred to the developing members. Nevertheless, one cannot deny that the less-developed members will have needs different from those of the developed ones. Thus, aside from flexibility in being granted longer time-frames, their need for structural adjustment to meet the new market arrangements should be recognized. To this end, development assistance in the form of capacity-building and technical assistance should be provided by the more developed member-countries, especially by the CER, to the less-developed members, specifically the newer members of ASEAN.

- 3.12 (g) *The AFTA-CER FTA would be open to accession by any other country or regional grouping that shares the common principles and underlying objectives of the FTA.*

Due to the discriminatory nature of trade preferences under an FTA, trade could be diverted away from more efficient nonmember countries. A way to minimize trade diversion is to allow for eventual enlargement of its membership. Enlargement increases the probability that the most efficient producers of traded goods are included in the FTA. Thus the

proposed FTA should be open to new members, either individual countries or other regional groupings, who are willing to abide by the rules adopted by the regional bloc. This is possible under the principle of ‘*open access*’ related to the open regionalism principle of APEC. Eventually including other like-minded, pro-liberalization economies into a regional FTA will improve its chances of becoming more trade-creating than trade diverting, not to speak of all the dynamic benefits that market enlargement can bring. Commitment to open regionalism helps ensure that the FTA will constitute a building block (rather than a stumbling block) toward multilateral free trade. On the other hand, it remains true that the deeper the integration that will be achieved by the regional arrangement, the more difficult it would be to uphold the open access principle.

- 3.13 (h) *The provisions of CER and AFTA are different. Neither is an appropriate base model for an AFTA-CER FTA. However, elements of either CER or AFTA may be incorporated in the proposed AFTA-CER FTA agreement.*

As separate agreements, the provisions of CER and AFTA differ, reflecting the priorities of each group and historical evolution of each. For this reason, neither is considered by the members of the Task Force as an appropriate model on which to base the proposed FTA. On the other hand, certain aspects of either regional group may be considered desirable and, hence, may be adopted and incorporated by the proposed FTA agreement.

- 3.14 (i) *AFTA and CER will continue to exist as functioning agreements.*

The new agreement under the AFTA-CER FTA will replace neither AFTA nor CER, each of which will continue to function as a regional arrangement.

SECTION 4

PROPOSED ARCHITECTURE OF THE AFTA-CER FTA : THE MODALITIES

4.1 Objectives

The objectives of the AFTA-CER FTA would be as follows:

1. To enlarge the market for the improvement of the efficiency and competitiveness of firms and industries for the economic well being of the peoples of the two regions,
2. To liberalize and facilitate trade in goods and services,
3. To establish a framework conducive for investment,
4. To establish simple and transparent rules.

The rationale for the first two objectives, market enlargement as well as liberalization and facilitation in trade of goods and services, is discussed at length in Section 2 under the economic benefits of an FTA. The rationale for the third objective is discussed below under para 4.7-4.9. The fourth objective, namely, establishment of simple and transparent rules underscores the firm belief of the members of the Task Force in the merits of regional integration. They desire to ensure that complexity and non-transparency in rules not be used to mask policies that protect inefficient domestic industries and firms.

4.2 Scope

The AFTA-CER FTA should cover trade in all goods, services (covering all modes of supply), investments, technical barriers to trade and mutual recognition arrangements (MRAs). There may be areas not covered in either AFTA or CER (e.g. e-commerce) which could possibly be included in the AFTA-CER FTA.

As discussed in Section 3 under Principle (a), para. 3-1-3.5, the scope of the proposed FTA is *comprehensive*. Thus, it should cover trade in all goods, services – including all modes of supply – and investments. Technical barriers to trade should be covered by the Agreement and so should the adoption of MRAs to ensure that differences in product standards among member countries are not used to inhibit trade among member countries. In addition, the FTA should be flexible enough to cover other areas not presently included in either regional group. A good example of such an area that is currently under discussion is that of e-commerce.

4.3 Tariffs

Some elements of an agreement can be achieved earlier than others. The overall objective is to achieve free trade in goods by 2010, and 2015 for the four newer ASEAN member countries with some flexibility, or earlier where possible. As a guide, ASEAN could consider extending the AFTA tariff phase-outs to CER, and CER would progressively reduce tariffs for ASEAN from the conclusion of negotiations, reaching free trade by 2005. Specific time-lines and the integration of those few agricultural products not fully incorporated into the CEPT would be the subject of negotiation.

While complete liberalization in goods trade is envisioned under the proposed FTA by 2010, and 2015 for the newer ASEAN member countries with some flexibility, the Task Force members recognize the additional gains of achieving free trade in goods at the earliest possible time. Being developed economies with close-to-zero protection in most goods, CER economies are in a better position to achieve free trade vis-à-vis ASEAN at an earlier date, that is, by 2005. This can be achieved by a progressive tariff reduction for ASEAN goods from the conclusion of negotiations, reaching free trade by 2005. On the other hand, ASEAN could consider extending AFTA-tariff phase-outs to CER. Negotiations, however, will have to be undertaken to determine specific time-lines for liberalization as well as the integration of remaining agricultural products that are not yet fully incorporated under the AFTA's CEPT.

4.4 Rules of Origin

The ROO threshold for an AFTA-CER FTA would be at 40 percent. There is a need to simplify and standardize the ROO for the two regions.

To avoid the possibility of trade deflection – wherein nonmember goods enter the FTA through low barrier countries – FTAs adopt *rules of origin* (ROO) which specify the degree of value added the goods must embody before they can be considered as domestically produced. Such rules, however, can and have been used as protective devices, by designing them to remain complex. For instance, the rules of origin section of NAFTA contain over 11,000 separate product entries and run to about 200 pages, while that of EU's agreement with Poland has 81 pages of fine print. NAFTA rules are specific in certain 'sensitive' sectors such as automobiles, textiles and clothing, and certain agricultural products. The result could then be distortive, shifting trade and investment to high cost sources. An example is the requirement of almost one-hundred percent sourcing of inputs from North America if Mexico is to benefit from tariff-free access to the North American market in most clothing exports. The 'yarn forward' rule requires finished products to be made from North American fibers. The result then is diversion of imports from low-cost sources of inputs to possibly

high-cost North American sources. Another example may be found in the local content requirement of 62.5 percent for automobiles which has shifted sourcing away from cheaper Japanese or southeast Asian plants, or the diversion of Japanese investments away from plants in other countries towards a North American location.

- 4.5 A way to avoid the use of ROO as a protective device is to keep the regional content requirement at a reasonably low level as well as to keep it as simple and as transparent as possible. AFTA has a 40 percent content rule while CER has 50 percent⁶. The proposed FTA should adopt AFTA's lower ROO threshold of 40%.

4.6 **Non-tariff Barriers**

An agreement would need to cover areas such as anti-dumping, standards and conformance, price undertakings, import licensing, labelling, import quota, and SPS issues.

Rules on these non-tariff measures must be simple and transparent and administered efficiently so that they would not be used as trade barriers, particularly anti-dumping measures.

These measures should observe the principle of standstill and rollback.

