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EU–ASEAN: The beginning of a beautiful friendship?

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Summary

The recent decision to start negotiations towards a free trade agreement (FTA) between the EU and ASEAN is to be welcomed for several reasons:

- It greatly reduces the risk of trade diversion for both EU and ASEAN firms as a result of agreements signed by each region with other parties.

- Asia has been the 'missing link' in the foreign economic policy of the EU. Agreements already exist or are being negotiated by the EU with various countries and regional groupings in both Africa and Latin America.

- Fifty years of experience with regional integration have given the EU unparalleled institutional expertise which it can share with ASEAN. Southeast Asia currently lags far behind the EU in the integration of its regional market. An FTA would give renewed impetus to technical cooperation which has been under way for several years under the Trans-Regional EU–ASEAN Initiative (TREATI).

But good politics do not always make for sound economics:

- Multilateral agreements remain the best way forward. In this sense, the outburst of FTA negotiations is an admission of failure to progress at a multilateral level.

- With the exception of Singapore, it seems unlikely that the EU will get far in terms of liberalization within ASEAN in the near term. Industrial policies are still very much in vogue in some ASEAN countries.

- The best that can be hoped for is that negotiations today represent an investment in the future of ASEAN, a region which – although overshadowed by China – is destined to become one of the world's largest markets. The FTA will provide an institutional framework to negotiate more contentious issues in the future.

- Liberalization of sectoral trade and non-trade barriers, particularly in services, as well as of investment regimes, is crucial for ASEAN if it is to create a genuine internal market and hence play a more prominent role in the global economy. Through both negotiation and inspiration, the EU might be able to contribute towards this goal.

The European Union and the Association of Southeast Asian Nations (ASEAN)[1] agreed in May 2007 to begin talks on a possible free trade agreement (FTA).[2] A Joint Committee comprising senior officials from all ASEAN member countries and the EU is to develop the details of the modalities, work programme and time schedule. The aim is to complete negotiations within two years.

ASEAN and the EU have been slowly moving closer together for a number of years, but their political relations still lag behind those established by firms from the two regions. At present, the economic relationship is asymmetrical, with the EU market much more important to ASEAN than the reverse. But in the long run, the size and growth of the ASEAN market will make it a key source of growth and profitability for EU firms.

Willingness to negotiate and the possibility of large economic gains, particularly for some ASEAN countries, do not automatically imply a successful outcome to negotiations. Many ASEAN members remain reluctant to embrace the so-called 'Singapore issues' such as investment, competition, government procurement and intellectual property. Other than limiting the risk of discrimination from FTAs signed elsewhere, the ASEAN–EU FTA is likely to be most important for its symbolic value as a bridge between Asia and Europe, as a basis for enhanced cooperation, and as a stepping-stone for future negotiations on contentious issues.

Motives

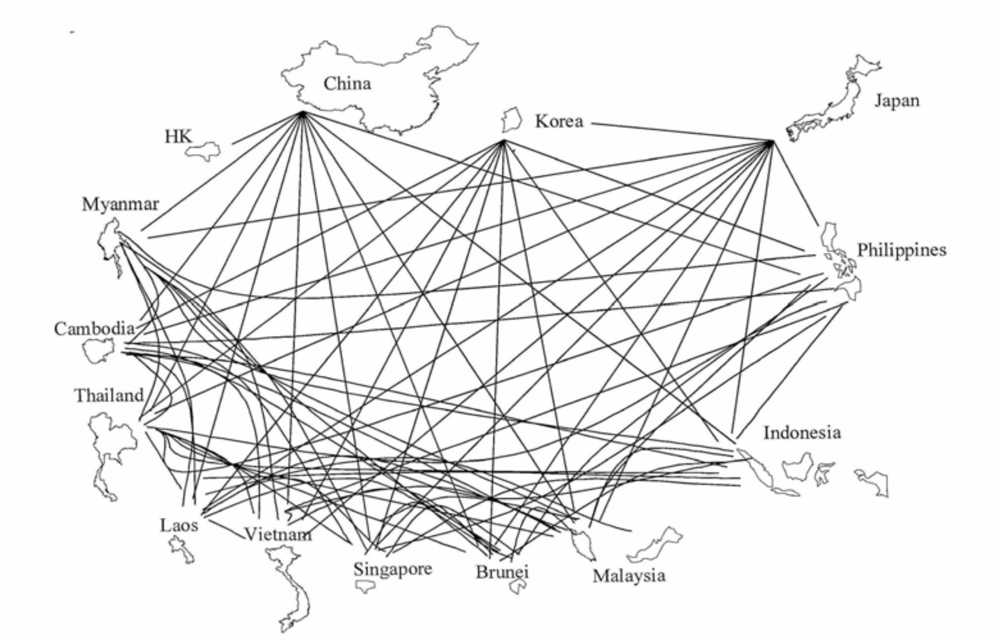
The growth of FTAs worldwide is both a response to the disappointing results of multilateral trade talks and a response to that response, i.e. the proliferation of bilateral, intra- and inter-regional trade agreements. Nowhere is this explosion of FTAs more in evidence than in East Asia. The common comparison with a bowl of noodles or spaghetti is readily apparent in Figure 1.

