Bridging Economic Borders

Free Trade Agreements

JULY 2016

Preface

International trade is important to a country's economic growth and development. The recent signing of the Trans Pacific Partnership Agreement ("TPPA") in New Zealand sees global trade being pushed into a new era. The world is witnessing global trade partnerships enlarge beyond geographic alliances for bilateral trade gains to strategic alliances for sustainable economic growth that will also enhance geopolitical influence.

International Trade Partnerships

International trading blocs form an integral part in driving how large multinational companies (MNCs) capitalise the global market access. The impact of international trades, without nose-diving into the evolution and mechanics of trade agreements, affects each and every one of us in all spectrum of our lives, even in the simplest of our daily routines; breakfast.

In this 2-part article, we look at four key roles of Free Trade Agreements ("FTAs") i.e. facilitating trade accessibility, trade efficiency, trade speciality and trade equity, with the aim to understand:

1. The evolving objectives of trade alliances or Free Trade Agreements ("FTAs"), and
2. How MNCs utilise these trade alliances to improve their competitiveness, with particular emphasis on Malaysia and South East Asia.

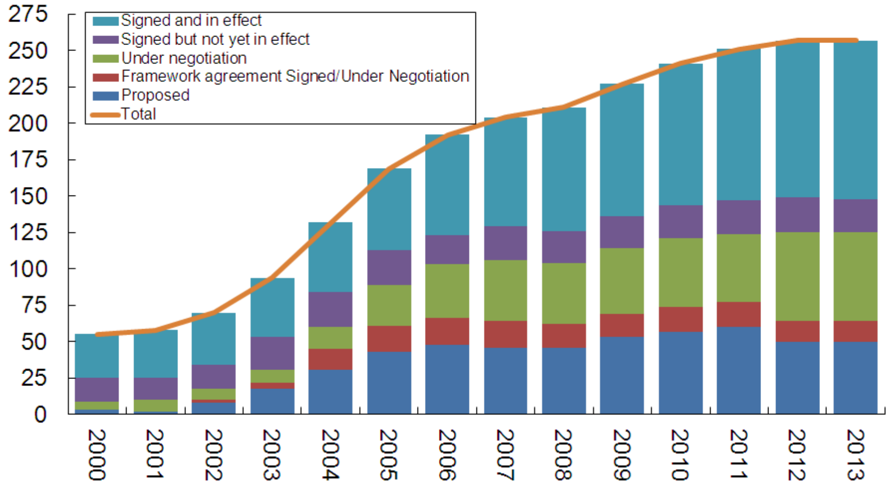
The Roti Canai

The Roti Canai, a staple breakfast favourite among Malaysians, is made of flour imported from Australia, spices imported from Sri Lanka, cooked by a foreign immigrant kitchen staff, and served on a metal plate made in Thailand.

Free Trade Agreement in A Nutshell

Trading is critical to mutual economic growth as it leverages the natural advantages of various countries and promotes competition. Nations that see they are able to gain from either exporting their products or importing another nation's inputs at a cheaper rate would try to expand trading to realise synergistic economic growth. An instrument used to facilitate this is FTAs. FTAs address fiscal barriers such as import duties and tariffs, as well as non-fiscal barriers which create complexities in cross-border shipment and sale of goods. These could be anything from licensing, quotas, product registrations or overly complicated customs processes. Recognising the benefits of trade, nations have embarked on establishing trade agreements even before 1990s such as the International Trade Organization ("ITO"), General Agreement on Tariffs and Trade ("GATT"), and the World Trade Organization ("WTO"). We see that continuing at an accelerating pace where the new era of trade agreements would involve greater number of parties and expand beyond geographic clusters and addressing more complex trade issues such as those found the European Union ("EU"), North American Free Trade Agreement ("NAFTA") and TPPA.

FTAs by Status—Asia (cumulative), selected years



FTA = free trade agreement.
Notes: **Proposed** = the parties consider an FTA; governments or relevant ministries issue a joint statement on its desirability or establish a joint study group/joint task force to conduct feasibility studies. **Framework agreement signed/under negotiation** = the parties, through relevant ministries, negotiate the contents of a framework agreement (FA) that serves as a framework for future negotiations. **Under negotiation** = the parties, through relevant ministries, declare the official launch of negotiations, or start the first round of negotiations. **Signed but not yet in effect** = the parties sign the agreement after negotiations have been completed, but the agreement has yet to become effective. **Signed and in effect** = FTA provisions become effective, after legislative or executive ratification. Data as of January 2013.
Source: *ARIC FTA database*, Asian Development Bank.