As discussed under Principle (a), para. 3.3, the Agreement should cover all forms of trade barriers, and specifically non-tariff measures that serve to inhibit trade. These include anti-dumping, standards and conformance, price undertakings, import licensing, labeling, import quota and SPS measures. Recognizing the possibility that these NTMs could be used for protection, the members of the Task Force insist on the importance of formulating simple and transparent rules governing the use of NTMs as well as the need for their efficient administration. No new NTMs should be adopted and existing ones should be reduced, and if necessary, eliminated.

4.7 **Services**

A separate agreement or protocol on services may need to be formulated and agreed upon. A negative list approach should be adopted.

⁶ The details of application, however, differ between the two regions. In AFTA the 40% content rule applies and a product is considered to have originated in the region when the value of materials, parts or produce originating from the region, or of undetermined origin, is more than 40% of the FOB value. In the case of CER, the last process of manufacture is to have occurred in Australia or New Zealand and 50% of the factory or works cost of the product should be from materials originating in the area, labour or factory overheads incurred in the area, or inner containers originating in the area.

Liberalisation of trade in services should be achieved in advance of the APEC deadline, i.e., 2010 for developed economies and 2020 for developing economies.

Since the mid-1990s there has been a conspicuous increase at the sub-regional level of arrangements seeking to open services markets among member countries on a preferential basis. This is in recognition of the need for an efficient services sector in a country's economic development, its important links with production and trade, as well as the cost to the economy of restrictions on services transactions. Country experiences in services trade liberalization all point to significant reductions in cost and improvements in the quality of services. However, in spite of these realizations, there still exists a great deal of hesitation, especially among developing countries, to rapidly and comprehensively open the services market, a fact that probably explains the limited success achieved in services trade liberalization at the multilateral level under GATS, in contrast to the current dynamism in the area at the sub-regional level (Stephenson, 1999). The members of the Task Force, however, want to affirm the necessity of an efficient services sector without which much of the expected gains from the FTA will not be achieved. The AFTA-CER FTA should therefore include an agreement or protocol on services. A negative list approach should be adopted. Moreover, as in goods trade, the proposed FTA should be APEC-plus, so that the deadlines for services trade liberalization should be set earlier than those agreed upon under APEC.

4.8 **Investment**

The agreement should contain a framework of investment principles and rules which would increase and secure capital flows within the region.

Some of the dynamic benefits of membership in an FTA will have to be forfeited if certain areas of integration are not included in the agreement. One such area is that of investment flows. FDI has become increasingly complementary, rather than substitutable, with trade. An FTA enhances the locational advantage of countries in the region for FDI by both members and nonmembers. However if barriers to capital flows exist – such as outright barriers to invest in certain areas, limits to foreign equity participation, domestic content requirements, limits or prohibition of profit repatriation, etc. – such investment flows will be discouraged.

- 4.9 Under the Framework Agreement of the ASEAN Investment Area (AIA, 1998), opening up to and national treatment of investments from other member countries are envisioned. Coverage of the AIA includes manufacturing, agriculture, mining, fisheries forestry and services incidental to these sectors, although exceptions are found in the exclusion lists (temporary and general exclusion and sensitive list). On

the other hand, there are no specific provisions on investment in CER. Investors from each country are subject to the general foreign investment policies and requirements of the other CER country.

- 4.10 Since one of the major goals of forming an AFTA-CER FTA is to improve the attractiveness of the region as an investment site, the agreement should contain a framework of investment rules which envisions freedom of capital movement within the region.

4.11. **Technical Assistance**

Neither CER or AFTA have provisions on technical assistance. The agreement would need provisions on technical assistance to facilitate transfer of know-how, particularly in relation to the newer members of ASEAN.

Among other areas, such technical assistance should cover the following:

- (a) technical assistance in the development, strengthening and diversification of the production and export bases of ASEAN countries, particularly for the less developed members,*
- (b) assisting of the ASEAN countries in their capacity building, and*
- (c) assisting of the ASEAN countries in their capacity building toward complying with the SPS requirements of the CER countries.*

The proposed AFTA-CER FTA will be a regional arrangement among developed and developing economies, including some that may be considered transition economies. It is therefore important to ensure that differences in levels of development and market systems do not prevent the less developed members of the FTA from benefiting fully from the static and dynamic gains arising from the regional grouping. To this end, technical assistance, particularly in the area of capacity building, will have to be provided by the more developed members. While some forms of technical assistance have been extended among AFTA member countries, there are no provisions for technical assistance under the CER. The AFTA-CER FTA should incorporate certain provisions for technical assistance to ease the adjustment process and improve capabilities required of members in the new environment. Examples of technical assistance are as follows:

- Information on existing and potential markets for exports;
- Assistance in the development, strengthening, diversification of production and export bases of member countries to reduce adjustment difficulties;
- Capacity building, especially in the field of technical skill-formation and human resource development;
- Capacity building for meeting requirements of new markets (e.g. testing; quarantine techniques, etc.);

- Cooperation on standards and conformance (such as studies on the identification of capacity gaps, confidence-building among regulators).

4.12 To determine the areas where assistance is required by the new members of the ASEAN, the Secretariat requested the Task Force members from Cambodia, Lao-PDR, Myanmar, and Vietnam to submit their proposals on this issue (c.f. Appendix G). In general, the priority areas identified were in the following fields: upgrading of the quality of domestic products, general training to government officials, HRD programmes in agriculture, commerce, finance, industry, trade; capacity building in SPS to enhance the prospects of agricultural exports to CER; standards and conformance assessment, customs; e-commerce, and SME development. Appendix H contains a list of the development assistance and capacity building measures provided by CER countries to ASEAN. In particular, projects on capacity building are in the areas of standards and conformance and in quarantine measures to improve access to CER markets of ASEAN country exports.

4.13 **Trade Facilitation**

The work on trade facilitation activities already being undertaken between AFTA and CER should be continued, with emphasis on short-term deliverables.

Activities designed to facilitate trade among member-countries are already underway in AFTA and CER (c.f. Appendix A). They include such activities as harmonization of customs nomenclature and procedures, harmonization of standards, mutual recognition arrangements (MRAs), quarantine harmonization, etc. Such activities should be pursued further. However, the members of the Task Force stress the need for trade facilitation activities to yield short-term deliverables in order to accelerate the achievement of gains under the proposed FTA and to encourage member-economies to proceed with confidence along the path of policy reform required by the AFTA-CER FTA.

4.14 **WTO Consistency**

Any agreement must be consistent with the WTO. A decision is required whether notification would need to be made under Article XXIV/GATS V or the Enabling Clause. The Task Force expressed the preference for notification under Article XXIV/GATS V.

Expert opinion has been sought on the question of whether notification of the proposed FTA should be made under Article XXIV/GATS V or under the Enabling Clause (c.f. Appendix F). After a thorough analysis of the arguments for and against each option, the conclusion has been reached that the legal provisions as well as the practice under the WTO are strongly on the side of notification of the proposed FTA under the GATT Article XXIV and GATS Article V. Briefly, while there are few

advantages and some potential disadvantages of notifying under the Enabling Clause, the most important disadvantage is that it could prejudice legal claims by members of the Agreement invoking Article XXIV or Article V in dispute settlement cases in the WTO. On the other hand, the most important implication of notification under Article XXIV and Article V is the requirement of comprehensiveness in scope of the FTA. However, such comprehensiveness is already envisioned in the AFTA-CER FTA and there are many precedents for longer transition periods, given the level of development of the member countries. The members of the Task Force, therefore, prefer that notification of the AFTA-CER FTA be made under Article XXIV/GATS V.

