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A HYPOTHETICAL ANALYSIS ON THE IMPACT OF THE ASEAN FREE TRADE AGREEMENT IN THE LOCAL CAR INDUSTRY

NORLAILA ABDULLAH
Lecturer, Faculty of Accountancy
UiTM Bukit Sekilau, Kuantan, Pahang,
MALAYSIA.

ABSTRACT

AFTA (ASEAN Free Trade Area) brings the ASEAN countries collectively into the frontier of today's world market. This is an economic issue that every Heads of States and Government of each member country has to resolve. A member country resolution is focused towards a move that is in the best interest of the member country and the ASEAN members as a whole. ASEAN countries having relatively bigger growth in poputation and natural resources; but its economic reputation is still incomparable to India, South Korea, and China, the emerging neighboring countries. These countries will continuously develop its product standards and markets alongside with direct inflow of foreign investments. Consequently, if ASEAN countries will not adopt changes on its economic strategy then it will be left behind. ASEAN needs to build good economic reputation to the international market by producing quality products and designs that are relatively comparable with those products in the developed countries. This requires member countries to be economically integrated to take advantage of every resources available such as techonology, information technology infrastructure, human and capital resources. AFTA is the avenue for ASEAN member countries to achieve these goals; thus strengthening its competitive advantage in terms of product quality, pricing, access to informations, and human resources capabilities. Should this move fails, some member countries will be economically lesser at par while others with good financial and economic strenght would find it less fit to survive as its market and other resources are relatively smaller to compete with the giants in the international arena.

INTRODUCTION

The emergence of an ASEAN Free Trade Area (AFTA) is a move by the World Trade Organization (WTO) to make the ASEAN become a giant economy. Uniting these regional group into a stronger economic block will lead to the creation of the world's third economic union after the NAFTA (North American Free Trade Area) and the EU (European Union).

It should be noted that ASEAN member countries have a cumulative population of about 500 million, a total area of 4.5 million sq. km., a combined gross domestic product of US$ 735 billion and are conducting trade worth US$ 720 billion per annum.[1] Its growing population and economies coupled with relatively cheaper labour costs, ASEAN is considered as a favourable segment to develop and be converted into a leading production base of the world's market.

With the advent of globalization and advanced information technology requires countries within the region to be united so that they could capitalize on each others' strenght and weaknesses. This will enable the region to develop competitive advantage against the other economic unions in terms of product quality, specifications, volume of production, market share and pricing. This will also enable ASEAN to improve its economic performance that is relative to other neigbouring developed economies.

AFTA poses challenges to all international business entities not only within the region but also the Australia and New Zealand Closer Economic Relation Trade Agreement (CER) and bigger neighbouring countries such as India and China. Some of these countries may be worried over it while others have positive prospects. Unanimously, it may be viewed as an avenue to penetrate cross border country's business prospects in a most efficient way. For those giant entities that have strong financial backings would prefer to spread their wings by making buyouts in order to dominate the industry.

It is certainly positive that the governments of the ASEAN group is working hard to eliminate disparities and make this AFTA a success and become more sensitive to the economic and political pressures of the world market.

Background of AFTA

AFTA was established in 1992 and officially started in 1993 by the ASEAN Heads of States and Government. The countries envolved are Brunei Darulsalam, Combodia,

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[1] http://alps.asiansources.com

Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

Its prime objective is to increase the regional competitive advantange as a production base for the world market.

It is envisaged that AFTA will aid to liberalisation of trade amongst ASEAN by progressively removing intra-regional taxes, tariff duties and non-tariff barriers such as deregulation of quota. These are important aspects in attracting foreign investments into the ASEAN markets. Products would be priced cheaper when rates, duties and tariff are regulated. The resultant effect would bring this region in line with the economic activities of other regional markets in the world i.e., the European Union, the NAFTA and other giant neighboring markets. The international economic conditions are changing it is then necessary for the ASEAN to be on the tract in order to survive collectively. Laxity by some member countries will ensure adverse economic consequences brought about by the current flow of the world changing economy and market development.

