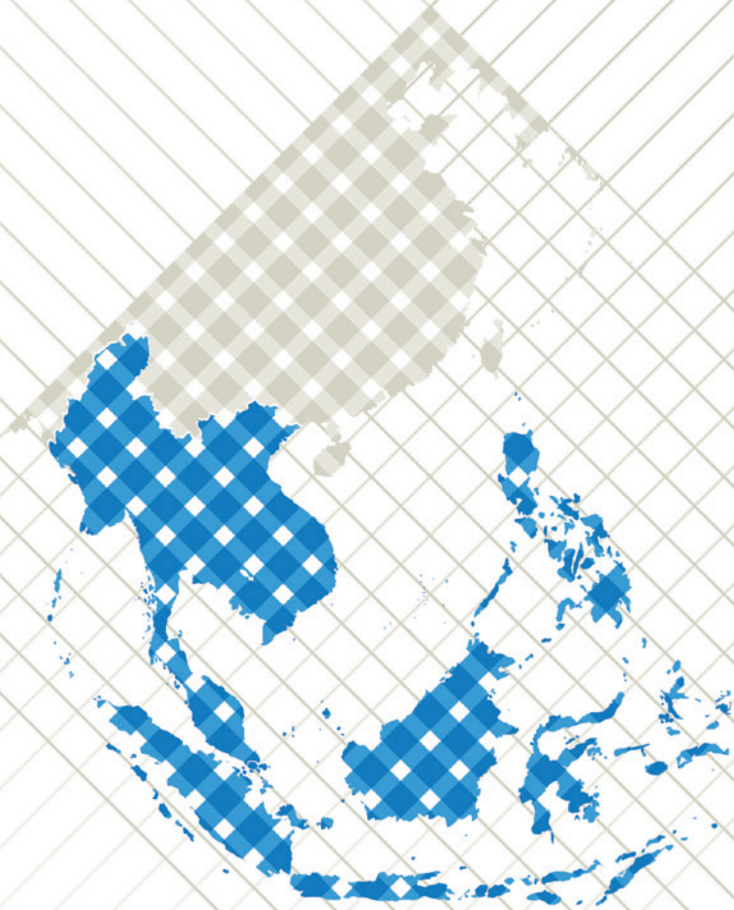
# FTAs in South-east Asia:

## Towards the next generation

An Economist Intelligence Unit report



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# Contents

# Executive Summary

Bilateral and regional free-trade agreements (FTAs) have proliferated in recent years as efforts to secure a global deal on trade liberalisation through the WTO have stalled. South-east Asia has been at the centre of this trend: in 2000 there were only three FTAs in the region, but today they are so numerous that their overlapping and competing preferences are often compared to a "noodle bowl". But are exporters using them? If not, why not? What benefits have they provided? What's life in the "noodle bowl" like and what are businesses' expectations of the next generation of FTAs and other regional agreements? How will this affect the trade relationship with the region's most important markets, especially China?

To answer these questions for this paper, the second in a series on FTAs in Asia sponsored by HSBC, The Economist Intelligence Unit (EIU) surveyed 400 exporters in four countries in ASEAN[1]—Singapore, Malaysia, Indonesia and Vietnam—to reveal how they use FTAs and their attitudes toward these agreements. The EIU also conducted in-depth interviews with companies, analysts and policymakers across the region.

The key findings of the report include:

- **Usage rates of FTAs in ASEAN are low but FTAs bring benefits:** The average usage rate of each of the FTAs signed and in effect by the four countries in the survey is just 26%; in other words just one in four exporters uses the terms of each agreement. Even the agreement covering free trade between ASEAN countries is used by only 50% of exporters, on average. Nonetheless, 85% say their exports have increased as a result of the FTAs they use, while 72% agree that FTAs represent the best hope for the future of their overseas businesses.

- **Complexity is off-putting; more outreach is required:** About half the exporters in ASEAN (48%) say they do not use some FTAs because of the complexity of agreement terms, while 29% say the benefits do not compensate for the difficulties in using them. Negotiating troublesome details such as Rules of Origin (ROOs) suggests that FTAs deliver less trade liberalisation than their preferences imply. A clear majority (64%) say that they would like to see greater outreach to businesses like theirs on trade issues by their governments.

- **Low usage also reflects low ambition of current FTAs:** Tariffs have been reduced for many goods in Asia, but because existing FTAs are "unambitious"—that is, they rarely go beyond simple tariff cutting—companies see limited upside in accessing their preferences. "Behind the border" issues such as trade in services, e-commerce, intellectual property rights, competition policy, customs

[1] The Association of South-East Asian Nations (ASEAN) includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Singapore, Thailand, the Philippines and Vietnam. In this paper, survey results from ASEAN refer to the four countries included in the survey. References to ASEAN in other contexts refer to the entire bloc.

cooperation, environmental rules and other regulations are tackled only in a limited way. For trade to become truly free in the region, reducing non-tariff barriers successfully is also a primary requirement.

- **There are high hopes for the next generation of trade deals:** Some 81% of ASEAN exporters see it as very important or important that their governments sign FTAs with more comprehensive provisions while 77% want FTAs with larger economies. Consequently many ASEAN businesses want their governments to engage in the "mega-regional" pacts now under negotiation, including the Regional Comprehensive Economic Partnership (RCEP) and the Trans-Pacific Partnership (TPP), of which the latter addresses "21st Century FTA" issues like freeing up trade in services. Hopes are also high for the implementation of the ASEAN Economic Community (AEC) in 2015, although its trade and investment liberalisation measures are likely to be undertaken gradually.

- **Liberalisation of trade in services is crucial:** As supply chain fragmentation across ASEAN increases trade becomes increasingly dependent on logistical, legal, financial and other services, which account for an increasingly large proportion of the value of goods shipped across borders. The liberalisation of trade in services is therefore crucial: better access to quality services would also help businesses expand into other markets.

- **Freer trade in ASEAN is changing the region's relationship with China:** Companies in the region, already increasingly able to enjoy a cost advantage in production, can solidify that advantage as they continue to establish intra-regional supply chains and make them more effective. However, ASEAN companies will also increasingly benefit from the growth of China's domestic demand, as a market into which to sell finished goods, while Chinese companies will also seek to increase investment in the region.

# About the research

For this paper sponsored by HSBC, the Economist Intelligence Unit (EIU) surveyed executives at 400 companies in Singapore, Malaysia, Indonesia and Vietnam—100 from each of the four countries. To reflect the views of small and medium sized enterprises, the survey was weighted in their favour, with 80% of the respondent companies having annual revenues between US$50m and US$150m, while 20% have revenues in excess of US$150m. All have exposure to cross-border trade and investment and all respondents are knowledgeable about the corporate strategy this involves. Half of the respondents are C-level executives or board members, with the other half ranging from manager and department head to senior vice president or director. Respondent companies operate in a range of sectors, including IT and telecoms, consumer goods, retail, financial services, manufacturing and others.

The EIU also conducted in-depth interviews with a number of corporate executives and trade policy experts. Interviewees included:

- Iwan Azis, head of the office of regional integration, **Asian Development Bank**
- Deborah Elms, executive director, **Asian Trade Centre**, Singapore
- Rizar Indomo Nazaroedin, director for regional cooperation, **Investment Coordinating Board of Indonesia**
- Mark Holloway, supply chain director, Asia-Pacific, **Diageo**
- Nicholas Kwan, director of research, **Hong Kong Trade Development Council**
- Simon Littlewood, president, **Asia Now**, Singapore
- Patrick Low, senior fellow, **Fung Global Institute**; former chief economist, WTO
- Jailani Mustafa, chief executive, **The eCEOs**, Malaysia
- Michael Plummer, Eni professor of international economics and director, **SAIS Europe, Johns Hopkins University**; former head of the developmental division of the OECD
- Le Phuoc Vu, chairman, **Hoa Sen Group**, Vietnam
- Ganeshan Wignaraja, director of research, **Asian Development Bank Institute**
- Robert Yap, chief executive, **YCH Group**, Singapore

The EIU would like to thank the survey participants and interviewees for their time and insights. The findings of this report are those of the EIU and do not necessarily reflect the views of the sponsor. The report was written by Tom Leander and edited by David Line.

# 1 There but unused

*In an age of proliferating free trade agreements, a surprisingly small proportion of exporters in ASEAN seize the benefits*

"Free trade is not based on utility, but on justice," said Edmund Burke, the Irish statesman and political theorist. If so, justice is spreading. The World Trade Organisation requires its 160 members to notify it if they agree to new trade agreements—defined as reciprocal agreements between one or more partners—or join an existing one. Since the WTO was created in 1995, it has received over 400 such notices. Under the General Agreement on Trades and Tariffs (GATT), which spanned 1948-1994, 124 notifications were given. Currently 379 are in force.