4.15 **Institutional Arrangements**

Establishment of dispute settlement and review mechanisms should be incorporated in the AFTA-CER FTA .

Certain mechanisms will have to be put in place in case there are violations of the provisions of the Agreement. Under the AFTA Protocol on Dispute Settlement Mechanism, members are obliged to enter into consultations with other members on any matter affecting the implementation of the agreement. If after consultation and mediation the dispute is not resolved, it may be referred to the Senior Economic Officials Meeting (SEOM) which may either deal with the case directly or refer it to a panel for a report to help it arrive at a ruling. If the concerned party does not implement the ruling of the SEOM, the injured party has the right to suspend concessions under the Agreement. Appeals may be directed to the ASEAN Economic Ministers. Under the CER there are no specific dispute settlement procedures. However a consultation and review mechanism is provided for under Art. 22 of the Agreement to ensure that the Agreement is properly implemented.

4.16 **Intellectual Property Rights**

The AFTA-CER FTA should affirm commitment to implement the WTO-TRIPs Agreement. The member countries should also consider strengthening cooperative links between national IP institutions, the strengthening of IP offices and enforcement capabilities.

Rampant violation of the rights to intellectual property (IP) will result in unfair competition as well as in a possible reduction of the volume of trade in proprietary goods. Thus, in a regional arrangement, a commitment and effort to uphold intellectual property rights (IPR) should be demonstrated by member economies.

- 4.17 Under AFTA there is an existing Framework Agreement on Intellectual Property Cooperation which exhorts members to explore areas of cooperation, such as in the possible establishment of an ASEAN Patent Office, a trademark system and an IP Association. On the other hand, the CER does not have similar provisions on IP except to recognize the

right of members to implement measures for IP protection. The proposed FTA should commit to implement the WTO-TRIPs Agreement. It should consider cooperation in the enhancement of IP enforcement and protection, re-enforcing the cooperative links between national IP institutions, as well as strengthening IP administration and enforcement capabilities.

4.18 **Competition Policy**

The AFTA-CER FTA should provide a framework to cover competition policy taking into account those principles endorsed by APEC Leaders on 13 September 1999. Practical steps that promote and protect the process of competition will be established and maintained, as may be agreed between AFTA and CER countries.

The experience of older RIAs such as the EU has shown that obstacles to market integration are not limited to the application of border measures (such as tariff and non-tariff barriers). Competition can be inhibited by anti-competitive practices of firms, such as the abuse of a dominant position. Although domestic anti-competitive practices can be handled by domestic competition policy, such practices can be applied across borders, particularly when firms are engaged in intra-regional selling or buying activity, and hence lie beyond the purview of domestic competition policy. This becomes more prevalent as the degree of intra-regional integration deepens, e.g. when FDI regimes are liberalized and M&As increase. The EU took recourse to crafting a common competition policy that gave authority at a supranational level to address cross-border anti-competitive practices.

- 4.19 On the other hand, some contingent protection, such as anti-dumping policy, can be addressed by domestic competition policy. In this case, the approach adopted by CER was to harmonize domestic competition policy that allowed Australia and New Zealand to abolish anti-dumping procedures between them. Domestic competition laws were legislated to address anti-competitive conduct that affected trans-Tasman trade in goods.
- 4.20 In a prospective AFTA-CER FTA, agreement should cover competition policy in order to ensure effective movement toward regional market integration. A good starting point would be to consider the principles and rules arrived at by the WTO Working Group on Competition as well as those endorsed by the APEC Leaders during their September 1999 meeting (APEC Principles to Enhance Competition and Regulatory Reform).

SECTION 5

CONCLUDING REMARKS

- 5.1 In sum, through market enlargement and liberalization as well as through facilitation of trade in goods and services, the proposed FTA will create an environment conducive to the improvement of efficiency and competitiveness of firms and industries in member countries. It will establish a framework that is favourable to increased investments from within and outside the region. Its adoption of simple and transparent rules, its recognition of the need for flexibility in the light of diversity in development stages of its members, as well as its commitment to extend technical assistance particularly to the newer members of the ASEAN, will ensure that the benefits of the proposed FTA will be shared by all its member-countries, and thus enhance the economic well-being of the peoples of the two regions. All in all, the formation of the proposed FTA will send a strong signal to the world of the AFTA-CER region's continued commitment to pursue political stability and dynamic economic growth.
- 5.2 Given the above objectives, the members of the High-Level Task Force think that the establishment of the AFTA-CER FTA is an appropriate response to the global and regional challenges facing both regional groups. They, therefore, suggest that the Economic Ministers from both AFTA and CER undertake the necessary steps toward the establishment of the proposed AFTA-CER FTA at the earliest possible time.
- 5.3 In a world of constant flux, to stand still is to fall back. ASEAN and CER must take this decisive step. They must seize this unique opportunity to move forward.

Appendix A

MAJOR FEATURES OF AFTA AND CER

1. THE ASEAN FREE TRADE AREA (AFTA)

At the Fourth ASEAN Summit held in Singapore in 1992, the ASEAN Heads of Governments announced the goal of creating an ASEAN Free Trade Area (AFTA). The Common Effective Preferential Tariff (CEPT) Agreement, signed during the Summit, required that tariff rates levied on a wide range of products traded within the region be reduced to 0-5%. Quantitative restrictions and other non-tariff barriers would also be eliminated. Although originally scheduled to be realized by 2008, the target of a free trade area in ASEAN was continuously moved forward, so that it is now to be established by the year 2002.

The objective of AFTA was to enhance intra-regional trade and make the region an attractive manufacturing base for domestic and foreign investments. At a time when there was much uncertainty about the success of the Uruguay Round of multilateral trade negotiations, AFTA provided an important option for countries eager to maintain the momentum of economic growth and trade liberalization in the Southeast Asian region.

1.1 Liberalization of Goods Trade The centerpiece of the AFTA is the Common Effective Preferential Tariff (CEPT) scheme which envisions the phase-down of intra-ASEAN tariffs to a range of 0-5 percent as well as the elimination of non-tariff barriers over a broad range of manufactured goods. During the Sixth ASEAN Summit of December 1998, the phase-down period starting 1 January 1993 was eventually accelerated to end instead in 2002 in response to the financial and economic crisis then raging in the region. The ultimate target is to eliminate all customs duties by 2010 for the first six member-economies, and 2015 for the four newer members (Cambodia, Laos, Myanmar, and Vietnam).

In recognition of the needed adjustment in difficult-to-liberalize or sensitive sectors, member countries were left free to select which products to include in four kinds of lists: Inclusion List (IL) where products were immediately subjected to trade liberalization; Temporary Exclusion List (TEL) where products could be shielded from liberalization up to a maximum of seven years; Sensitive List (SL) where only unprocessed agricultural products could be designated and which need not be fully liberalized until 2010; and the General Exclusion List (GEL) where products which pose a threat to national security, animal, plant and human life or health need not be liberalized at all. However, further acceleration of the liberalization process was undertaken on 1 January 1996 by including unprocessed agricultural products (UAPs) into the CEPT scheme and by gradually phasing in products in the TEL. As of 1 January 2000, 82.5 percent of all tariff lines in ASEAN are in the IL, 15.6 percent in the TEL, 0.6 percent in the SL, and 1.4 percent in GEL.