As per AFTA's conceptual framework, its implementing mechanism will be based on the Common Effective Preferential Tariff (CEPT) which requires that taxes and tariff rates on a wide range of products traded within the region are reduced to 0-5% on each other country's imports. This mechinism will be gradually implemented over a 15 year period
until year 2010. Products under this tariff reduction program will be classified into two segments. Firstly the fast tract products which include the following:

Vegetable oil	Cement
Chemicals	Pharmaceutical
Fertilizers	Plastics
Rubber products	Leather products
Textiles	Ceramics and Glass Products
Electronics	Wooden and Rattan Furniture
Gems and Jewelry	Copper Cathodes

The second is the normal track products which are envisaged to reduce its tariffs over a period between 10 – 15 years.

Current bottlenecks

Just for discussion purposes, we take the car industry. Comparatively speaking we have insufficient and available locally made supporting industries required in the manufacture of car such as parts and components, engine and transmission system. Assuming forty percent of the parts and components required is locally produced by now; the residue is imported from other countries. Local cars are assembled on a completely knock down (CKD) basis where car's parts and components are made in other countries. This scenario would result to high production costs and ultimately its selling price. Consequently, customers are charged with indirect taxes on these imported materials, engine and transmission system which are imported from Japan.

Source of car component

Majority of local car parts and components are imported from other countries. The costs of these components including freight, insurance and taxes occupy the highest portion of the production costs. Dependence from sole supplier of these parts and components would tantamount to putting the local industry at supplier's mercy in terms of quantity of supply and price. This would bring the local market into a state of perenial suffering of escalating prices brought about by foreign exchange adjustments and inefficiencies in the production process of parts and components' manufacturers.

Steel sheets used are imported from countries like Japan, South Korea, and U.S.A. No local company is producing the specified steel requirement for cars as basic materials are not available. Plastics used are imported as there are no available chemical industries producing such plastics specifications required for car manufacturing.

Devaluation of Ringgit

The production cost of a unit of output that more or less totally dependent on imported materials is greatly affected by its monetary purchasing power devaluations more so if the country's monetary units is less stable. Enormous price adjustments on all imported purchases of basic materials would continuously exist and end consumers would ultimately be affected.

Market share

Locally manufactured cars dominate the domestic market. Currently, local cars garnered a 60% market share. Factors that trigger the attainment of this share are basically caused by price variables as local cars are reasonably cheaper than imported ones. It is also comparable in size; only that its body is of lesser density as compared to the imported cars. Its design is comparable or even better. The price is lower by 15-20 % depending upon the brand and specifications.

Addage on advertisements such as buy Malaysian-made products is working well in this market segment thereby affording greater returns on both parties inaddition to propagation of economic growth. Government and commercial sectors prefer to purchase local models for their fleet of cars for use in their operations.

Our local cars are also being exported to other countries like the United Kingdom, South Africa, Indonesia and Singapore. Imported and luxurious cars are available in the local streets and highways. By ocular survey, they occupy the least share in the market. Users of these cars are normally those group that belongs to higher income level and/or occupying higher position in the commercial, industrial and government sectors. Few other units were bought by students who studied in abroad as they could acquire at cheaper price as compared to procuring them locally.

Threats are posed by ASEAN Free Trade Area upon this industry as aired out by a Japanese director of Proton. According to Yoshimi Fumio, an alternative director of Persusahaan Nasional Berhad, who casts his doubts about Proton long-term prospects when Malaysia opens its vehicle market to foreign competion by year 2005. Yoshima had warned that Proton's share of the local car market would drop below 30% from its current market share. This is quite alarming. Proton is our national car. It should be protected from market dilution. This shield may come in many ways such as reducing its production costs, improved quality and performance. Lasty, by coming up with new designs that is totally indegineous that will cater the taste of not only the local market but the regional and international as well. Thus making our national car competitive with the giant car manufacturers. This strategy would enable Proton to retain its current reputation in the local market.