Exporters within ASEAN—the region under scrutiny in this report—have no lack of options in their approach to free trade agreements, because their governments have ensured them choices. Singapore—the most FTA-inclined nation in the region—has 20 FTAs in force (including those signed by the ASEAN bloc), varying from the free-trade area within the bloc itself, to an FTA with Jordan in the Middle East, to a bilateral trade deal with Costa Rica. It is in ongoing negotiations over another seven agreements, from the super-regional Trans-Pacific Partnership (TPP) involving 12 countries on the Pacific Rim to a bilateral agreement with troubled Ukraine. According to the Asian Development Bank, Malaysia has 27 FTAs in effect, in negotiation or proposed and under study; Indonesia 25 and Vietnam 20.

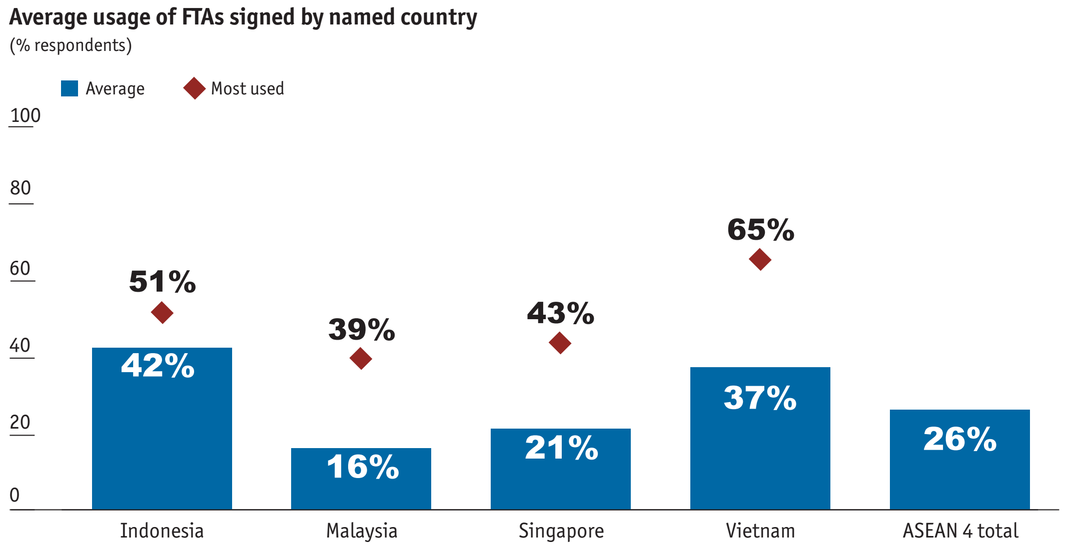
## Utilisation gap

The choices may be rich, but utilisation is surprisingly low. The EIU survey shows that the average usage rate of each of the FTAs signed and in effect by the four countries in the survey stands at a meagre 26% (Figure 1). In other words, each FTA signed in ASEAN is used, on average, by only one in four exporters. Malaysia is lowest, at 16%. Part of the low figure can be explained by Malaysia's high proportion of exports in non-agricultural commodities, which are subject to few trade barriers—about 28% of the nation's top exports in 2013 were petroleum or natural gas-related commodities.

Yet manufacturing is a major driver of Malaysia's export growth as well—some 33% of Malaysia's exports are electronics and electrical products and the government has stated its intent to turn Malaysia into a regional hub for making cars. Manufacturing in the nation is undergoing a restructuring toward high-value production—an area where utilisation of FTAS could offer companies access to benefits.

Despite Singapore's dependence on exports (exports of goods and services were 191% of GDP in 2013, compared to 82% in Malaysia and 24% in Indonesia) and the government's trade-friendly engagement, the average usage rate of FTAs signed by that country is only 21%. Average usage rates for FTAs signed by Vietnam

Figure 1: There but unused




(37%) and Indonesia (42%) are higher, but still low considering the export ambitions of both nations, particularly Vietnam, where exports of goods and services have grown to 80% of GDP in 2012 from 63% in 2009.

It should be noted here that the figures are influenced by exporters' tendency in ASEAN to use regional FTAs with neighbouring countries more than bilateral agreements with far off nations—14% of exporters in Vietnam use preferences available with Australia/New Zealand, compared to 65% that use the ASEAN FTA, for example.

Even so, the average usage rate of all the exporters in the survey for the ASEAN free-trade area is just 50%. After Vietnam, usage rates in Indonesia (51%) are highest, followed by Singapore (43%) and Malaysia (39%). The figure seems modest amid a high degree of cross-border supply chain integration in the region in recent years. The World Bank's ASEAN Integration Monitoring Report (2013) notes that "trends over the last seven years for various indicators point to a high degree of intra-regional merchandise trade integration within ASEAN, which is increasing at a faster pace than its GDP, though not faster than its trade with the rest of the world."[2]

Figures for usage rates for FTAs with China are also unspectacular, given China's significance as a major focal point of regional trade. Usage rates by exporters in Vietnam, Indonesia and Singapore of any trade treaty with China[3] (46%, 45% and 43%, respectively), all seem low, yet still significantly outpace the 26% reported by Malaysian exporters. Usage rates of FTAs with Japan are stronger, if unimpressive. Only 37% of exporters in Singapore use its FTA with the US. Usage rates are surprisingly low across the board.

## Recognising the benefits, but abhorring the costs

This is odd, given that some 72% of ASEAN respondents strongly agree or agree that FTAs represent the best hope for the future of their overseas businesses. The advantage, stated plainly by Le Phuoc Vu, chairman of Vietnam steelmaker Hoa Sen Group, includes both overseas business growth and the prospect of a better business environment at home.

[2] World Bank ASEAN Integration Monitoring Report, 2013

[3] Including bilateral and regional deals signed under the auspices of the ASEAN bloc.

"Hoa Sen Group has to import raw materials and we also export products to over 40 countries and territories around the world. Therefore, the knowledge and usage of FTAs are very important for us," Mr Vu says. "The ongoing integration in the ASEAN region through FTAs would certainly be great motivation for Vietnam to complete its legal framework, thereby improving the business environment of the nation," he adds. (ASEAN has given newer countries to the bloc like Vietnam, as well as Cambodia, Laos and Myanmar, a longer timeframe for full compliance with intraregional trade liberalisation, and has allowed delays on the reduction of some tariffs.)

For those respondents in ASEAN that use FTAs, the benefits stand out, with 22% saying that exports to the applicable markets have increased significantly, and 63% citing a moderate increase, as a result of using FTAs in general (Figure 2). Trade pacts are cited by 58% of the respondents as creating new investment opportunities, while 51% say that they have opened up entirely new markets—indications that these respondents appreciate that FTAs cover more than just tariffs and deliver more than just market access.

If FTAs have such benefits, why aren't ASEAN's exporters using them more? The answers are both obvious and complex. Iwan Azis, head of the office of regional integration at the Asian Development Bank, argues that the most-favoured nation (MFN) tariffs for many products are already zero, meaning that the benefits of having lower preferential tariffs are negligible. Only in a few sectors can the benefits be reaped. He also sees a disconnect between the bureaucratic complexity of accessing FTAs and businesses' daily drive to gain profits. "Businesses are practical and pragmatic. In their struggle with day-to-day business operations, FTAs are either unknown, perceived as too costly, or not seen as their first priority," Mr Azis says.

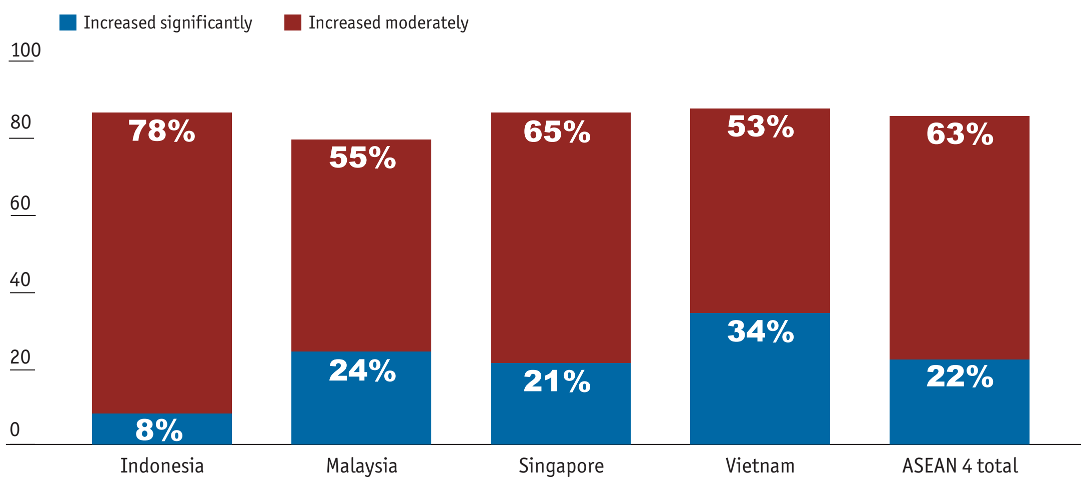
Also, for many types of goods for which tariffs have already been cut, the benefits are perceived as minimal.