To avoid the problem of trade deflection (wherein a good enters the FTA through the lowest-tariff country and is transshipped), the Rules of Origin (ROO) of AFTA stipulate that a product can be considered as having originated from the region only when the value of materials, parts or produce originating from the region is 40 percent or more of its FOB value.

1.2 Liberalization of Services Trade ASEAN member countries agreed to liberalization of trade in services beyond their commitments under the General Agreement on Services (GATS) of the WTO by signing the ASEAN Framework Agreement on Services (AFAS) during the Fifth ASEAN Summit in Bangkok in December 1995. Instead of a negative list approach adopted by other regional arrangements such as CER and NAFTA, ASEAN chose to adopt to the GATS framework or a positive list approach. This meant that liberalization commitments are negotiated by sector and mode of supply, and then listed in schedules of commitments.

Thus far, ASEAN has completed two rounds of negotiations on liberalizing trade in services in seven sectors: air transport, business services, construction, financial services, maritime transport, telecommunications and tourism. However, many of the commitments simply reflected the existing services regimes of the countries and hence did not go very far in freeing up the services sector to more intra-ASEAN competition. To take the process further into the ASEAN Vision of 'free flow of services', a new round of negotiations covering all services sectors and all modes of supply to begin in 1999 and end in 2001 was agreed upon at the Sixth ASEAN Summit in December 1998.

1.3 Liberalization of Investments Given the paramount objective of encouraging investments into the region, the ASEAN leaders agreed to establish an ASEAN Investment Area (AIA) during the Fifth ASEAN Summit in Bangkok in December 1995. Under the AIA two major liberalization commitments were undertaken by member states: accordance of national treatment initially to ASEAN investors but ultimately to all foreign investors, and commitment to open up all industries initially to ASEAN investments and ultimately to all foreign investments. The deadlines set for these two commitments to ASEAN investments was the year 2003 for the six older ASEAN members, together with Myanmar which opted for this earlier deadline, and 2010 for three remaining new members: Cambodia, Laos, and Vietnam. Complete liberalization of investment regimes toward non-ASEAN members was set originally at 2020 under the AIA Agreement, a date currently being reviewed for possible acceleration.

1.4 Trade Facilitation Going beyond the confines of trade liberalization, ASEAN has taken initiatives to facilitate trade, particularly in customs and standards and conformity assessment. Thus in year 2002, ASEAN will have adopted a Harmonized Tariff Nomenclature. There are also existing commitments to implement the WTO Valuation Agreement and for expeditious customs clearance for ASEAN products through the 'Green Lane'. Adoption of a harmonized nomenclature system within ASEAN will facilitate trade by ensuring greater uniformity, transparency and consistency in the application of

commodity description and coding. Similarly, the use of the transaction value in customs valuation will greatly simplify customs transactions for traders in the region who currently have to contend with different customs valuation regimes in ASEAN. Needless to say, the Green Lane, which was launched in 1996, expedites the clearance of CEPT goods.

Moreover, two important initiatives by ASEAN are designed to eliminate technical barriers to trade, namely harmonization of products standards for priority sectors and development of sectoral or product-specific mutual recognition arrangements (MRAs). Thus far, twenty priority sectors have been identified by ASEAN for alignment of their product standards to international standards. From these sectors come the most widely traded products in the region, e.g. radios, television sets, refrigerators, air conditioners and telephones. A Framework Agreement on Mutual Recognition Arrangements was signed in December 1998 to accelerate the development of bilateral as well as regional MRAs on standards and conformity assessment among ASEAN members. Sectors for which MRAs are being considered include cosmetics, pharmaceuticals, electrical and electronic products, and telecommunication equipment.

Other cooperative schemes designed to spur greater industrialization among its members have been tried by ASEAN over the years with varying degrees of success, such as the ASEAN Industrial Joint Venture Scheme (AIJV) and more recently the ASEAN Industrial Cooperation Scheme (AICO).

AFTA does not have disciplines that cover subsidies, countervailing measures or anti-dumping measures. However safeguard measures are allowed whenever import surges lead to serious injury or become a threat to a domestic industry.

1.5 Technical Assistance and Cooperation Various types of technical assistance have been extended by the older ASEAN members to assist the new members to participate more meaningfully in the ASEAN. The priority areas for technical assistance, identified by the ASEAN Economic Ministers in October 1997 center on

- information exchange (e.g. trade database, information on services regime, on sanitary and phytosanitary measures and other technical barriers to trade),
- capacity building for standards development, laboratory testing and conformity assessment,
- implementation of the various agreements and schemes (e.g. rules of origin, ASEAN Harmonized Tariff Nomenclature, GATT Valuation Agreement, the AICO Scheme),
- human resources development,
- trade policy

Moreover, regional cooperation among ASEAN countries has taken many forms over the years. A prime example is the ASEAN-Mekong Basin Development Cooperation (AMBDC), which joins in a cooperative venture for

the sustainable development of the Mekong River Basin in order to spur economic growth in the region and improve the standards of living of its peoples. Another important development in regional cooperation are the 'Growth Triangles' or sub-regional economic zones (SREZs) formed among geographically contiguous areas of different countries to gain a comparative strength in export promotion. They involve close cooperation between the private and public sectors of the countries involved to exploit the complementarities among them. A number of these SREZs has been formed among ASEAN countries, such as the Johor-Singapore-Riau Growth Triangle involving Malaysia, Singapore, and Indonesia, the Northern Growth Triangle involving contiguous sub-regions of northern peninsular Malaysia, southern Thailand, and northern Sumatra, and the BIMP-East Asian Growth Area involving Brunei Darussalam, Indonesia, Malaysia, and the Philippines (BIMP-EAGA).

1.6 Rules and Disciplines In view of the ASEAN enlargement to include new members and with the expansion in scope and deepening of commitments for economic cooperation, the informal and cooperative style of decision-making in ASEAN had to be complemented by a more rules-based mechanism. For this purpose, two key agreements were signed by the ASEAN Economic Ministers, namely the Protocol on ASEAN Dispute Settlement Mechanism (DSM) in 1996 and the Protocol on Notification Procedures in 1998. The former provides an expeditious and transparent way of settling disputes that arise from the implementation of the ASEAN economic agreements. The latter Protocol on Notification Procedures obliges member-countries to provide early notification of actions or measures that may nullify existing benefits enjoyed by other members. Moreover, Article 6 of the CEPT Agreement on Emergency Measures was amended to make it more consistent with the WTO Agreement on Standards.

However, although ASEAN has considerably strengthened its rules and institutions, many of these have not been tested. For instance, no member has ever used the Dispute Settlement Mechanism since its signing in November 1996. Thus, it is not known whether such mechanism will prove adequate in dealing with serious conflicts among ASEAN members.

1.7 Openness to Other Regional Groups AFTA is committed to remain open to linkages with other regional groupings. The AFTA-CER linkage, established in September 1995, is the most established of such linkages. Likewise, the ASEAN ministers have sought to undertake consultations with other regional groups, such as MERCOSUR, SADC, and EFTA. Since the ASEAN-Plus-Three Summit in Manila, ASEAN trade ministers conduct regular consultations with the trade ministers of China, Japan, and Korea. Similarly, an AFTA-India study is due for completion this year.