Beyond the obvious fact that FTAs are currently in vogue, each country and region has slightly different motives behind their decision, and this could have implications for the scope of an eventual agreement between the EU and ASEAN.

EU trade and association agreements

With its own recent enlargements and its emphasis on multilateralism, the European Union has for many years lagged behind the United States in pursuing trade agreements with willing partners. Early agreements signed by the EU tended to involve neighbouring regions. These included association agreements with seven countries[3] bordering the Mediterranean with the aim of forming a Euro-Mediterranean free trade area by 2010, as well as a mutual cooperation agreement with the Gulf Cooperation Council (GCC) which entered into force in 1990. Negotiations for a possible EU–GCC FTA were resumed in 2003 and are still on-going. The only exception to this regional emphasis in early

FIGURE 1: FTAs SIGNED OR BEING NEGOTIATED BY EAST ASIAN GOVERNMENTS



Source: Richard Baldwin, 'Managing the noodle bowl: the fragility of East Asian regionalism', *CEPR Discussion Paper* No. 5561, March 2006.

negotiations was a Trade, Development and Cooperation Agreement with South Africa that came into effect in 2000, with a 10–12-year transition period for liberalizing bilateral trade.

Recent agreements have tended to be more ambitious in scope and in the depth of liberalization involved. Partners have been chosen on the basis of their willingness to accept high standards rather than for geographical or political reasons.

The Economic Partnership, Political Coordination and Cooperation Agreement between the EU and Mexico which came into effect in October 2000 goes beyond tariffs and border issues to include 'Singapore issues'. The more recent agreement with Chile (signed in 2002 and implemented in 2005) is even more ambitious in its commitments in these new areas and is considered to be a template for any future EU agreements, including with ASEAN.

Another EU motive behind recent agreements is to promote regional integration elsewhere, building on fifty years of experience in Europe. Examples include on-going negotiations with Mercosur, the agreement with the GCC and possible future ones with Central America and the Andean Pact, as well as on-going Economic Partnership Agreements with regional groupings in Africa, the Caribbean and the Pacific. The EU Trade Commissioner Peter Mandelson has stated explicitly in the context of possible EU–ASEAN negotiations that the aim is 'not just boosting trade, but encouraging regional integration in ASEAN'.[4] In this way, the EU benefits not just from greater market potential in the partner region but also from more cost-effective efforts in the regulatory area.

Agreements involving ASEAN member countries

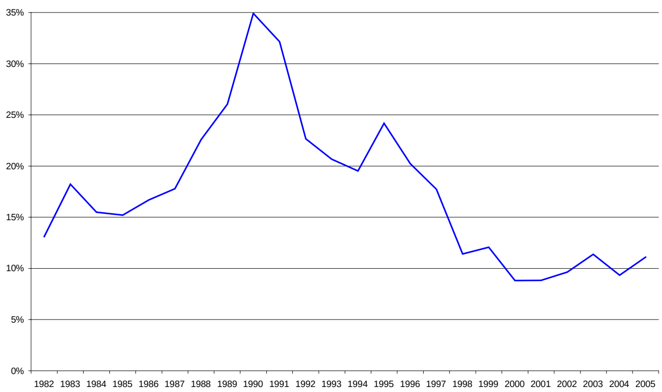
ASEAN motives behind the recent wave of negotiations are informed in large part by the rise of China and by the proliferation of agreements involving East Asian countries. Not only does ASEAN seek to play a key political role in the region to counterbalance both Japan and China, it is also keenly aware of the threat of China to its export markets and hence to its traditional role as a magnet for foreign direct investment (FDI). Fear of China has also driven both the ASEAN Free Trade Area (AFTA) and the ASEAN Investment Area (AIA). The implications of China for ASEAN can be seen in terms of both trade and FDI.