"The work of eliminating tariffs has been done, by and large," says Patrick Low, a senior fellow at the Fung Global Institute in Hong Kong, and former chief economist for the WTO. "Companies may believe that the cost of accessing preferences is higher than the advantage."

> "Businesses are practical and pragmatic. In their struggle with day-to-day business operations, FTAs are either unknown, perceived as too costly, or not seen as their first priority."
>
> *Iwan Azis, head of the office of regional integration, Asian Development Bank*

**Figure 2: Exporters' advantage**

**Firms reporting increase in exports as a result of FTAs used**
(% respondents)



"You have to have the resources to understand and make the right choices [between overlapping ROOs]. But if you avoid doing your own work, go the simple route, it may turn out that your competitor has found a better way, and you lose out."

*Nicholas Kwan, chief economist, Hong Kong Trade Development Council*

These comments jibe with the ASEAN results. The costs involved are not mysterious—they amount to precious time and investment in personnel to understand and use FTAs appropriately. About half of the respondents (48%) say they do not use FTAs because of the complexity of agreement terms, while 29% say the benefits do not compensate for the difficulties in using them (Figure 3). A similar proportion, 28%, say that the FTAs are irrelevant since they already enjoy duty-free access for their products.

The problem of complexity is marginally more of an irritant in ASEAN than in China, Hong Kong, Australia or India, also surveyed by the EIU. In these four markets, 42% of the respondents cited complexity as a reason they don't use FTAs. The disparity may be a reflection of the sheer number of FTAs signed and in force by governments in ASEAN. The proliferation of FTAs—sometimes dubbed the "noodle bowl" of overlapping and entwined agreements—has encouraged indifference toward the agreements. Just 9% of the respondents among the ASEAN countries say that they use all FTAs they are aware of.

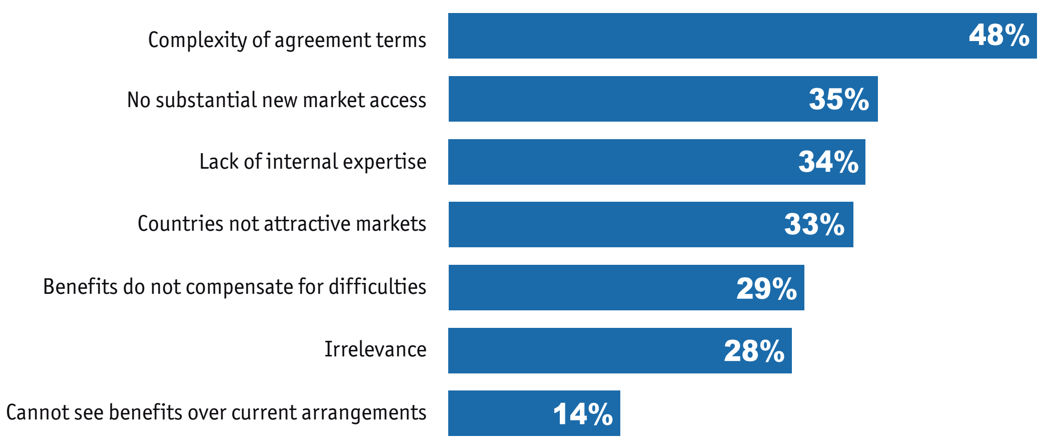
Just what is this complexity? One problem is the rules of origin (ROO) requirements embedded in the pacts. The ROOs are needed to determine the national source of a product, due to the fact that in most cases duties and restrictions depend on the source of imports. ROOs' purpose is to prevent "trade deflection", particularly in the context of global production networks that involve intermediate goods made in two or more countries that eventually are combined into a single finished good. According to a study, *The WTO and Preferential Trade Agreements* (2011)[4], "ROOs may result in far less trade liberalisation than is implied by the preferences granted. This is because ROOs, when restrictive and complex, may raise transaction costs for firms to a degree that makes utilisation of FTA preferences uneconomical."

Companies face difficulty in sifting through competing ROOs within overlapping agreements in ASEAN, but generally prefer the flexibility of being able to choose between ROOs for the same product, as one ROO may be better aligned with technology and production processes of a given industry.

Satisfying conditions for ROOs is another thing. Hoa Sen's Mr Vu notes that FTAs are not too complex in general for his company to navigate, but that "it is sometimes difficult to satisfy the

**Figure 3: Let's not bother**

**Reasons for not using FTAs**
(ASEAN 4 total, % respondents)




[4] WTO, World Trade Report 2011; The WTO and Preferential Trade Agreements

conditions to receive preferential treatment under an agreement. Regarding rules of origin, in reality enterprises cannot satisfy and effectively exploit the preferential terms."

Complex ROOs in existing trade deals impose a burden on companies both in terms of the resources needed to abide by them and the potential opportunity costs of failing to do so. Nicholas Kwan, director of research for Hong Kong's Trade Development Council, puts it this way: "You have to have the resources to understand and make the right choices [between overlapping ROOs]. But if you avoid doing your own work, go the simple route, it may turn out that your competitor has found a better way, and you lose out."

## Getting the message out

The survey suggests that governments in ASEAN might have leeway in increasing FTA usage rates by education and outreach programmes. A clear majority (64%) say that they would like to see greater outreach to businesses like theirs on trade issues by government (Figure 4). This stands in contrast to the EIU survey of China, Hong Kong, Australia and India, where fewer respondents (45%) call for greater government outreach.

To be sure, governments in ASEAN typically have education programs to help companies access FTAs. Rizar Indomo Nazaroedin, director for regional cooperation at the Investment Coordinating Board of Indonesia, notes that his government provides seminars in all local states and that it briefs local government regulatory offices. But he admits, "There's a lot of public information, but when companies seek to implement, they need direct assistance, a resource person able to respond to their queries on a regular basis. This is something we cannot provide at this moment."

The ADB's Mr Azis says, "A seminar is one thing, but facing the reality is another. Actual serious efforts on the part of governments to promote FTAs are not as common." None of the countries in ASEAN has the thorough approach of South Korea, he says (which was not included in the EIU survey). "Korea has a systematic plan, bringing a number of institutions into the process, including the ministries of finance and commerce, not just the trade ministry."

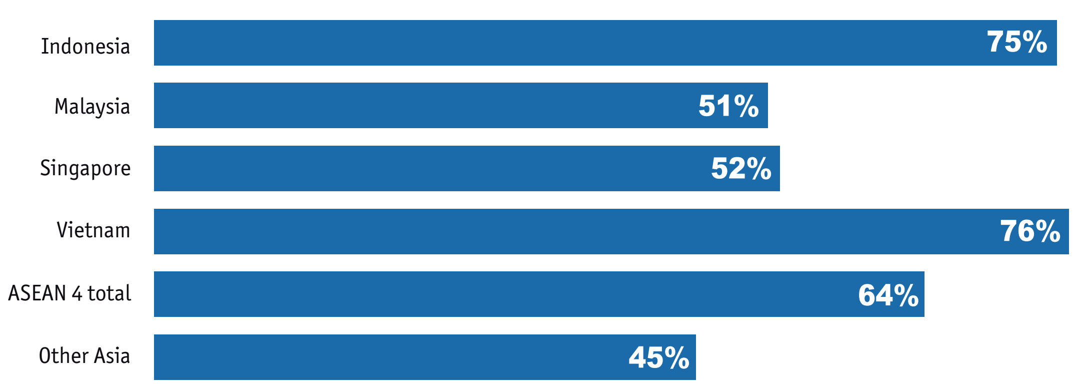
Difficulty in using FTAs imposes opportunity costs not only on companies in ASEAN, but on societies as well, in loss of job creation. Larger companies can most afford to absorb the costs associated with FTAs and will be more likely to

"A seminar is one thing, but facing the reality is another. Actual serious efforts on the part of governments to promote FTAs are not as common."

*Iwan Azis, head of the office of regional integration, Asian Development Bank*

**Figure 4: Speak to us**

**Would like to see greater outreach to businesses like mine on trade issues**
(% respondents)




NB: Other Asia = Australia, China, Hong Kong, India have established supply chains and or a wide distribution of global sales. They also have the means to lobby their governments for direct help on FTAs. But as mature businesses, they are not adding large numbers of jobs.

But it is expansion in the small-to-medium-sized sector that offers the greatest route to job creation, and this is precisely the sector that is more likely to be stymied by the complexity and costs of accessing the benefits. This suggests that societies are being short-changed of the positives of the FTAs their governments have signed.