2. THE AUSTRALIA-NEW ZEALAND CLOSER ECONOMIC RELATIONS AGREEMENT (ANZCERTA or CER)

The CER Agreement, which is the primary instrument governing economic relations between Australia and New Zealand, is founded on a series of preferential trade agreements between these two countries, among which is the 1965 New Zealand-Australia Free Trade Agreement (NAFTA). Based on these agreements, as early as 1970, about 80 percent of trans-Tasman trade had undergone a removal of tariffs and quantitative restrictions. However, lacking an effective mechanism for a compulsory removal of remaining restrictions, the governments of the two countries agreed in March 1980 on the development of 'closer economic relations' between them which remained consistent with an outward-looking approach to trade and with each country's obligations under the GATT and other multilateral and bilateral trade agreements. Thus the CER Agreement took effect on 1 January 1983 and provided for free trade in goods between Australia and New Zealand.

Since 1983 the CER Agreement has undergone three general reviews that have resulted in accelerating the achievement of free trade in goods meeting the CER rules of origin by June 1990 by eliminating all tariffs and QRs; widening of the scope of the 1983 Agreement to include services trade; and deepening of the Agreement through harmonization of a range of a non-tariff measures affecting the free flow of goods and services. Moreover, over the years, several aspects of the CER Agreement have been amended, refined, or become redundant, the most important changes being on joint food standards systems and mutual recognition of regulatory requirements as well as the phasing out of margin of preference obligations.

2.1 Liberalization of Goods Trade The CER Agreement prohibits all tariffs and quantitative import or export restrictions on trade in goods originating in the CER. To be considered to originate in the FTA, goods must meet the following minimum requirements in its Rules of Origin:

- Last process of manufacture should have occurred in Australia or New Zealand;
- At least one half (50 percent) of factory or work costs of the goods should be made up from expenditures on any of:
 - materials originating in the Area,
 - labor and factory overheads incurred in the Area,
 - inner containers originating in the Area

Aside from tariffs and QRs, payment of export subsidies and export incentives were recognized as inconsistent with the objectives of the Agreement. It therefore called for the elimination of all export incentives and subsidies in trans-Tasman trade. Following the 1988 General Review of the CER Agreement, it was agreed that from 1 July 1990, neither country would pay export incentives or like measures aimed at stimulating exports to the other at the expense of industry in that country.

On the other hand, **countervailing measures** to remove injury to an industry caused by the importation of goods benefiting from government subsidies can be taken only in accordance with the GATT Code on Subsidies and Countervailing Duties (now superseded by the WTO Agreement) and the provisions of Article 16 of the CER and when no other mutually acceptable alternative solution has been found. However, third-country countervailing actions are permitted under the Agreement to address cases where subsidized imports in one Member State from a third country are causing or threatening material injury in the other Member State.

Moreover it was agreed upon in 1988 that as of 1 July 1990 **anti-dumping actions** could no longer be taken in respect of trans-Tasman trade in goods to which ANZCERTA applied. However, as in the case of countervailing duties, third-country anti-dumping actions are allowed by the CER Agreement, where dumped imports in Australia or New Zealand from a third country are causing or threatening to cause material injury to industry in the other country.

2.2 Liberalization of Services Trade With the exception of a number of services subject to existing government regulations at the time (specifically inscribed in the Annex to the Protocol), the 1988 CER Trade in Services Protocol provides for free trans-Tasman trade in all services. Both Australia and New Zealand are committed to the progressive removal of these inscriptions, so that currently, only eight (8) of the original twenty-one (21) inscriptions remain.

The Protocol provides for national treatment, market access, rights of commercial presence, and most favored nation treatment, all subject to both countries' foreign investment policies.

2.3 Liberalization of Investments There are no specific provisions on investment in the CER Agreement. Thus investors in each country are subject to general foreign investment policies and requirements of the other country. However, to liberalize their investment regimes, both Australia and New Zealand have raised their thresholds on foreign investment business acquisition.

2.4 Trade Facilitation Recognizing that it was not enough to liberalize trade in order to bring about a true integration of markets on both sides of the Tasman, Australia, and New Zealand undertook a number of measures to make this a reality. Following are some of the major steps in this direction:

(a) Standards Harmonization CER countries have concluded a Memorandum of Understanding on Technical Barriers to Trade (MOU on TBT), which applies insofar as it is not inconsistent with the WTO Agreement on Technical Barriers to Trade. The MOU covers cooperation in the determination of standards, access to information, acceptance of test results and transparency and non-discrimination in test requirements. Other agreements relating to standards include the Agreement on Standards, Accreditation and

Quality (ASAQ), the Trans-Tasman Joint Accreditation System (JAS-ANZ), and the Trans-Tasman Mutual Recognition Arrangement. On the harmonization of food standards, the CER countries have established the Australia-NZ Food Authority which in 2000/2001 is expected to complete an Australian-NZ Food Safety Code. Since 1997, except for those that are 'risk-classified', foods can be exported without import and export certification and inspection requirements.

(b) Mutual Recognition Arrangements Through the Trans-Tasman Mutual Recognition Arrangement (TTMRA) signed by both CER countries in 1996, regulatory barriers to the movement of goods and service providers will be progressively removed to facilitate trade. In principle, under the TTMRA goods legally able to be sold in one country will legally be able to be sold in the other, and a person registered to practise an occupation in one country will be entitled to practise an equivalent occupation in the other country.

(c) Quarantine Harmonization In order to prevent the deliberate use of quarantine requirements as a technical barrier to trade, New Zealand and Australia signed in 1988 a Protocol on the Harmonization of Quarantine Administrative Procedures. Under the Protocol, the two countries, among other things, agreed to work toward arrangements to advance the harmonization of quarantine standards and procedures, and the adoption of common inspection standards and procedures, also to develop a consistent approach to pest risk assessment and quarantine requirements for imports from third countries, and to establish a Consultative Group to help resolve outstanding technical differences and provide overall impetus and direction for harmonization.

(d) Customs Harmonization The CER countries undertook to pursue harmonization opportunities and maintain common approaches to customs issues to the greatest extent possible. To this end, they agreed to a Joint Understanding on Harmonization of Customs Policies and Policies during the 1988 Review of CER.

2.5 Rules and Disciplines The 1983 CER Agreement commits Ministers of both countries to meet annually or otherwise as appropriate to review the operation of the Agreement. In the event that either country has a grievance concerning adherence to any part of the Agreement, the other country is obliged to enter into consultations to seek an equitable and mutually satisfactory solution, at the written request of the other.

However, there are no specific dispute settlement procedures in the CER Agreement. Since consultations are not binding, successful settlement depends on the goodwill of both parties to work out amicable and practical solutions.

2.6 Competition Policy The CER countries have agreed to extend the application of their competition laws on the misuse of market power to trans-Tasman markets. Successful harmonization of their competition policies

has led to a breakthrough in terms of removing the possibility for applying anti-dumping procedures against each other.