PART 1: FACILITATING TRADE ACCESSIBILITY AND TRADE EFFICIENCY

In this first part, InvestKL discusses how FTAs plays a pivotal role in facilitating Trade Accessibility by creating greater market access for flow of trade via fiscal measures, namely reduction and elimination of tariffs.

The reduction of tariff barriers between nations effectively increases the competitiveness of businesses and thus benefits consumers alike. Additionally, the input or raw materials as well as finished products obtained from member countries will be cheaper as compared to other non-member nations that do not have FTAs.

It is observed that in most trade agreements, Trade Efficiency is often the second priority where it seeks to improve the ease of doing business. Governments can achieve trade efficiency by cutting down red tapes particularly in customs administration, reducing technical barriers to trade especially in regulations and licensing, liberalising government procurement policies, putting robust competition policies in place, and enabling movement of natural persons.

Providing a predictable, transparent and consistent business environment will result in the ease of doing business, which will translate to efficiency, reduced risks and cost savings for businesses in the long term.

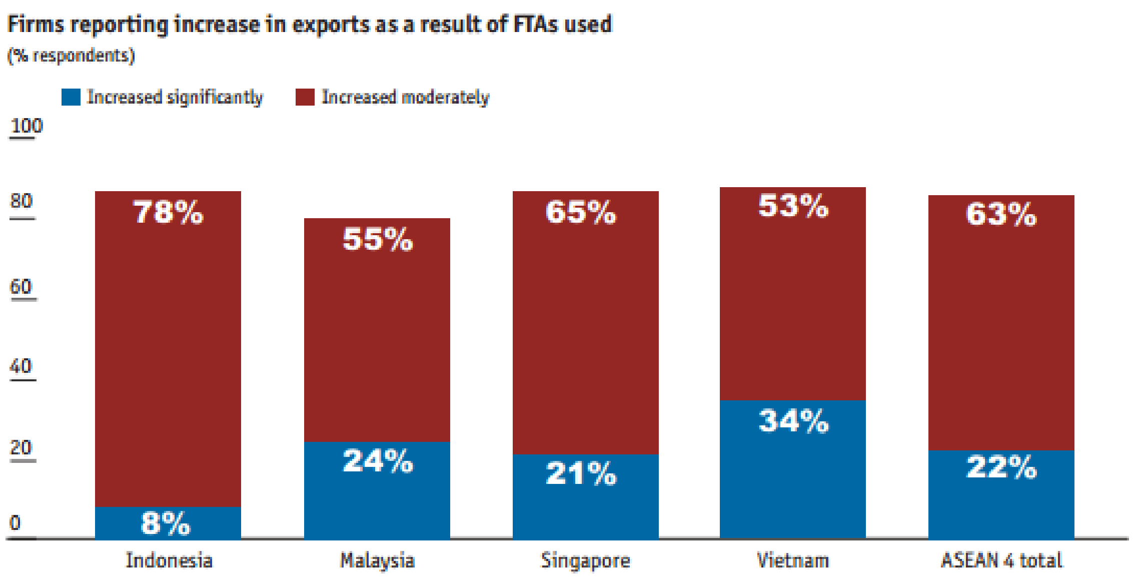
TRADE ACCESSIBILITY: ELIMINATING THE GOALKEEPERS

The first generation trade agreements such as the ASEAN Trade in Goods Agreement ("ATIGA") signed in 2009 has its primary focus on tariff elimination - a key feature of FTAs. To date, through ATIGA, Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand have eliminated intra-ASEAN import duties on 99.65% percent of their tariff lines. This can be likened to removing the goalkeepers from a football match so both parties can score more goals. How?

Source: ASEAN Trade in Goods Agreement

Removal of tariff creates greater market access between the member countries of the FTA, thereby allowing consumers to enjoy wider range of imported goods and better quality services at competitive prices. Meanwhile, the businesses, in particular the manufacturers, are able to source cheaper inputs or raw materials as a result of liberalisation. Malaysia, for example, a member country of ASEAN, has enjoyed a 54% increase in trade over 5 years with other members of ASEAN, growing from RM 251.86 billion in 2009 to RM 389.03 billion in 2014.