"If utilisation of FTAs is going to be raised," says Mr Azis, "it will have to offer benefits beyond tariffs and it will have to arise from the efforts of policymakers." This is the only way, he says, "for access to existing opportunities in the business sector [under FTAs] to go up dramatically."

# 2 Life inside the "noodle bowl"

*Disenchantment with multilateral approaches led to multiple FTAs in ASEAN; so many, in fact, that companies face an uphill battle trying to find out how to use them*

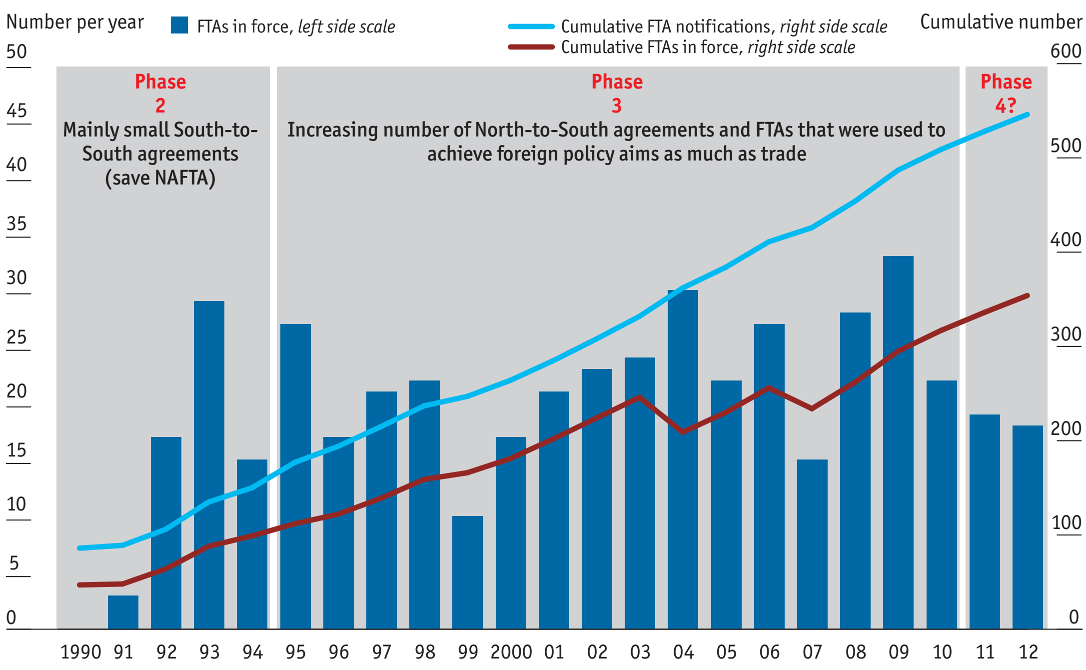
The global trade agreement framework has evolved in several stages, from GATT (precursor of the WTO) to the proliferation of smaller bilateral and then regional deals as the multilateral framework has struggled to achieve consensus (Figure 5).

Asia's "noodle bowl" of overlapping free trade agreements emerged from within the multilateral approaches to such deals.

According to the WTO, this "conversion to regionalism can be traced in part to the international community's inadequate reaction to the collapse of Asian trade following the Asian financial crisis in 1997."[5] The reaction led to the many bilateral pacts negotiated between separate nations in Asia, and beyond, and also to the expansion of the ASEAN Free Trade Agreement to the ASEAN 10-plus-4 framework that exists today.

## Figure 5: Now entering stage 4

**The evolution of global trade agreements**




NB: "Phase 1", under GATT, is not included in this diagram.

Source: Economist Intelligence Unit, adapted from Craig Van Grasstek, *The History and Future of the WTO*, WTO, 2013.

[5] WTO, World Trade Report 2011

In 2003, the ASEAN trading partners agreed to create the ASEAN Economic Community, a unified market along the lines of the European Community that would introduce the free flow of goods, services, investment and skilled labour, and the freer flow of capital.[6] The target for integration is 2015.

Meanwhile, a push towards mega-regionalism has accelerated over the past decade. These pacts aim to incorporate elements of trade liberalisation that have eluded the WTO, under the auspices of huge trading blocs (Figure 6). Two of the three largest of these include many Asian markets. The Trans-Pacific Partnership (TPP), a proposed bloc with 12 negotiating Pacific Rim partners; the Regional Economic Comprehensive Partnership (RCEP), a proposed partnership between the 10 states in ASEAN and six other nations with which these states have existing FTAs. The Transatlantic Trade and Investment Partnership (TTIP) is a proposed FTA between the EU and the US.

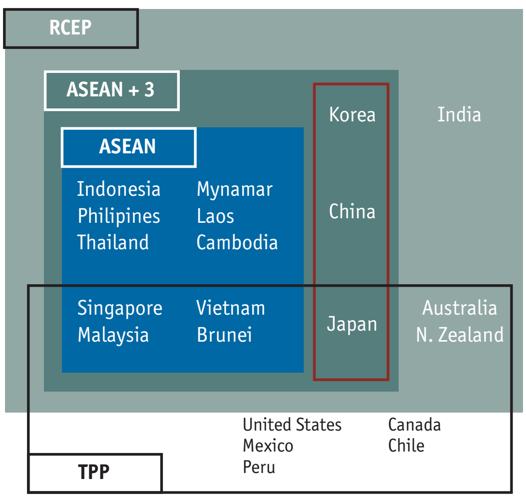
## An ambitious trade agenda

Mega-regional trade pacts under negotiation now—with the TPP and RCEP of the most immediate concern to ASEAN governments—aim to address "behind the border" issues, such as trade in services and issues such as investment, financial services, telecommunications, e-commerce, intellectual property rights, competition policy, customs cooperation, environmental rules and sanitary and phytosanitary measures (keeping food free of contamination and toxins).  Agreement on how to handle these is, on the evidence, not easy and negotiations for both have been marked by delays.

To a degree, the goals set down by mega-regional pacts are attractive to the respondents in the survey. Some 81% of respondents see it as very important or important that their governments sign FTAs with more comprehensive provisions. A clear majority of respondents (77%) either believe it very important or important that their governments sign FTAs with larger economies (Figures 7a and 7b).

### Figure 6: The mega-regionals

Proposed regional trade agreements



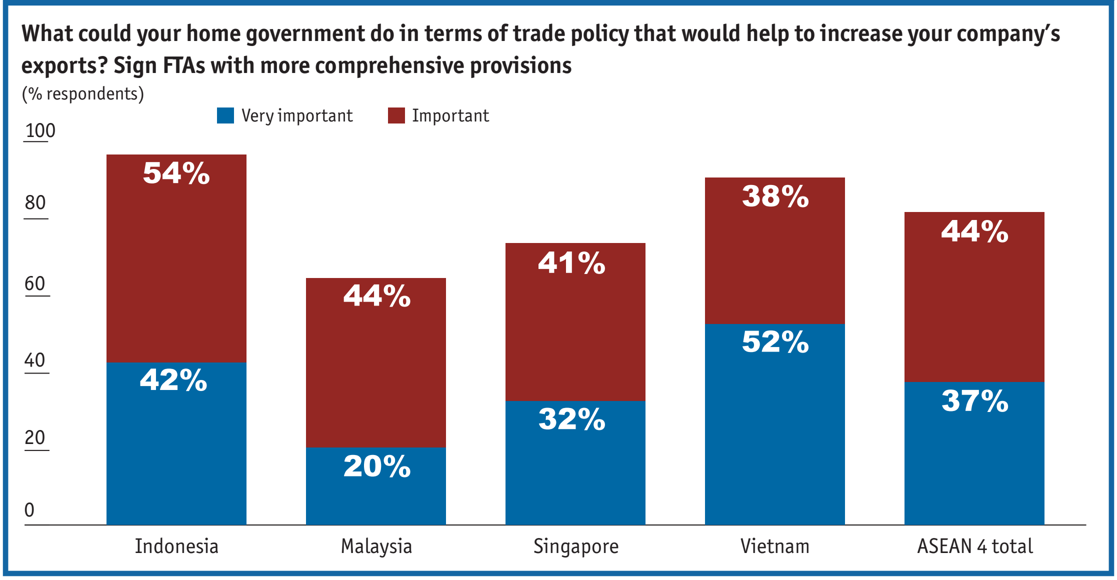

**Regional agreements: size and world share**

| FTA | Trade (2013) | | GDP (2013) | |
|---|---|---|---|---|
| | US$bn | % world | US$bn | % world |
| TTIP | 15,860 | 43.1 | 34,171 | 46.2 |
| TPP | 9,449 | 25.7 | 27,750 | 37.5 |
| RCEP | 10,693 | 29.1 | 21,268 | 28.7 |
| CJK FTA | 6,784 | 18.4 | 15,305 | 20.7 |
| World | 36,774 | 100 | 73,982 | 100 |