2.7 Harmonization of Business Laws In 1988, the CER members agreed on an MOU on Business Law Harmonization which requires both countries to jointly examine the scope of business laws and regulatory practices, including the removal of any impediments. To coordinate such harmonization, a Steering Committee of Officials has been formed.

2.8 Intellectual Property Rights These are not formally covered under the CER family of agreements, and domestic legislation relating to IP is explicitly excluded from the operation of the TTMRA. However Australia and New Zealand are members of the WTO and thus adhere to the World Intellectual Property Organization's (WIPO) multilateral Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).

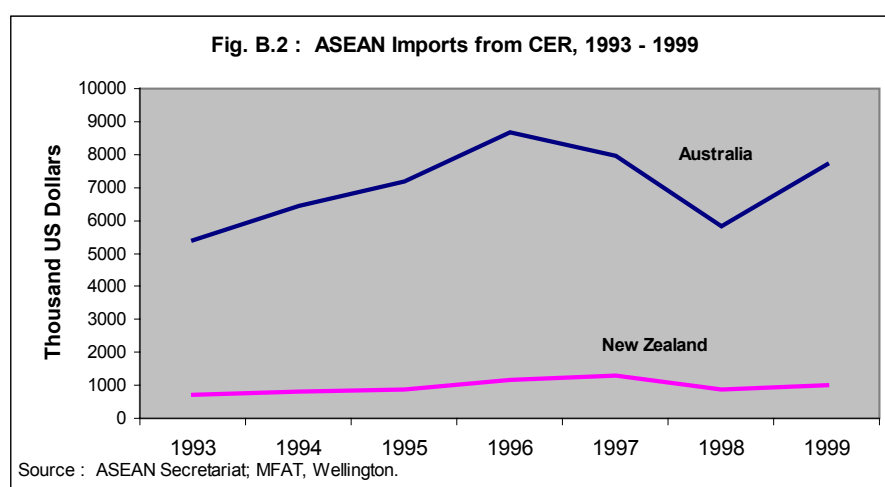
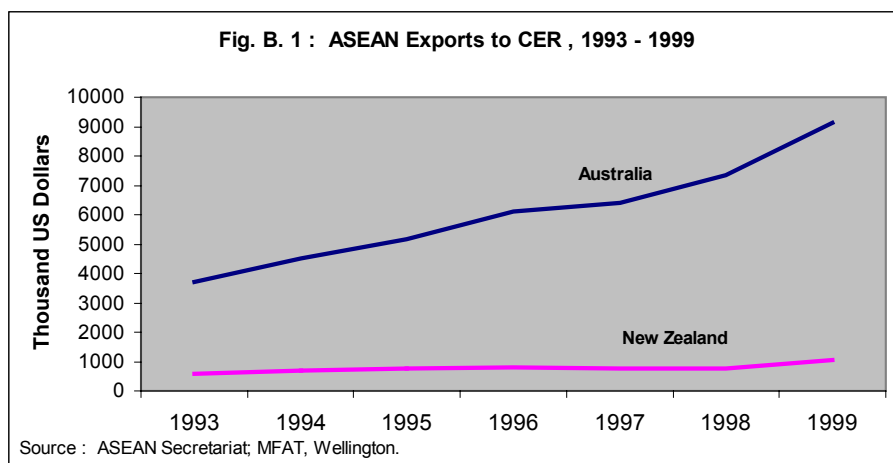
2.9 Openness to Other Regional Groups CER members have actively encouraged the establishment of informal linkages with parallel bodies from other regions for economic cooperation. In particular, both are active members of the Asia-Pacific Economic Cooperation (APEC). Moreover, Australia and New Zealand are in dialogue with members of MERCOSUR, while New Zealand has entered into formal talks for a free trade area with Singapore.

Appendix B

ASEAN-CER LINKS

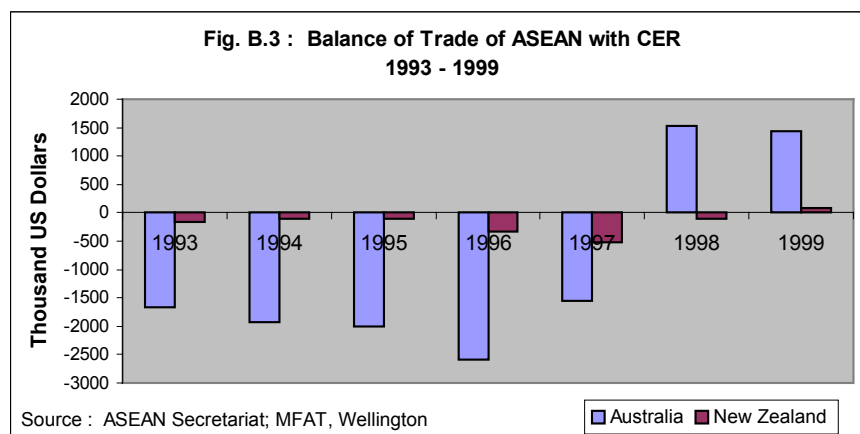
1. TRADE AND INVESTMENT LINKS BETWEEN ASEAN AND CER

Figs. B.1 and B.2 show the trade flows between ASEAN and the CER during the period 1993 – 1999. ASEAN exports to Australia – which are about seven to eight times those to New Zealand in absolute terms – rose at an annual rate of 16.3 percent, while those to New Zealand expanded at a slower rate of 12 percent annually. On the other hand, ASEAN imports from Australia rose 8.2 percent per annum while those from New Zealand grew at a rate of 7.5 percent annually. Because the CER countries were not directly hit by the recent Asian crisis, ASEAN exports to them did not seem to have been affected much by the crisis. However, imports by ASEAN countries, particularly from Australia, dipped in 1998 and 1999 but are recovering in 2000.

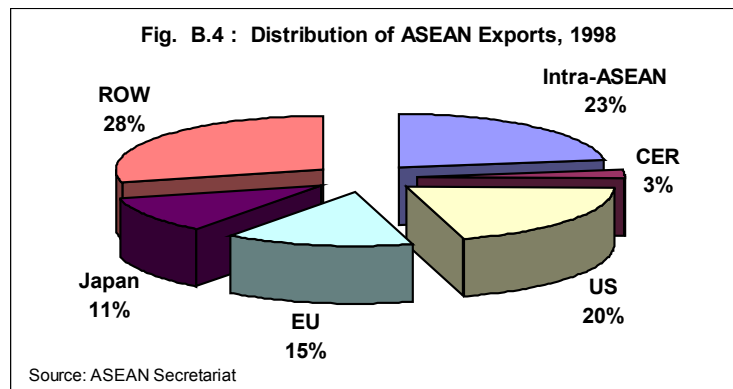


ASEAN had been collectively incurring trade deficits with both CER countries during most of the nineties. However, with the slowdown in imports

during the crisis, ASEAN's balance of trade with Australia turned positive in 1998 and 1999, while that with New Zealand became positive in 1999 (Fig. B.3).



In spite of the geographical proximity of the two regions, the trade links between ASEAN and CER economies remain relatively limited. The Triad (US, EU, and Japan) remains the dominant market for ASEAN exports, making up a little less than half of total in 1998. In contrast, CER represents only a 3 percent share of the ASEAN export market (Fig. B.4).