A recent study conducted by The Economist Intelligence Unit ("EIU") across 400 exporters in four ASEAN countries showed that 85% of the companies reported either significant increase or moderate increase in their exports as a result of FTAs used.



With a young and growing population of over 600 million people and a GDP of USD 2.5 trillion, it is no surprise that many large MNCs are increasingly setting up their production bases in ASEAN, not only to tap into the workforce potential, but to take advantage of ATIGA to grow their market share in this lucrative geography. This can be clearly seen from recent Foreign Direct Investment ("FDI") trends into ASEAN.

Source: KPMG

While tariff elimination may be a primary economic objective of ATIGA, a broader benefit of a geopolitical integration is that ASEAN now has the size and scale to begin negotiating trade agreements with its larger neighbours. Between 2005 and 2010, ASEAN has signed FTAs with Japan, Korea, India, China and Australia-New Zealand; however it has still to conclude its FTA trade negotiations with the European Union ("EU").

Putting things into perspective, with the signing of the Malaysia-Japan Economic Partnership Agreement ("MJEPA") in 2006, Malaysia's total trade with Japan, a country with a Gross Domestic Product ("GDP") of USD 4.6 trillion, stood at USD 33.5 billion in 2014, making Japan the 3rd largest trading partner with Malaysia. In contrast, Malaysia's total trade with EU which has a GDP of USD 18.5 trillion (4 times that of Japan), is only marginally higher at USD 34.8 billion. Perhaps with the recent signing of TPPA, it may be timely for a resumption of ASEAN-EU trade talks.

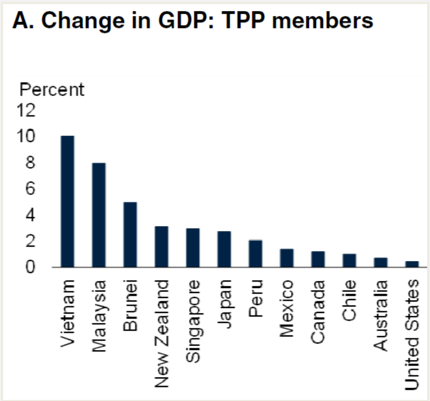
A European company in Malaysia with no ASEAN-EU FTA

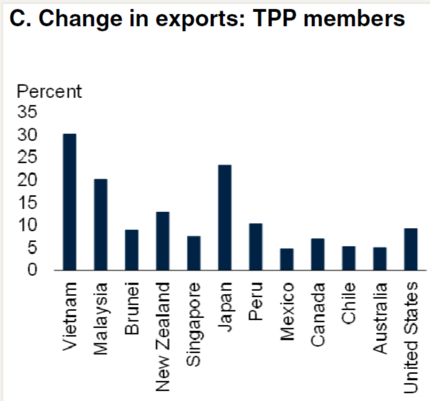
A French leading producer of chemicals in Europe buys raw materials from all over the world and exports its end products to more than 100 countries. With its Asia Pacific hub in Malaysia – a member of ASEAN, the company will see tariffs lowered or eliminated in Australia, China, Hong Kong, Japan, Korea, New Zealand, India, and other ASEAN countries. However, trades between ASEAN as a regional grouping and EU will face trade barriers as a result of the absence of an ASEAN-EU FTA. The company's manufacturers, importers and producers as well as consumers in Europe will lose out as their goods or services will be more costly due to tariff imposed or quota placed to safeguard domestic markets.

In summary, FTAs allow trade accessibility through market access and increase competitiveness between the participants of the FTAs. Goods exporters and importers enjoy cost savings from elimination or reduction of customs duties, trade facilitating customs procedures and removal of onerous regulations. Consumers are presented with better value and quality of goods and services with broader choices of product and services.

Benefits of FTAs

Being part of a trading agreement is essential to Malaysia's continuous growth in trade and investment. Malaysia as a trading nation needs to be included and inclusive. We participated in TPPA, we are taking the lead in ASEAN Economic Community ("AEC"), and we are in negotiations for Regional Comprehensive Economic Partnership ("RCEP"). With TPPA, Malaysia's Gross Domestic Product ("GDP") and exports will grow by 8% and 20% by 2030 respectively. Combined with RCEP, Malaysia's GDP and exports will grow even more and ensure Malaysia to remain in the game!