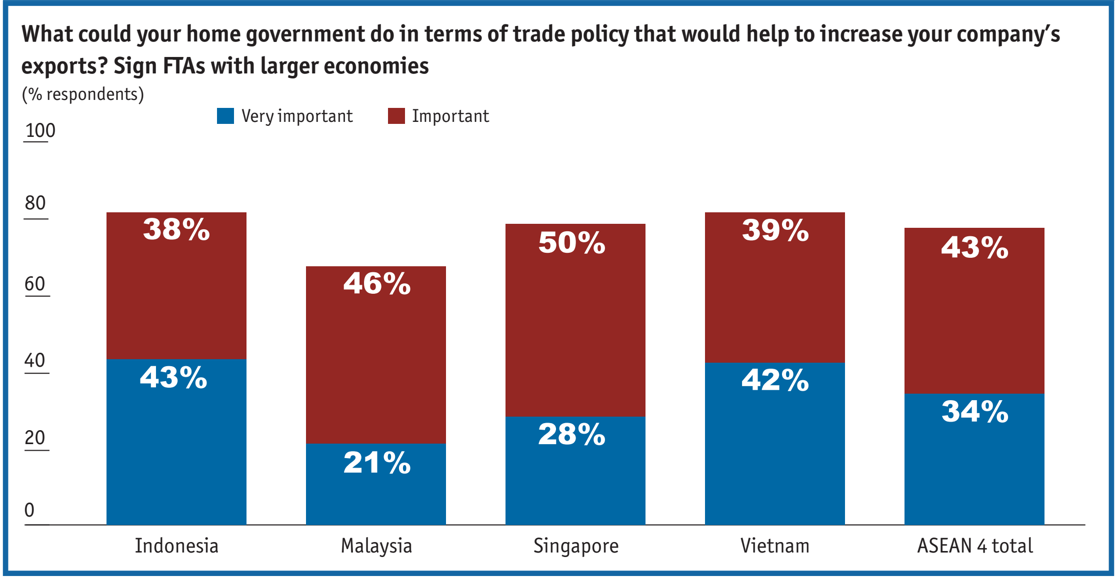
Source: EIU; diagram adapted from Yorizumi Watanabe, *The Growth Strategy and the TPP*; 2013. 2013 data in table from International Trade Centre, IMF, EIU.

[6] Siow Yue Chia, *ASEAN Economic Community: Progress, Challenges, Prospects*, 2013

## Figure 7a: Better...




## Figure 7b: ...and bigger




Yet "behind the border" issues—the thrust particularly of the TPP—seem to be of limited relevance to the ASEAN respondents. Only 37% say that they would like to see greater focus on cross-border issues other than trade (i.e. trade of goods), such as investment protection and promotion, visas and the movement of labour and other concerns. It could be that policymakers and negotiators overstate these issues, but it is also the case a lot of the costs imposed are hidden from exporters' direct view.

Stasis in negotiations and limited interest by businesses may be an outgrowth of the same issue: the pacts contribute to a sense of disbelief in attempting to do so much in mixing economic and social goals. Some of these goals address non-tariff barriers like bureaucratic delays by customs officials; others social goals, such as environmental regulation, that are intended to use trade as a lever for sustainable production. Liberalisation of trade in services, meanwhile, requires a shift in mindset, demanding a look at the whole business of trade in a different way.

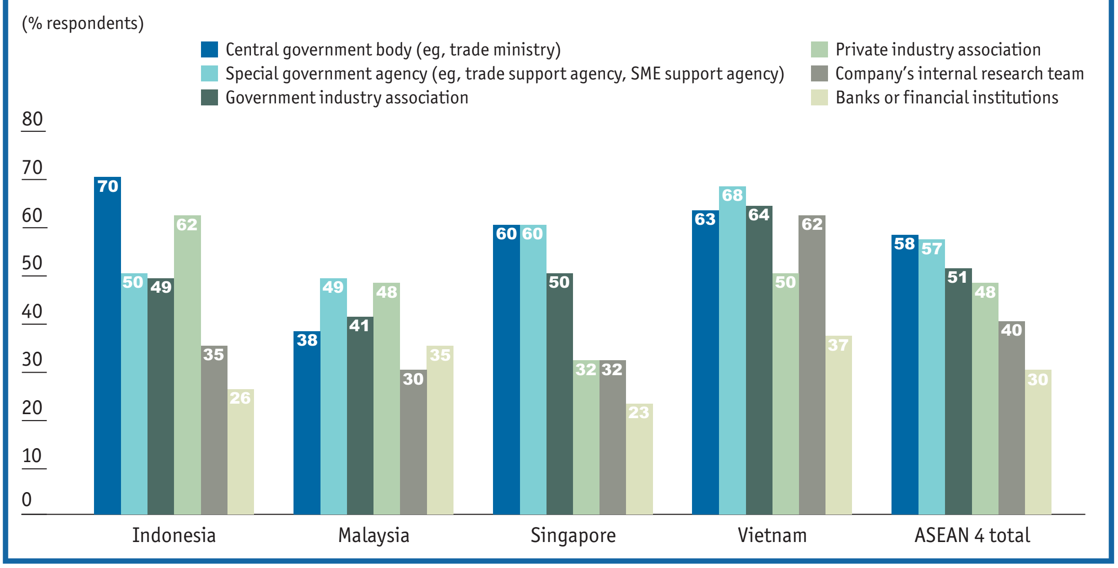
## No easy path to information

As the "noodle bowl" expands, companies face a confusion of choices. Deborah Elms, executive director of the Asian Trade Centre in Singapore, points out that small and medium-sized enterprises in particular face obstacles in finding information. "It's difficult for companies at that level," she says. Singapore's information system on FTAs is computerised, but an exporter, say, of paper cups to Malaysia still must navigate the system armed with some foreknowledge. "If you're that cup exporter, the system should tell you right away that there are five agreements that you use here, these are the different rules of origin, and these are the preferential tariffs," says Ms Elms. "The government relies on you to find out what options are available to you. If that's the way it is in Singapore, imagine Indonesia."

A significant majority (73%) of survey respondents regard it as very important or important that the government provides more support in terms of education and advice on existing FTAs. Of those that do not use FTAs that they know about, a big majority (84%) say that lack of internal expertise is a very important or important reason for not doing so, strongly implying the need for more information resources.

Only 38% of respondents from Malaysia turn to a central government resource for information on how to use FTAs, suggesting a need for greater information outreach there. In comparison, 70% of Indonesian and 63% of Vietnam company respondents tap their trade ministries for guidance on how to use FTAs (Figure 8). More respondents from Vietnam said they used alternate government resources, such as a special government agency (68%) and government industry association (64%), than respondents from the other nations. Ms Elms says that Vietnam still has robust information channels in place in the wake of its push to join the WTO in 2007.

**Figure 8: Sources of information on FTAs**



# Case study: Hoa Sen: Pushing for the Trans-Pacific Partnership

***Steelmaker Hoa Sen Group chairman sees a great advance for Vietnam if the TPP ever comes into force***

Le Phuoc Vu, chairman of Hoa Sen Group, Vietnam's second-largest steel producer, began a business selling sheet steel at a crossroads near Hanoi in 1994 with savings from his wages and a bit of family money. In its financial year 2013, Hoa Sen boasted US$252m in steel exports, up from US$180m in 2012 and only US$5m in 2009.

Free trade agreements have played a major part in taking Hoa Sen down this road. A sweeping reduction of tariffs as part of the ASEAN Free Trade Agreement in 2007 allowed Hoa Sen to start selling its rolled steel to companies in neighbouring ASEAN states (Vietnam had joined ASEAN in 1995).

Now Mr Vu has global ambitions that he believes can only be satisfied by the Trans-Pacific Partnership, that trade pact under negotiation with 12 nations, including Vietnam, on the Pacific Rim.

"The agreement of the TPP can help Hoa Sen Group to boost exports to TPP nations, including Mexico, Chile and Peru, since we currently face import tariffs as high as 25% in Mexico, 6% in Chile and 5% on some products in Peru. Hoa Sen Group expects to export at least 120,000 tonnes of steel a year to the Americas within a year of any agreement on the TPP, compared with less than 12,000 tonnes a year now," Mr Vu says.

The benefits will be more tangible than just an increase in sales volume. Hoa Sen's transportation costs to North and South America are onerous because it ships a relatively small amount of steel there. But a removal of tariff barriers under TPP would allow it to "use full ships to carry our products, which can reduce transportation costs and increase our competitive advantage."