EU trade with ASEAN is currently at the same level as EU trade with Japan: the fifth greatest source of imports and the sixth largest export market for the EU as a whole. Over time, however, the relative importance of ASEAN for the EU has been falling (from 6% in 2001 to 5% in 2005) while that of China has been rising (from 6% to 9% over the same period). Indeed, over the past five years, EU–ASEAN trade has stagnated, while total external trade of the EU has grown by 20% and with China by 87%. Among the major ASEAN countries, only Singapore and Vietnam exported more to the EU in 2005 than in 2001.

The same tendency with trade can be observed for FDI. More than any other developing region, ASEAN has based its development strategy on attracting FDI. Foreign investors from Europe, North America, Japan, Korea and Taiwan were enticed with incentives to set up export platforms long before such a strategy became fashionable in the rest of the developing world. As a result, foreign enterprises are ubiquitous in many ASEAN countries and represent a high share of the exports of the electronics goods that have traditionally been the mainstay of ASEAN export-led development.

ASEAN countries continue to receive large amounts of inward investment. But, with the exception of Singapore, such flows are on a clear downward trend when measured either as a share of all developing-country inflows or as a share of ASEAN GDP. This trend pre-dates the 1997 financial crisis.

FIGURE 2: SOUTHEAST ASIAN SHARE OF DEVELOPING COUNTRY FDI INFLOWS, 1982–2005



Source: UNCTAD.

Declining FDI inflows in relative terms are symptomatic of a broader problem – the lack of competitiveness of many ASEAN economies. According to estimates by the International Labour Organisation, output per worker in Southeast Asia grew by only 16% between 2000 and 2005, compared with 27% in India and 63% in China.

ASEAN as a group has so far negotiated agreements only with other countries in Asia, although individual ASEAN members – principally Singapore – have concluded agreements further afield. The first ASEAN FTA was signed with China in 2002, followed by framework agreements with Korea, Japan and India. Negotiations are under way with Australia and New Zealand.

Because of the relatively low degree of integration within ASEAN, both economically and institutionally, most agreements involving ASEAN as a group represent a series of *de facto* bilateral treaties between each ASEAN member and the partner country.[5] Each country is usually left free to establish its own list of sensitive items for exclusion from the agreement, and liberalization commitments often vary according to the level of development of each signatory. This same multi-bilateral structure would doubtless prevail in any eventual EU–ASEAN FTA. Javier Solana, the EU Commissioner for External Affairs, has said that the FTA would 'not be an agreement with ASEAN as such. It would be with member states of ASEAN.'[6]

For this reason, it is instructive to look at some of the bilateral FTAs that have already been signed by individual ASEAN members. They suggest, at least in the case of Thailand and Singapore, that the impetus behind FTAs is not just a bid for continuing economic and political relevance in Asia but also an attempt to push open markets abroad for competitive local products – such as certain agricultural or electronic products – and to provide assurances that rising ASEAN FDI in the EU – often by government-linked companies – will not be restricted.

Singapore has so far been the most ambitious ASEAN country in signing bilateral FTAs, in terms of both the number of agreements and the depth of commitments. Agreements have been signed with the Japan, United States, Australia and New Zealand, and the European Free Trade Association. Before the decision to begin EU–ASEAN negotiations was formalized, Prime Minister Goh expressed the desire to negotiate a bilateral FTA with the EU as a precursor to the broader and more difficult inter-regional agreement.

ASEAN–EU relations – the state of play

Institutional cooperation between the two regions dates back to the early 1970s and has involved regular meetings of ministers or other senior officials. The EU has provided technical assistance, including for trade and export promotion. Since 1997, cooperation has been expanded to include such areas as intellectual property rights, standards and the harmonization of customs procedures. The aim has clearly been to draw on the EU's own experience and expertise to foster greater regional integration within Southeast Asia.

An early agreement which entered into force in 1980 provided Most Favoured Nation (MFN) treatment for trade between the two regions, as well as a commitment to joint actions for improving commercial, investment and scientific relations and some provisions on development cooperation. More than twenty years on, the European Commission described this agreement as rather limited in scope, albeit useful, but with no realistic prospect of renegotiation.[7]

In a 2003 strategy paper 'A New Partnership with South East Asia' the Commission set out to revitalize relations with ASEAN. As part of this endeavour, the Commission proposed a Trans-Regional EU–ASEAN Initiative (TREATI) which sets up a framework for dialogue on all trade facilitation, investment and regulatory issues and which is explicitly intended as a cornerstone for a future FTA. All other issues are covered in a Regional EC–ASEAN Dialogue Instrument (READI).