[Source: World Bank]

FTAs provide market access for Malaysian companies to compete more efficiently and effectively at the global level, and it will build investor confidence and attract foreign investment into Malaysia. While Malaysia has historically been an attractive place for MNCs to do business in, the recent signing of the TPPA will strengthen Malaysia's position as a base for them to not only tap into the domestic market, but to use Malaysia as their centre of operations such as Regional Headquarters or Supply Chain Management in Greater Kuala Lumpur ("GKL") to grow in the region.

TRADE EFFICIENCY: BRINGING THE GOALPOSTS CLOSER TOGETHER

Although the same EIU report referenced earlier states that 85% of companies surveyed showed an increase in their exports due to FTAs, it also states that companies, especially smaller ones, tend to shy away from FTAs due to the complexities of agreement terms and that the benefits do not compensate for the intricacies.

Recognising the need to pursue trade policies that will create a more liberalising and fair global trading environment, the more recent trade agreements such as MJEPA and TPPA seek to go beyond tariff reductions. This is where two parties come together and decide not just to remove their goalkeepers from the game but to bring the goalposts closer via cooperation in policy making.

Policy makers, in drafting the modern trade agreements, are making it easier to do business by addressing key complexities such as Customs Administration and Trade Facilitation, Technical Barriers to Trade, State-Owned Entities ("SOEs") and Government Procurement, Competition Policy, and Movement of Natural Persons.

Customs Administration and Trade Facilitation

Governments would commit to predictable, consistent, and transparent processes for customs clearances of goods between member states especially around standardising rules of origin calculations. There would also be ongoing cooperation with each other to simplify rules, use common standards where possible, and integrate and automate systems to speed up processing and clearance of goods between their countries.

Technical Barriers to Trade

Certain regulations, license requirements and sanitary and phytosanitary measures adopted by the central government favour local businesses and effectively creates a barrier for foreign businesses to participate. This could come in the form of limitations in foreign equity shareholding, or requirements for domestic content, or a non-science or risk-based approach to audits.

In seeking greater liberalisation from both parties, each government would need to review each policy with an aim that foreign owned businesses would be accorded the same treatment as local businesses.

State-Owned Entities ("SOEs") and Government Procurement

Recognising that Government Procurement is often used as an economic instrument for domestic growth such as infrastructure projects, and SOEs tend to be charged with specific long term economic goals related to national stability and security rather than quarterly earnings reports, these are two of the more challenging areas of collaboration. However, with the signing of TPPA, governments have begun to look at these domains with intent to balance the gains in efficiency via liberalisation against the risks posed to the countries long term socio-economic position.

Competition Policy

This is where governments would cooperate in policy making to promote fair competition, consumer protection, prohibit anti-competitive business conduct such as fraud and deceptive commercial activities.

Movement of Natural Persons

People run businesses, and as the value of economies is shifting more towards the provision of services, the movement of skilled knowledge workers and management expertise becomes a crucial part of running a global business. Governments which are able to facilitate this movement with ease will indirectly impact MNCs as they globalise their businesses.

It is therefore not surprising that in the process of selecting a location for an MNC's regional or global operations outside of their home country, more and more companies are motivated to look at the trade alliances that the host country has. These alliances translate not only to market access and increased international trade, but depending on the provisions in these alliances, it results in improved ease of doing business.

A German company leveraging on Malaysia's FTA with JAPAN and ASEAN

A German "hidden champion" that specialises in complete press production systems for various industries will expand its Asia Pacific business from their recently established Asia Pacific Engineering & Services Hub in Kuala Lumpur, Malaysia. As a company that supplies services internationally, Malaysia's FTAs will liberalise market access and reduce regulatory barriers in different service sectors for the company. For example, they are able to provide engineering services and systems across the border to its clients in Singapore and Australia from Malaysia. The FTAs will also give better mobility for business travel, especially for the regional management team and technical support team who would need to work in the overseas branch or project in the FTA partner country. In addition, the recently signed TPPA will give their clients in Thailand and Vietnam market access opportunities to Japan, as well as trading partners that Malaysia presently has no FTAs with such as Mexico and Unites States.

In summary, FTAs benefit companies as it improves Trade Efficiency or ease of doing cross-border businesses. Overall cost reductions and better risk management are achieved by operating in a predictable, transparent, and consistent business environment.

In the first-part series, we saw how FTAs can facilitate Trade Accessibility and Trade Efficiency. We now move onto the second and final part of this trade agreement series to understand the other two key roles of FTAs, i.e. Trade Specialty and Trade Equity.