Mr Vu also sees the TPP as Vietnam's best chance to move up the value chain in global manufacturing. The TPP would encourage greater investment in Vietnam from the US, Australia and New Zealand. This would help "especially in areas which Vietnam wants to develop such as high-tech industries, improvement of the industrial sector, services and agriculture, enabling Vietnam to better participate in the regional and global value chain."

The TPP would position Vietnam to capitalise on the slowing of China's growth, and the rising cost of doing business there. Many manufacturers have already moved portions of their supply chains to South-east Asian nations, including Vietnam. The TPP would accelerate the process by offering "a large door giving Vietnam chances to become a regional trade hub, especially in those areas where China's influence is fading, thanks to Vietnam's ideal location at the southern border of China," says Mr Vu.

# 3 Tariffs are just the beginning

*High duties are no longer necessarily a barrier to trade in ASEAN, but the liberalisation of services and investment will be a lot harder to achieve*

With the reduction of tariff barriers already effective on many manufactured goods through ASEAN, access to remaining benefits can simply be too much trouble. Many producers of goods that have already seen a lot of trade liberalisation might think that FTAs currently in force are of limited benefit to their companies—reflecting the generally low level of ambition in existing FTAs. Lack of confidence in government handling of FTAs appears to fortify this scepticism. About half (55%) of ASEAN respondents strongly agree or agree that their government does not consider their business's interests and needs when conducting FTA negotiations.

As mentioned, about half of the companies (48%) responding to the survey cite negotiating complex rules as a reason they don't use FTAs that they are aware of.  But only 29% say that the benefits do not compensate for the difficulty of using FTAs and a mere 14% say they cannot see the benefits over current arrangements. This suggests that companies might be open to seizing more benefits if they encountered less costs due to time and complexity.

"It is relatively difficult for all kinds of businesses to see the benefits against wading through of hundreds of pages, shortage of resources in many cases, and the time involved," says Mr Kwan.

## Taking FTAs to the next level

Many fault existing FTAs for being unambitious in their primary focus on tariff reduction, but arguably this simplicity has been necessary to ensure the deals got signed at all. The next crucial step—the freeing up of trade in services and investment—has met with almost no success at the WTO level, and not much more in South-east Asia's regional deals.

"If it's done at all in ASEAN, it's done in the most limited fashion," says Ms Elms.

Liberalisation of trade in services becomes more relevant to trade growth as modes of production undergo great change in the region. As ASEAN and other East Asian markets have gradually lifted trade barriers, multinational companies have dispersed supply chains throughout the region, led by electronics and automotive firms. The trend now includes Cambodia, Laos, and Myanmar.

When supply chain fragmentation increases, connectivity becomes dependent on services. Several types of service may be involved in delivery of a particular type of product.[7] Sometimes a service cannot even be separated from the actual good it supports. Mark Holloway, supply chain director for the Asia Pacific Region at Diageo, a beverage company, likes to stress that a bottle of whiskey exported to say, Vietnam, has minimal cost tied up in the

[7] Stuart Harbinson and Aik Hoe Lim, "Trade in Services", in *Transpacific Partnership: A Quest for a 21st Century Agreement*, 2012

physical spirit or the bottle. Most of the cost—bottling, packaging, marketing, distribution, legal services and financing—are tied up in supply chain services, often "fragmented" over varying locations.

But although freeing up of trade in services is included in the AEC Blueprint as well as in the goals of the TPP and RCEP, government resistance could stand in the way. "The reality is countries are very partial to liberalisation of services only if the net benefit is to them," says Simon Littlewood, president of Singapore-based finance and accounting consultant Asia Now, a firm of about 30 employees that exports services throughout Asia. "It's all right if you're London or Singapore, but if your economy has not developed a service infrastructure, all you will think of is how it will suck money out."

As difficult as loss of tax revenue may be for governments to contemplate, the openness required of true liberalisation of services is a bigger stumbling block. Governments would be required to have "national treatment"—treating foreigners and locals equally—for treasured assets like telecommunications companies. "They'd have to forgo extensive controls on participation of foreign ownership," says Michael Plummer, Eni professor of international economics and director, SAIS Europe, Johns Hopkins University.

## Invisible enemies

The appeal of trade barriers even on physical goods still abounds in ASEAN. Indonesia—part of the AEC and in negotiations with the mega-regional RCEP—imposed a ban on raw mineral exports and a 20% tax on export of mineral concentrates in January 2014. The purpose was to stimulate investment in the nation's refining industry. It has succeeded in shutting down exports in minerals like nickel, bauxite, and iron ore—all major exports from Indonesia—estimated at US$500m per month.

Non-tariff barriers come in more mundane varieties. Robert Yap, chief executive of YCH Group, a Singapore logistics provider, notes that the diversity of ASEAN is a strength—offering variance in cost structures across the region supportive of supply chains—but also gives rise to irritating NTBs such as regulations requiring different types of equipment on trucks from nation to nation. Local business groups ensure these regulations remain in place. That bumps up his company's costs.

"NTBs are like an invisible enemy," Mr Yap says.

"The reality is countries are very partial to liberalisation of services only if the net benefit is to them… It's all right if you're London or Singapore, but if your economy has not developed a service infrastructure, all you will think of is how it will suck money out."

*Simon Littlewood, president, Asia Now, Singapore*

## Case study: The eCEOs: Laborious work

Malaysian project management and business intelligence solutions firm The eCEOs may currently derive around nine-tenths of its revenues from its home market, but it has clear regional ambitions. CEO Jailani Mustafa hopes its international business will account for up to 40% of sales within the next three years. The company recently launched operations in Indonesia and is ramping up hiring in South-east Asia's biggest economy.

Given its pedigree and focus, The eCEOs would seem naturally positioned to take advantage of ASEAN's growing integration. But despite being—along with the CFO—the lead arbiter of the company's trade strategy, Mustafa says he "doesn't have much visibility" on how it's benefited from ASEAN's patchwork of free trade agreements, or what it may gain from the establishment of the ASEAN Economic Community in 2015.

Part of that has to do with location. Based in Malaysia's Multimedia Super Corridor (MSC), a technology-focused special economic zone, The eCEOs is generally free to source talent from around the world and has already been importing much of its hardware tariff-free for a decade. "I don't really see more benefits [from the ASEAN FTAs] as to some extent we have them already," Mr Mustafa says.

As the firm expands in other ASEAN markets, regional pacts will become more important—but unfortunately, says Mr Mustafa, they don't tend to apply where they're needed most. "The agreements already in place relate more to products and goods, not services," he explains. "There are non-tariff barriers or issues that make things more difficult—like work permit applications, security and local content requirements."

Top of The eCEOs' wish list, says Mr Mustafa, is for trade agreements to extend to labour policy. Getting staff the right to work in other ASEAN markets can still be "nightmarish," making it difficult for technology companies to temporarily deploy workers to tackle a large project or train new recruits. He also hopes to see the easing of limits on foreign ownership and requirements that foreign companies team up with local partners. "That would be liberalisation for our business."

Despite the lack of progress in some areas, Mr Mustafa credits ASEAN and its secretariat with doing a good job in sometimes less than ideal conditions. "[ASEAN is] very consensus-driven, so it's difficult to move on policy," he says. "They've been struggling to get some initiatives implemented. I think [the ASEAN Economic Community] could be something far from what was envisioned."

# 4 ASEAN, the AEC and China: A changing trade relationship

*Opportunity abounds for both the ASEAN trade bloc and China as the AEC unfolds, depending on how China adapts to ASEAN's success*

Ten years ago the land around Bac Ninh, a town about 30 miles from Hanoi, looked like a lot of territory in the country's north—sun drenched, lushly green, roads elevated from rice paddies occasionally decorated with young trees. Since then there's been a new addition to the landscape: South Korea's Samsung has built two major production facilities in a new industrial park there. This bit of FDI, its fourth greenfield project in the country, brings Samsung's total commitment to Vietnam to US$7bn and gives it a full production base in the country.

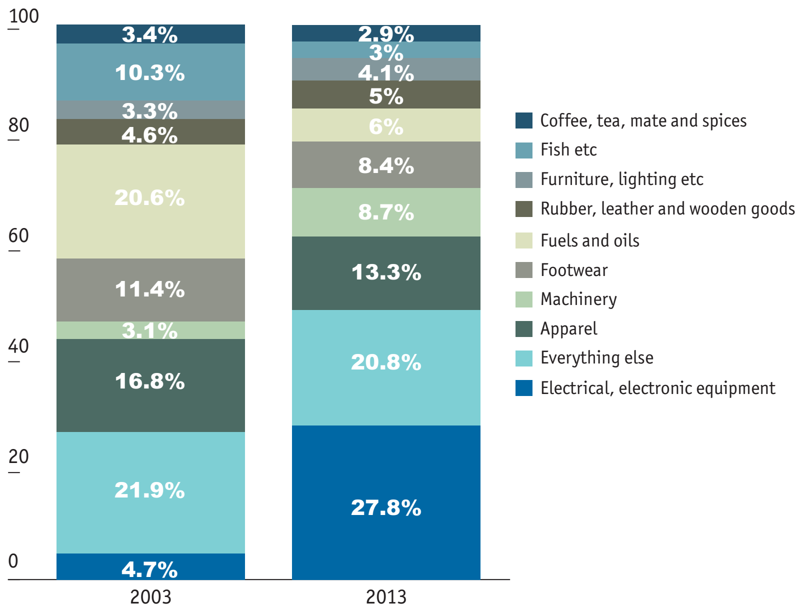
These plants were shifted from China—only two hours' drive from the town—where production costs have grown; the so-called "China plus one" strategy in action. It's less the transfer of jobs and tax income that looms as a competitive threat to China than the speed at which Vietnam is moving up the value chain.