> The ultimate ambition is to develop a deeper understanding and intensify our co-operation to facilitate the eventual negotiation and implementation of an EU-ASEAN FTA in the future. In a way, we want to tackle the most difficult issues first, without which an FTA risks remaining mere paper. We differ here from other partners of ASEAN, who launch FTA negotiations first and backload the more contentious regulatory barriers.[8]

The greatest hindrance to further institutional cooperation is the problem of Burma/Myanmar, a member of ASEAN since 1997. The EU suspended all non-humanitarian aid and development programmes in 2003 in the face of human rights violations. According to the Commission, the EU Common Position on Myanmar prevents 'de facto' the conclusion of new contractual relations with the country, or for that matter with ASEAN itself. Although FTA negotiations have now been launched, there is still disagreement over whether Burma/Myanmar will be included, with the Commission preferring to proceed through a series of bilateral negotiations with 'those who are prepared and willing to [sign on to the trade pact]'[9]. So far, at ASEAN's insistence, Burma/Myanmar has been allowed to participate in the negotiations but the EU has ruled out any deal that would include it.[10]

The scope of an eventual EU–ASEAN FTA

The Joint Ministerial Statement launching the process of negotiations towards an FTA calls for comprehensive trade and investment liberalization. As in most regions, the main obstacles to trade in goods in ASEAN do not involve tariffs. All ASEAN agreements include commitments that go beyond tariff reductions but provisions on investment and services are often imprecise and lack a timetable for implementation.

Some ASEAN countries actively pursue industrial policies, often involving the full panoply of policy instruments. In Malaysia, for example, the automobile sector has been fostered by prohibitive tariffs, import licensing, restrictions on inward investment including *de facto* technology transfer requirements for authorized investors, subsidies through partial state ownership, and favouritism in government procurement – all of which imply quasi-monopoly status for the national champion.

Greater market access in one area will not produce the desired results if restrictions remain – or are even expanded – elsewhere. In Malaysia and Indonesia, for example, when tariffs were lowered on automobiles as part of AFTA, the move was accompanied either by an increase in excise taxes on larger engine sizes which discriminated *de facto* against foreign firms or by a rebate offered to the national producer.

For this reason, although the potential liberalization commitments described below are discussed separately, it is clearly the total package of commitments that matters most.

Merchandise trade

Trade in goods between ASEAN and the EU is not greatly hindered, with certain sectoral exceptions, but there are nevertheless some issues in both regions that need to be addressed in an FTA even in this sphere.

ASEAN

Exporters to individual ASEAN countries face tariff peaks and import licensing in certain key sectors such as automobiles. Even in other sectors where applied tariffs are not high, they nevertheless remain significantly below bound tariff levels in many cases – leaving considerable discretion to raise tariffs on certain items without violating WTO commitments.

Even for intra-ASEAN trade under the AFTA, customs procedures remain both costly and time-consuming. As a result, very few local firms take advantage of the Common Effective Preferential Tariff for intra-ASEAN trade. Given the experience with AFTA, including the numerous sectoral exclusions, it seems unlikely that an FTA with the EU would offer much liberalization of trade in goods in the short term. At the very least, it would greatly reduce the risk of trade diversion from other ASEAN agreements. In addition, narrowing the differential between bound and applied tariffs, while offering no immediate opportunities for EU exporters, would reduce policy uncertainty.

European Union

In the agricultural sector, much of what is produced in the two regions is complementary. Where there is overlap, such as with rice, ASEAN exporters sometimes face restrictions. It seems very unlikely that the EU would be willing to put its agricultural support system on the table during the negotiations with ASEAN. Liberalization in this area will only come as part of a process of reform of the Common Agricultural Policy.

ASEAN exports, particularly but not exclusively for food products, are also impeded by technical requirements, including sanitary and phytosanitary standards (SPS). As in other FTAs signed by the EU, it seems likely that the agreement will include commitments to provide technical assistance for trade facilitation and customs cooperation, some of which is already included in TREATI.