PART 2: FACILITATING TRADE SPECIALITY AND TRADE EQUITY

In the second part of this series, InvestKL discusses how the next generation FTAs such as TPPA and the upcoming Regional Comprehensive Economic Partnership ("RCEP") focuses more on Trade Speciality and Trade Equity.

As economies progress, every country (and company) develop unique resources, technologies and talent in their production value chain, leading to what is called a Trade Specialty. Trade Specialty also leads to the birth of intangible values being embedded into the production value chain in the forms of Intellectual Property ("IP"), Research & Development ("R&D"), branding, and associated costs related to management and business support services.

With the current complex fragmented global value chain, countries recognise the need for an effective FTA that allows for accumulation of value (both tangible and intangible) amongst a larger pool of member states. The value chain evolution creates the necessity of treaties such as TPPA to account for the accumulation of value arising from production and services rendered. Moving forward, under the new era trade agreements, companies are relooking at consolidating their value chain in response to the Organisation for Economic Co-operation and Development's ("OECD") Base Erosion and Profit Shifting Guidelines.

Finally, under Trade Equity, FTAs are beginning to look at ensuring sustainable and equitable growth where profits do not come at the expense of the people or planet and is conducted in a framework that encourages fair business practices. Here, we will see increased focus on protecting the rights of businesses and labour, the environment, commitments to poverty eradication, and facilitating the growth of small-medium enterprises.

Let us begin exploring these four objectives of FTAs by drawing analogies from one of the world's favourite game, English football.

TRADE SPECIALITY: SKILLED PLAYER, BIGGER FIELD

A common misperception is that iPhones are thought to be made in China. However, it is attributed to China only because the final assembly of the product before the phones are exported and distributed occurs there. As a matter of fact, the intermediate inputs that go into the iPhones are actually produced in various countries such as Germany, South Korea, and Japan.

Figure 11: The US trade balance in iPhones (USD m)

Source: Adapted from Bo Meng and Miroudot (2011) as quoted in WEF (2012)

The US reports a USD 1,901 million in trade deficits to China due to iPhones, but in reality, when a global value chain analysis is conducted, only 3.8% (USD 73 million) deficits come from the assembly process in China.

It is important to note that as products become more complex, each country starts developing competitive advantage in areas such as input materials, specialised skillsets and technologies leading to the product supply chains becoming more and more fragmented and global in nature. Such competitive advantage in areas such as input materials, specialised skillsets and technologies leading to the product supply chains becoming more and more fragmented and global in nature. Such competitive advantage can simply be known as Trade Specialty.

The consequence of Trade Specialty may lead to situations where the bilateral trade agreements begin to lose its relevance. These modern day products would not have sufficient value created within the member states in order to be eligible for reduced tariffs under their bilateral rules of origin.

Value of the Little Blue Pill

An important thing to note is that apart from the physical goods produced, the value of services (e.g. intellectual properties (“IP”) and management services) embedded in products are beginning to be more pronounced. The manufacturing costs associated with leading pharmaceutical products such as the little blue pill (Viagra), in the early 2000s may be less than a tenth of the total product cost in the market whilst the other associated services costs embedded within those products such as branding, IP, R&D, and management services make up the remaining value. As companies seek to meet rules of origin requirements governed by multi-lateral trade agreements, it is critical to accumulate not just the value of goods and intermediate inputs, but also the associated value of services within the nations associated with the multilateral trade network.

One of the measures to address this issue is via multilateral trade agreements that allow recognition of cumulative value in each product stages within its member states. Ultimately, by applying the rules of origin under the multilateral trade agreements, each member state would be able to enjoy the final product at lower prices.

As a result of the Trade Specialty, large MNCs are starting to look at ways to further integrate their production bases and those of their suppliers within member states in order to deliver their final products as competitively and efficiently as possible.

We will likely see further global integration and more multilateral FTAs such as TPPA in the near future especially with RCEP currently being negotiated.