Exports from Vietnam have been transformed in a mere decade. More sophisticated manufacturing, particularly of electrical and electronic gear and of machinery, has taken a much larger share (Figure 9). Vietnam is now host to manufacturers like Intel and LG as well as Samsung. China is still by far the largest exporter of electronics, shipping cross-border about 15 times the US$38bn in electronics exported from Vietnam last year. But Vietnam has reached this level from almost zero in a mere decade. Vietnam, in other words, has become very competitive with China very quickly.

The nation has had a little help from its ASEAN friends. In common with the newer nations to the bloc, Vietnam has been granted a longer period to meet full compliance with the ASEAN Free Trade Area and other deals signed by the bloc—advantages that have benefitted its fast development. It has also been allowed to delay ratifying reduction of individual tariffs, such as those on automotive parts.

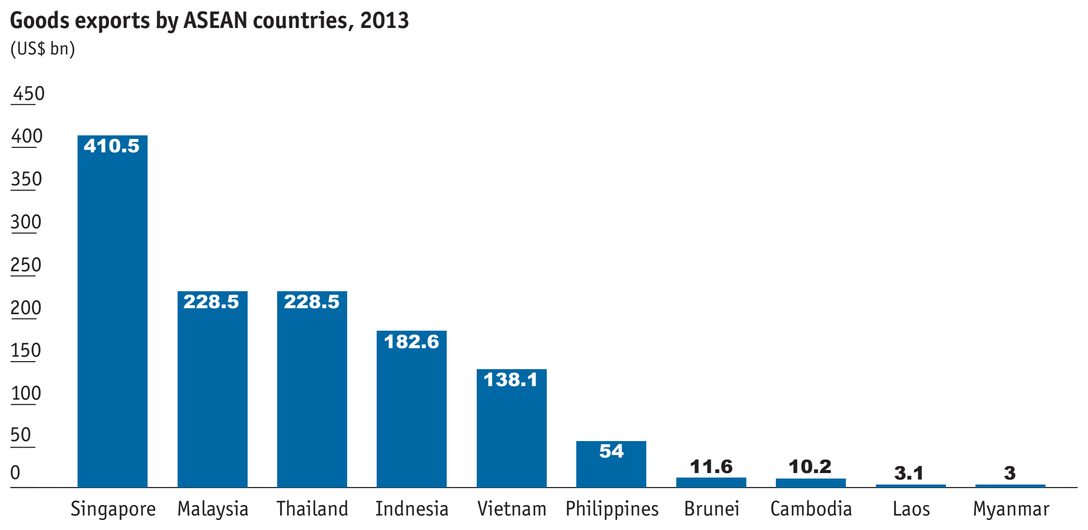
**Figure 9: Up the value chain**

**The changing shape of Vietnam's exports**




Source: International Trade Centre, based on UN COMTRADE statistics

## Figure 10: Shipping more and more



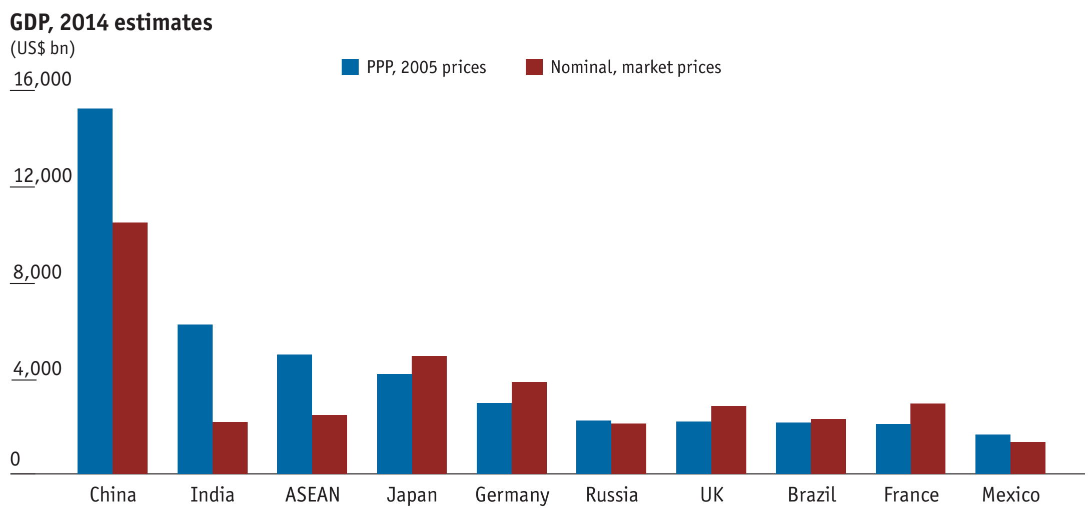

Source: International Trade Centre calculations based on UN COMTRADE statistics. 2012 for Myanmar

## Mutual benefits

Vietnam is only the showcase example of how fast nations can develop in ASEAN as trade barriers fall. According to EIU estimates ASEAN countries' combined GDP in 2014 will reach nearly US$5trn in purchasing-power-parity (PPP) terms (rebased to 2005 constant prices). That is still a long way behind the Chinese economy but it is bigger than Japan. The region's ongoing growth also means that ASEAN output in these terms has risen to be roughly two-fifths bigger than the powerhouse of the eurozone economy, Germany, and is nearly three times that of Brazil (Figure 11).

China has been the primary partner in the bloc's prolonged economic advance. Trade interdependency between ASEAN and China is reflected by the intensity of the growth, up 10.9% year-on-year to US$444bn in 2013, exceeding China's total trade growth rate for

## Figure 11: ASEAN's growing economic power




Source: The Economist Intelligence Unit

the year of 7.6%. The nature of the relationship is changing: as mentioned, lower-cost assembly of electronics is beginning to make more sense for ASEAN's less developed economies than for China. But as China's economy transitions to one based more on consumption rather than investment, and with a growing middle class eager for rich-world products and services, China will increasingly be a greater source of final demand for ASEAN's exports.

Everyone expects ASEAN to keep growing at strong rates for some time (the EIU forecasts average GDP growth per annum for the bloc of 5.6% for 2014-2018). But the sustainability of that growth will be determined by its success in reaching for those "higher hanging fruit" laid out in the ASEAN Economic Community's blueprint: liberalisation of services trade, lowering investment barriers and loosening capital flows.

It is inconceivable that China plays no part in this, simply because of that interdependency. Sluggish though negotiations on the Regional Comprehensive Economic Partnership may be, the exclusion of China in the US-led TPP galvanized China's involvement in the RCEP, making China the pivotal figure in negotiations.

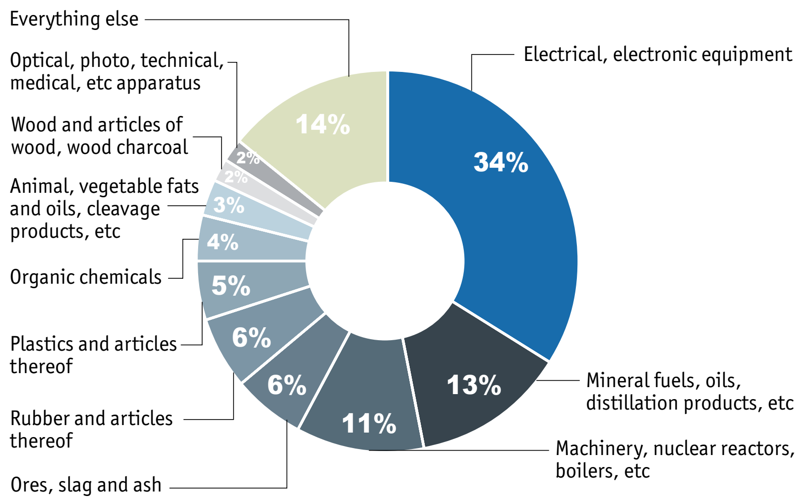
Mr Plummer argues that the common view that two pacts are in direct opposition—a vying for Asian influence between US and China—lacks nuance. He argues that China has left the door open regarding the TPP, and wants to know how next-generation aspects of trade liberalisation proposed for the TPP could benefit China. "But they have to be encouraged," he says.