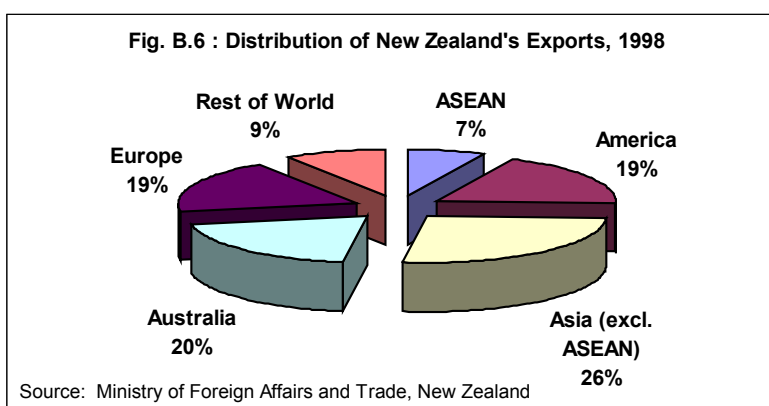
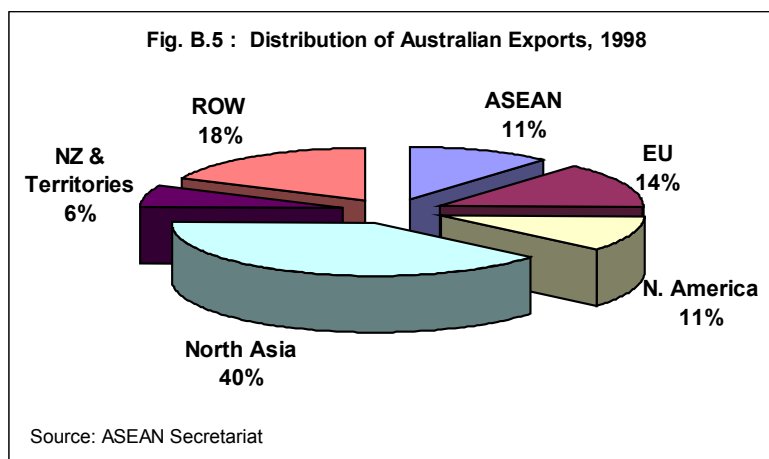


The six original ASEAN members currently account for a lion's share, i.e. about 97-98 percent of the region's exports to CER. Indeed, Singapore is ASEAN's biggest exporter to CER⁷, having accounted for 37 percent and 43 percent of total ASEAN exports in 1998 to Australia and New Zealand, respectively.

On the other hand, ASEAN is relatively more important to Australia as a market for its exports. As Fig. B.5 shows, ASEAN absorbed about 11% percent of total Australian exports for 1998, and about 15-16 percent during the

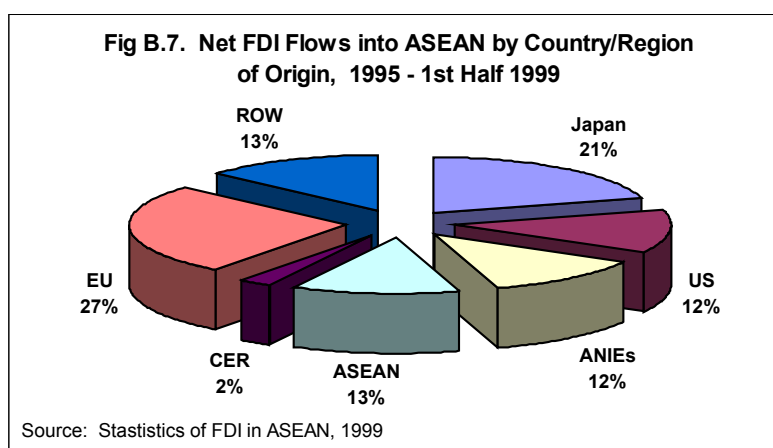
⁷ What is not known is the 'ASEAN content' of Singapore's exports, given this city-state's role as entrepot trader in the region.

pre-crisis years. Australian exports are currently concentrated in the ASEAN-6 countries which accounted for 96 percent of total in 1998, about 56 percent having found their way to only two ASEAN economies, namely Singapore (32 percent) and Indonesia (21 percent). For New Zealand, ASEAN was, relative to Australia, less important, as it constituted a market for only 7 percent of its exports in 1998 (Fig. B.6). Before the crisis, however, there was a trend of increasing share of ASEAN markets, having risen from 4.53 percent in 1985 to 8.9 percent in 1997. As in the case of Australia, the original five members of ASEAN were New Zealand's most important markets within ASEAN, having accounted for over 90 percent of total exports to the ASEAN bloc.



As in trade, the main sources of foreign direct investments of ASEAN are still the Triad, with EU, Japan, and US accounting for 60 percent of total net inflows between 1995 and the first half of 1999 (Fig. B.7). ASEAN itself is an important source of investment capital, and together with the ANIEs (Taiwan, South Korea, Hong Kong) accounted for 25 percent of total net inflows. Compared to these sources, the CER countries are still of relatively minor importance, with Australia and New Zealand having accounted for only about 2 percent of net FDI inflows into ASEAN during the period.

Australian direct investments to ASEAN accounted for an average of 4 percent of total Australian FDI outflows between 1991 and 1998⁸. Australian investment in ASEAN has grown annually on average by 10 percent since 1991. In 1997, a large investment outflow from Australia (A\$ 3.5 billion) was directed mainly to ASEAN. ASEAN thus became the second biggest FDI host to Australian capital, the first having been North America (A\$ 4.6 billion). By 1997 around 5 percent of Australia's FDI stocks abroad were in ASEAN countries. New Zealand's investment outflows have been concentrated mainly in the Netherlands and Australia (Bora, 1995). Indeed, New Zealand had been a net recipient of direct capital flows from ASEAN between 1995 to the present.



2. REASONS FOR THE CURRENT WEAK LINKS

In sum, the trade and investment links between AFTA and CER are currently weak, especially when seen against the possibilities for larger flows. In spite of the Asian crisis, ASEAN countries continue to hold the promise of being among the most dynamic economies in the East-Asian region. Moreover, ASEAN has succeeded in shedding off much of its protective arsenal of import-substitution policies in favor of outward-orientation. And the Asian crisis does not seem to have discouraged that resolve. Not only has there been no increase in protectionism; the ASEAN has even responded to the crisis by accelerating its CEPT liberalization schedule. On the other hand, Australia and New Zealand are among the more affluent countries in the region which have eschewed most of their import barriers.

And yet, 'natural partners' that they are when seen in terms of geographic proximity, the two regions prefer to trade, invest, and be hosts to FDI to more distant regions and countries, such as those of North America and Europe. It is all the more disconcerting, as Bora (1995) notes, when one realizes that 46 percent of the outward stock of Australia in 1980 were held by ASEAN and Hong Kong (from the Bureau of Industry Economics 1995, as

⁸ (transferred to main text) Traditionally, UK had been Australia's biggest FDI destination, although in 1998, a huge Australian disinvestment to UK took place (A\$ 2.6 billion). (I suggest we take out this comment.)

cited by Bora). This means a drop of about 40 percent of ASEAN share of Australian FDI outflows between 1980 and 1995. What, then, accounts for the current weak links in trade and investments?