Given the growth of intra-regional trade in ASEAN, the degree of liberalization will also depend on how rules of origin are defined. Such rules are necessary to prevent the transhipment of goods through a partner country but can severely hamper trade if they are too complex. The EU usually insists on its own rules being applied in FTAs, although in the Mexican agreement there was a transitional relaxation of such rules in exchange for greater market access for EU firms. The EU commonly applies a mixed system for determining the origin of a product that allows for some regional cumulation.

The complexity of this method has sometimes been criticized, particularly under the EU's EBA (Everything But Arms) initiative. In the case of Cambodia, although all of its exports to the EU are potentially eligible for duty-free status under the EBA, only one-third actually qualify under the existing rules of origin. On the plus side, the weak response of Burma/Myanmar, Cambodia, Laos and Vietnam to the opportunities offered by the EBA implies that the four poorest countries face less risk of preference erosion in cases where the same preferential access to the EU market is extended to all ASEAN members under an FTA. In addition, these four countries are likely to receive more favourable treatment in any trade agreement owing to their level of development. Such differential treatment usually includes a longer timeframe within which to comply with treaty obligations.

Services

With a competitive service sector, liberalization of services is clearly a priority for the EU, both multilaterally and through FTAs such as those with Mexico and Chile. In contrast, ASEAN service sectors – except for those in Singapore, along with tourism and the movement of natural persons – are not internationally competitive. They tend to be characterized by either heavy government involvement or quasi-monopoly status for the private provider. Some countries partially or temporarily liberalized certain services such as banking under duress during the 1997 financial crisis, but important restrictions remain.

Some idea of the willingness of ASEAN countries to liberalize services can be seen from their commitments under the ASEAN Framework Agreement on Services (AFAS) which seeks to open up these sectors on a regional basis. A recent study on a possible EU–ASEAN FTA commissioned by the European Commission argued that 'it appears that bolder and more far-reaching commitments have been made in [the General Agreement on Trade in Services or] GATS and that the liberalizing content of commitments made in GATS have often been watered down, rather than furthered, in AFAS'.[11] Both agreements use a positive list approach.

Among ASEAN countries, Singapore is the keenest on progressive liberalization of services, while the Philippines made the most advanced commitments in both the GATS and the AFAS. Indonesia, Malaysia and Thailand made few commitments in either agreement and Thailand requested the most MFN exemptions. The most common restrictions, in descending order, are foreign equity limits, restrictions on establishment, and barriers to the movement of natural persons.

Investment

In addition to those restrictions related to foreign investment in service sectors discussed above, most FTAs by both ASEAN and the EU contain general provisions on FDI. EU firms are collectively the world's largest foreign investors, so it is only natural that EU negotiators seek a more favourable treatment for FDI in partner countries. The ASEAN position is often less clear cut: on the one hand, FDI is often promoted as part of export promotion or import substitution policies; on the other hand, strategic local firms are protected from competition by foreign-owned firms operating in the host country. Another complicating factor for ASEAN is that their own firms are starting to invest abroad, particularly those in which the government has equity stakes.

An important distinction between investment and trade issues for the EU is that the European Commission only has the competence to negotiate trade issues. Substantive investment issues are still negotiated by each member country on a bilateral basis. For this reason, EU FTAs tend to have less comprehensive treatment of investment than bilateral investment treaties. ASEAN has investment provisions in existing FTAs, principally in the form of commitments to create a liberal and competitive environment for investment, strengthen cooperation in investment, improve transparency of laws and regulations, and protect investors. Less is typically said about market access for foreign investors, either because it might conflict with industrial policies or because local firms are deemed insufficiently competitive in the partner country.

Government procurement

With the exception of Singapore, ASEAN member governments are unlikely to agree to commit to anything more than greater transparency in the market for government procurement. And on the basis of past experience, the EU is unlikely to push aggressively for liberalization.

Only Singapore is a member of the WTO Agreement on Government Procurement, although Thailand and Malaysia participate in the WTO Working Group on Transparency in Government Procurement. Government procurement is often a key way of promoting industrial policies or other national public policy objectives. As a result, no ASEAN FTA addresses the issue, with the exception of Singapore FTAs with Japan and the United States. Malaysia, Laos and Burma/Myanmar have all expressed reservations about the inclusion of government procurement in any potential agreement.

Except for the FTAs with Mexico and Chile, EU agreements have had only weak commitments in the area of government procurement. Even with Mexico, the agreement only matched concessions granted by Mexico under the North American Free Trade Agreement (NAFTA).