Whichever acronym emerges from the alphabet soup, China will have to play a major role, in the view of regional businessman Mr Yap at YCH Group. He is suspicious of any kind of mega-regional free trade policy environment following the onset of the AEC without China in a leading role.

## Figure 12: What China wants

**China's imports from ASEAN, 2013**

(% respondents)




Source: International Trade Centre calculations, based on national statistics and the UN COMTRADE database

"China has to take an important role in the development of ASEAN, because it has so much to gain," says Mr Yap. Under this scenario, China would see ASEAN not only as a competitor but a region that provides a springboard for China's own expansion.

After all, under its FTA with ASEAN, China's own companies can exploit the same advantage seized by multinationals by establishing their own supply chains in the region, gaining similar pricing power and economies of scale. Some, like computer maker Lenovo and white goods manufacturer Haier, have already done so. Haier, for example, bought the white goods business in Indonesia, Malaysia, Vietnam and the Philippines from Japan's Sanyo Electric in 2012.

This is happening in anticipation of the AEC across sectors. China's biggest e-commerce company, Alibaba, in one example, bought a 10.35% stake in Singapore Post in May 2014 for US$314m. This followed Alibaba's opening of localised versions of its Taobao Marketplace in 2013, and a training school in e-commerce in Thailand the year before. There are rivals, of

> "China has to take an important role in the development of ASEAN, because it has so much to gain"
>
> *Robert Yap, chief executive, YCH Group, Singapore*

course, in every sector. In e-commerce, Japan's largest online retailer Rakuten set up a base in Singapore in 2013 with the aim to expand in South-east Asia.

## A piece of the action

China's companies will want to be part of the action as a host of industries benefit from a more trade-friendly ASEAN.

Companies in the 12 priority sectors laid out in the AEC Blueprint—agri-based goods, air transport, automotive products, e-ASEAN, electronics, fisheries, health care services, rubber-based goods, textiles and clothing, tourism, logistics and wood-based products—all will enjoy better access to neighbouring markets, though each faces specific impediments. Harmonisation of rules in the agri-food sector, for example, will be needed before an advance in trade in this sector can really take place. These include uniform regulations on nutrition labeling, pre-market product registration and other non-tariff barriers such as sanitary and phytosanitary rules.

Some reform in the banking sector has already been underway in preparation for the AEC, but the pace of liberalisation will accelerate, benefitting this sector as well. Insurance companies, meanwhile, could be winners in the race to establish regionwide markets, but this would require a harmonisation of risk-based-capital regimes in the ASEAN 10. Any effort of this nature would lead to consolidation, with the stronger players buying their small, less-capital-adequate counterparts. If ASEAN sticks by its program to expand the limited number of compulsory insurance regimes across the region to include manufacturing, the survivors will be able to enter new businesses.

As the expansion in these sectors is underway, tech companies will be needed to write software for uniform cross-border systems. In this context, rules governing data flows across borders and "digital trade" are also becoming increasingly important, as the line between what constitutes a good and a service is further blurred. Meanwhile, companies that specialise in business processes—from human resources specialists to back-office services—will be able to ride the wave of regionwide demand.

Perhaps the most immediate beneficiary will be in e-commerce companies. Both Alibaba and Rakuten are looking to adapt successful models from their home markets to catch ASEAN's eager e-consumers. Their early investment underscores their ambitions.

## Just words?

The biggest fear about the AEC is that it's all just words. ASEAN's high ambition to pluck the high-hanging fruit of services liberalisation is impressive—but it hasn't even managed a single window for customs, or made real headway against non-tariff barriers. Mr Plummer worries that the advent of the AEC will be applauded in 2015 and that will be the end of it.

That would be a shame. It will take liberalisation on the scale proposed by the 21st Century FTAs to engage that portion of ASEAN's economy that collectively holds the biggest key to greater wealth creation: smaller and medium sized businesses. Though they account for the bulk of employment and GDP in ASEAN, the participation of these firms in the region's lucrative production networks is low: 38% compared to 72% by large firms, according to research by the ADB into five representative ASEAN markets in 2012.[8]

This suggests that lack of engagement by smaller companies—the majority of respondents to the EIU ASEAN survey—undermines the region's pace of advance—and that the AEC will have to continue its trade liberalisation agenda after the fanfare dies down if its governments wish to ignite their growth potential.

[8] Ganeshan Wignaraja, *Engaging Small and Medium Enterprises in Production Networks*, Asian Development Bank, 2012

# Case study: YCH: Gradualism the key for ASEAN integration

***YCH's chief executive believes the AEC can only take off if the more-developed economies allow the least-developed a little time***

Robert Yap took over his father's home-grown Singapore transportation business 30 years ago. YCH—his father's initials—is a full-fledged supply chain solutions provider serving the Asia-Pacific region, and one of the largest local logistics providers in Singapore.

In the intervening years, YCH's stages of expansion tracked ASEAN's journey to freer trade. It started handling cargo in Singapore's port in the 1990s, and fanned out across the region to service multinational customers a few years later. It entered into supply chain solutions, developing its own information technology, as trade barriers were falling in 2007 (with broad reduction in tariffs across ASEAN) and in 2010 (with China).

As the ASEAN Economic Community beckons next year Mr Yap combines high expectations for the pact with anxiety that the AEC's vow to liberalise services will hit a protectionist wall.

"We're a services company, and removing barriers to services under the AEC would allow us to be a lot more aggressive," he says. "We could compete directly against a local company in new markets. And we could tap cross-border investment into those markets. It would make our local rivals more aggressive too—that's better for customers."

But he adds, "It is also very difficult to achieve common ground when talking about services, even within the bigger trading blocs."

This is particularly so in ASEAN. Countries are moving at different speeds. Mr Yap's idea to mitigate any stall in progress would be a phased liberalisation of services, allowing reluctant ASEAN members more time to prepare. A similar gradual approach has been taken with tariff cuts. "The diversity of ASEAN has always been the foundation of the relationship among the neighbours," Mr Yap says, perhaps allowing for greater patience with the stragglers in the pack.

Mr Yap cites his own company's policies as an example of gradualism in action. YCH hires networks of small businesses as partners in Indonesia. "You cannot possibly ask people from local family firms in Surabaya to be a good complementary partner unless you invest in education, training, and business process. After a while, you actually become instrumental in helping those companies move up the value chain."

His advice to the integrators of ASEAN: "The general feeling of kicking off in 2015 is positive, but we should look at it as the beginning of the game, not the end. We may have to accept that some will at first be more open than others."

# 5 Conclusion: Is ASEAN ready for 21st century trade?

*For exporters to access the huge growth potential of ASEAN, future trade deals must address the tough issues*

The average usage rate of the FTAs signed and in effect in ASEAN is a mere 26%, according to the EIU survey. Yet some 72% of the respondents believe that FTAs are the best hope for the future of their overseas businesses.

The gap between usage of FTAs and awareness of value is down to the current stage of development of FTAs—and the quality of the existing deals. The proliferation of bilateral and regional agreements in ASEAN have succeeded in lowering tariff barriers in many goods to the degree that businesses may see little point in going through the trouble of accessing existing preferences. But they simultaneously recognise that they potentially have a lot more to offer, both for goods and, especially, services exports.

This should matter to governments because its smaller and medium sized businesses have a huge share in contribution of GDP and employment in ASEAN nations, but currently account for a smaller proportion of exports.[9] The Asian Development Bank's research that found low average participation of small and medium-sized enterprises in production networks in ASEAN identified poor affordability and quality of business support services as the main reasons.[10]

Lack of access to affordable services throws up a barrier to business expansion. Lifting barriers to services in ASEAN would encourage services companies to expand intra-regionally, consolidate and create a competitive market with prices at levels these businesses could afford. This is only one way in which better access to services allows them greater participation in lucrative production networks. Liberalisation of cross-border finance and insurance is another, as would be clearer rules on the transfer of data.

None of this will happen unless the trade deals under negotiation now engage the sharp end of free trade liberalisation. Elements that governments say they embrace, such as services, investment and freer capital flows, remain largely untouched. With the onset of the ASEAN Economic Community very nearly upon the region, policymakers who negotiate the region's FTAs will have to confront the difficult issues if they are to realise their goal of granting access to benefits of freer trade at all levels of society.

[9] Ganeshan Wignaraja and Yothin Jinjarak, *Asian Pathways: Is Finance a Binding Constraint for SME Trade Participation?* Asian Development Bank, 2012

[10] Wignaraja, *Small and Medium Enterprises in Production Networks*, op. cit.

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