A number of explanations have been offered. First, in spite of effort on both sides to open up their markets to trade, explicit and implicit barriers remain on either side. Most of these barriers, unfortunately, are directed against goods of interest to the other region. Second, when it comes to investment flows, there is probably a current mismatch between ASEAN's locational attractions as host to FDI and Australian firms' advantage as investors (Bora, 1995). For instance, ASEAN's relatively abundant supply of labor has attracted much FDI flows in recent years from the Triad in search of low-labor cost export bases, whereas Australian firms have not been active investors in such areas. To a certain extent, however, the lack of Australian investments in labor-abundant ASEAN countries might well be the result of protection itself: peak tariffs have historically defended Australia's labor-intensive industries (textiles, clothing, footwear, autos), therefore effectively barring the need to import from and/or invest in low-labor cost countries. Third, there may exist real investment barriers on both sides that have to be brought down to trigger intra-regional investments. Limits to foreign equity participation and local content requirements easily come to mind. Fourth, both Australian and New Zealand investors may be more comfortable in the familiar investment sites of the US and EU. This may be a case of path-dependent FDI attributable to historical ties. On the other hand, ASEAN countries themselves might have projected a high-risk image to CER investors as against the actual profitability of investment projects. This underscores the information gap that must be bridged as regards to the enormous possibilities for both trade and investments that exist in each region.

3. THE AFTA-CER LINKAGE

3.1 Proximate Background and Objectives Cognizant of the possibilities for increased economic activity between the two regions, some initiatives have been embarked upon to establish a greater linkage between them. As early as November 1993, in the course of a visit to Australia, the Thai Deputy Minister Supachai Panitchmakdi officially raised, for the first time, the idea of establishing an AFTA-CER linkage. This idea was subsequently endorsed by the ASEAN Economic Ministers (AEM) who, during their 26th AEM Meeting in Chiang Mai in September of 1994, agreed to initiate informal consultations with various regional groupings, including the CER. In September of the following year 1995, the ASEAN economic ministers and the Ministers from the CER countries held their First Informal Consultations in Brunei Darussalam, where they laid down the guiding principles for the AFTA-CER linkage. They agreed that it must provide tangible benefits to both regions, build upon existing complementarities between these two FTAs, serve as 'building block' for trade facilitation, and contribute toward greater trade and investment flows between the two regions.

The Ministers likewise agreed upon areas of cooperation, namely information exchange, human resource development, customs matters, standards and conformance, trade and investment facilitation and promotion, competition policy, and industrial cooperation. These areas were later expanded to include elements of agriculture, transport, market access/trade barriers and electronic commerce.

3.2 Activities and Achievements Since 1995, four informal consultations on the AFTA-CER Linkage have been undertaken by the economic ministers during their annual meetings. Similarly, the ASEAN Senior Economic Officials (SEOM) and their CER counterparts have held regular consultations to monitor progress on the Linkage. Moreover, direct consultations by sectoral officials (those handling customs, standards, transport, tourism, etc.) have been encouraged to discuss various cooperative activities. Among the achievements of such consultations are the following:

- **Standards and Conformance** The signing of a Memorandum of Understanding on Standards and Conformance between ASEAN and CER (13 September 1996, Jakarta), providing a concrete framework for cooperation in this area; joint formulation of an Action Plan by the ASEAN Consultative Committee for Standards and Quality (ACCSQ) and their CER counterparts to serve as reference to activities organized under the Linkage. Of twenty (20) projects endorsed by the Action Plan, six (6) have been completed as of end 1999. Nineteen (19) more projects have been identified for endorsement.
- **Customs** Publication of a Handbook of Customs Procedures covering ASEAN and CER countries (3rd AEM-CER Informal Ministerial Consultations, October 1997); promotion of information exchange through hyperlinking of Customs websites of ASEAN and CER countries; technical assistance through a series training provided by the New Zealand Customs Service (NZCS) on WTO Valuation Agreement/Code for the four newer members of ASEAN (February, March, October, 1999) as well as on Pre-Entry Tariff Classification for all ASEAN members (24-26 January 2000).
- **Agriculture : Food standards, Sanitary and Phytosanitary (SPS) Measures and Quarantine Practices and Procedures** Proposals by the CER countries at various stages of discussion and implementation, on such projects as : an ASEAN-CER Directory of Food Standards Authorities; AFTA-CER Electronic Data Interchange Pilot Project on Electronic Health Certification Messaging (SANCRT); cooperation on phytosanitary and quarantine issues, including training on SPS risk analysis; AFTA-CER cooperation on practices and procedures to facilitate trade in animals (including fish), plants and their products
- **Trade and Investment Barriers** With the help of the private sector, identification and verification of trade and investment issues by ASEAN and CER countries deemed to constitute barriers between the two regions; drawing up during the AEM-CER ministerial consultations of a list of priority issues to be addressed,

such as anti-dumping, standards and conformance, foreign direct investment, intellectual property rights and quarantine procedures and practices.

- **Transport** Development of an AFTA-CER Transport Information Directory by the ASEAN Senior Transport Officials (STOM) and their CER counterparts to provide relevant information through the respective countries' homepages; development of the Mekong Freight Logistics Study covering Cambodia, Laos and Vietnam, to track two-way freight movement of perishable products along the "Mekong Circle" ; exploration by transport officials from the two regions of cooperative activities on human resource development, particularly in the area of multi-modal transport and freight logistics training.
- **Investment** Launching of a website to promote investment opportunities in ASEAN and CER countries; agreement among relevant ASEAN working groups and their CER counterparts to meet for discussion of specific project proposals of significant mutual benefit.
- **Competition Policy and Consumer Protection** Development of a project to provide an educative process on competition policy and consumer protection to ASEAN member countries.
- **Electronic Commerce** Identification of the area for further cooperation and discussion by relevant working groups in the two regions.
- **Private sector consultations** Joint meetings; discussions with AEM-CER ministers in 1996 and 1997 regarding trade and investment impediments.

In response to the suggestions made by the economic ministers during the 1996 AEM-CER Informal Consultations for joint studies to be conducted in order to assess the medium and long-term developments of the AFTA-CER Linkage, a conference was held in Singapore on 5-6 September 1997 on the theme "The AFTA-CER Linkage: The Way Forward". Among the proposals submitted to the Senior Economic Officials of ASEAN and CER were: formalization of informal consultations by AFTA-CER ministers; a two-pronged approach to cooperation, namely trade and investment facilitation and liberalization in goods, services, and investment; holding of regular meetings by joint AFTA-CER working groups in these areas; harmonization of rules between AFTA and CER, in particular where these are broadly similar between the two regions, e.g. rules of origin, anti-dumping, countervailing duties and dispute settlement.

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- A Major Features of AFTA and CER
- B ASEAN - CER Links
- C Survey of Research on RIAs : Benefits and Costs of RIAs
- D. Economic Benefits from an AFTA-CER Free Trade Area (Year 2000 Study by the Centre for International Economics)
- E. Consultations on the AFTA-CER Free Trade Area with the Private Sector
- F. Notification of the AFTA-CER Free Trade Area to the WTO
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- I. Terms of Reference and List of Members of the High-Level Task Force on the AFTA-CER Free Trade Area

Selected References