Competition

Only half of ASEAN members have enacted a competition law, and even in these cases enforcement is sometimes weak. State-owned companies are also often excluded from the purview of the competition authorities. Unsurprisingly, therefore, ASEAN agreements – including AFTA – contain no provision for the harmonization of competition policy and law. Even the Singapore–US agreement stipulates only cooperation but not harmonization. Most ASEAN members would be highly reluctant to dispense with state aid as a tool of development. The best that can be hoped for is likely to be some sort of minimum standard for preventing cartels and abuse of dominant position, together with capacity-building and dialogue.

Intellectual property

The six richer ASEAN members are all gradually strengthening their intellectual property regimes, but they are still deficient in the poorer countries. All ASEAN countries are nevertheless members of the World Intellectual Property Organization. Vietnam is likely to improve its legislation as part of its admission to the WTO, although implementation will take time. Unlike the US policy underpinning its FTAs, the EU does not tend to push partner countries beyond WTO commitments. The aim is likely to be to press for wider adoption of international conventions within ASEAN as well as more effective enforcement with technical and financial assistance provided by the EU.

Who stands to gain from the FTA?

ASEAN estimates that trade and investment with the EU could expand by at least 10% annually if a trade agreement were concluded.[12] A study commissioned by the European Commission estimates that the gains accruing to ASEAN members are very large, amounting to more than 2% of GDP in 2020 – assuming that tariff dismantling begins in 2008 and finishes in 2015. The gains to the EU amount to only 0.10% of GDP.[13]

As can be expected given the relatively free trade in goods between the two regions, the bulk of the gains accrue from the liberalization of services.

The most interesting results of the EU study concern the distribution of gains within ASEAN. With liberalization of both goods and services, Malaysia could see a gain in excess of 8% of GDP in 2020, given the high protection it currently affords its service sectors. Indonesia, Thailand and Vietnam benefit roughly in line with the ASEAN average, while remaining member countries see positive results, though significantly below the average for all ASEAN countries. Modest gains are expected for Singapore (0.4%) and for Brunei, Cambodia, Laos and Burma/Myanmar (0.3% collectively). The last three countries already enjoy tariff-free access to the EU under the generalized system of preferences (GSP) and EBA schemes.

The Philippines only gains if both goods and services are included or if sensitive sectors are excluded from goods trade liberalization. With complete goods liberalization but no reform in the service sector, the net effect on welfare would be negative.

Overall gains to ASEAN are slightly higher if other potential EU FTAs are included, particularly that with Mercosur, which is also an agricultural exporter.

Endnotes

1 ASEAN comprises Burma/Myanmar, Brunei, Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand and Vietnam.

2 This decision was preceded in 2005 by the establishment of a Vision Group on ASEAN–EU Economic Partnership to look into the feasibility of a possible ASEAN–EU FTA and other new initiatives for enhancing economic cooperation and ties between the two regions.

3 Tunisia (1995), Israel (1995), Morocco (1996), Jordan (1997), the Palestinian Authority (1997), Lebanon (2002) and Egypt (2004).

4 Press release, European Commission, IP/06/243, 17 May 2006.

5 This point was made in ‘A Qualitative Analysis of a Potential Free Trade Agreement between the EU and ASEAN’, Euro-Asia Centre (University of Limerick) and the Institut Français des Relations Internationales (IFRI, Paris), prepared for the European Commission, Directorate-General for Trade, 8 July 2006.

6 Roel Landingin, ‘EU-Asean trade pact stalls over Burma’, FT.com, 2 August 2007.

7 European Commission, *A New Partnership with South East Asia* (Brussels, 2003), p. 24.

8 Speech by Pascal Lamy as EU Trade Commissioner to Eurocham in Jakarta, 6 September 2004.

9 Landingin, ‘EU-Asean trade pact stalls over Burma’.

10 Alan Beattie, ‘Burma will take part in EU trade pact talks, say Asean presidency’, FT.com, 11 May 2007.

11 Euro-Asia Centre–IFRI (2006), p. 134.

12 John Burton, ‘EU-Asean to start talks on trade pact’, FT.com, 4 May 2007.

13 Houssein Boumellassa, Yvan Decreux and Lionel Fontagné, 'Economic Impact of a Potential Free Trade Agreement between the European Union and ASEAN', prepared for the European Commission, Directorate-General for Trade, 3 May 2006.

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