OVERVIEW OF ASEAN'S FREE TRADE AGREEMENTS

http://www.bilaterals.org/?time-to-revisit-an-asean-eu-fta

	TPPA	RCEP
Name of agreement	Trans-Pacific Partnership Agreement	Regional Comprehensive Economic Partnership Agreement
Number of countries	12	16
Countries involved	Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the US, and Vietnam	ASEAN Member States (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam) ASEAN FTA partner countries (Australia, China, India, Japan, New Zealand, and South Korea)
Population (2014)	806 million people	3.47 billion people
GDP (2014)	USD27.98t (RM91.56t)	USD22.58t (RM73.90t)
Percentage of world trade (2014)	25%	28%

Source: IMF (2015), CEIC

In summary, global value chains are becoming more complex due to Trade Speciality involving resources, talent, technologies and services from various countries. The benefit of having FTAs is that companies can achieve lower total costs of production by integrating both their products and service value chains within these new trade alliance networks.

TRADE EQUITY: NEW GAME, NEW RULES, NEW REFEREES

The football game which we started with in our first article has changed significantly. We've lost the goalkeepers, the goal posts have been moved closer together, more specialised players are on the field and as competition intensifies, it is likely that we may even see rugby style tackles and other less than legal plays. We need an empowered referee badly!

In the final evolution of modern trade alliances, the agreements will have provisions that are aimed at creating and enforcing equitable trade which is inclusive, where profits are made responsibly and sustainably. In the TPPA, for example, 7 out of 30 chapters reflect the need for Trade Equity by providing rules around:

- Intellectual Property
- Labour Rights
- Environmental Protection
- Economic Development (Poverty Eradication, Food Security, Improving Living Standards)
- Facilitating Trade for Small-Medium Enterprises
- Anti-Corruption
- Processes for Dispute Settlement

Even in the new ASEAN Economic Council Blueprint 2025, the second priority clearly aligns itself with Trade Equity.

Why is this important? When the sole focus of free trade is profit maximisation, the people and the planet are disregarded. When standards which protect the people and the environment is not enforced, we see incidences like the collapse of an eight-storey factory garment in Rana Plaza in Bangladesh that killed over 1,100 people and injured 2,500 more. The building housed five garment factories, supplying global brands such as Primark, Benetton, and Walmart.

As public awareness increases, these large companies including Nike, Gap, H&M and even Apple are struggling with Public Relations ("PR") issues as they come under intense scrutiny involving workplace conditions in far flung factories of their suppliers and their supplier's suppliers.

Companies who choose to operate within a network of countries that adopt a higher standard of labour protection and environment protection will find that their investments enjoy reduced risks of brand eroding claims which could otherwise come from operating in a nation that does not share the same standards. We take for instance, the coffee industry.

Despite being the second most valuable commodity in the world after oil, there is significant human trafficking and exploitation in the coffee industry. To combat these issues, Starbucks buys their coffee in a way that respects the people and places that produce it. The company practises ethical sourcing by adhering to a special guideline that helps their farmers grow coffee in a way that is better for both the people and the planet. Their Fair Trade Certified coffee ensures a better quality of life for the farmers, and their Organic coffee safeguards the planet.

In summary, the risk of brand erosion and consequently loss of business can be mitigated when companies integrate their production base within the network of FTA member countries that enforce Trade Equity standards.

KEY TAKEAWAYS

Recognising the fact that international trade is important to any country's economic growth and development, trading agreements have evolved and will continuously evolve to promote competitiveness and ease of doing business. The evolving FTAs benefit companies in the following manner:

- **Trade Accessibility:** FTA helps companies increase goods exports to a market due to competitiveness gained via preferential tariff treatments
- **Trade Efficiency:** FTA enables companies to manage their costs better by improving ease of doing business and with better risk management as it provides for a predictable, transparent and consistent business environment
- **Trade Speciality:** Companies can achieve lower total delivered costs for complex products involving resources, talent, and technologies from various countries by integrating their global value chains within a group of countries with a multilateral trade agreement such as TPPA and RCEP
- **Trade Equity:** Companies can participate in equitable trade when they operate from countries which have agreed to and are mutually enforcing standards promoting sustainable trade.

What can we look forward to in future evolutions of trade agreements? I believe the 5th evolution would be in establishing mutual rules around the medium of trade flows and capital flows which will address the following trends:

a) Growth of e-commerce and mobile commerce which are rapidly replacing retail
b) Evolution in delivery of content through digital channels which is rapidly replacing traditional broadcasting channels
c) Progress in sharing economy such as AirBnB and FinTech which are replacing traditional service providers
d) Remote delivery of services and Artificial Intelligence: An age where services can be delivered globally through Internet of Things ("IoT") technologies such as when doctors can perform surgeries through remotely controlled vision and robotics systems, and commercial vehicles can be operated and piloted remotely like drones

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