Further comments should be deferred until decision is made as to whether car is part of those earmarked products in the list for AFTA. One should note that some member countries do not have national car. On the other hand, should other member car producing countries penetrate our local car market with sleek designed cars at cheaper prices, would proton car be competitive?

International Trade Minister Dato' Rafidah Aziz said: "I'm sure Proton, knowing full well what AFTA is, is doing what it needs to do to cut costs." With this, the author is confident that Proton will be competitive by year 2005 and its market share will not be diluted by influx of foreign cars in the domestic market.

Competitors

The local car industry is saturated by many different brands of imported and locally manufactured cars. These imported cars are sourced from Thailand, South Korea, Japan and some European countries. The following are the models of cars available in the country:

	Imported Cars		*Local car*
1	Toyota	1	Proton Saga
2	Nissan	2	Proton Wira
3	Mitsubishi	3	Proton Satria
4	Audi	4	Proton Waja
5	Honda	5	Perdana
6	Mercedez Benz	6	Perodua Kancil
7	Fiat	7	Perodua Kenari
8	Mazda	8	Tiara
9	BMW		
10	Hyundai		
11	Renault		

Thailand produces many types of cars from various foreign car manufacturers. The country produces different brands of cars both western and oriental models. Multinational car manufacturers prefer that country because of its sufficient available supporting industries. Although they are using immitation materials but supply wise they are readily available at lesser costs when needed. Besides, the domestic market of Thailand is relatively bigger than Malaysia.

Thailand manufactured cars, therefore, are threats to the domestic car market as it will certainly take advantage of AFTA to build its export markets in the region as a retailiation on higher duties imposed on palm-oil by some member countries.

Government Policies

The Government of Malaysia has stimulated the growth for locally assembled/manufactured cars since the mid 80's. This gave leeways to the people to buy locally manufactured cars. To support this move, the government had increased taxes and tariff charges on alL imported (CBU) cars thus increasing the selling prices. The current import duty on motor vehicles are:[2]

[2] Ministry of International Trade and Industry of Malaysia , BPA(s)0.2.7. Import Duty

Engine Capacity	*CBU*	*CKD*
Less than 1800 cc	140%	42%
1800 cc but < 2000cc	170%	42%
2000 cc but < 2500 cc	170%	42%
2500 cc but < 3000 cc	200%	42%
3000 cc and above	200%	42%

In addition to the above, imported cars are also charged with 10% sales tax. Locally assembled cars are charged with the same rate but they are not levied with excise duties and tariff charges.

With the liberalization program of AFTA, these import duties and tariff charges will be reduced to probably at reducing staggered rates to 20% for the next three years and eventually reduce to 5% or 0% by year 2010. Would this make our national car more competitive? How serious is the Government in protecting the national car?

Car manufacturing requires huge funds

It needs huge investment in order to manufacture competitive advantageD cars. Investments are more concentrated on the acquisition of high tech machines. For example, machines required in the casting process, forging process, machine to manufacture the engine including the transmission system and few hundred types of knots and bolts. Multinational companies normally funds the industry just like what is happening in the manufacturing process in almost all developing countries

Increase in Production and Sales volume

When the AFTA is implemented using the CEPT machanism, car manufacturers can openly penetrate the markets of other member countries. This would result in a wider scope of market penetration. There would be no quota on volumes traded among countries as it will be one of the issues for liberalisation. A strategic approach would be to earmark the market where relative advantage of its product exists. Penetrating this segment means that production and sales volume to increase as market share increases proportionately.

Studies have shown that a company can generally reduce its costs by 20-30% each time its output is doubled, a phenomenon known as the experience curve.[3] The reduction in costs is caused by the fixed costs being recovered at faster rate due to

[3] Buzzel, R., Buzzel, B., Sultaw, G. and Sultaw, R (1975). "Market share: A Key to Profitabilty," Harvard Business Review.

economies of scales. Increase in sales volume is derived from both local and regional markets. Assurance in economic growth among member countries is positive to materialise.

Requires additional huge investments to achieve competitive advantage

Penetrating the markets of cross border countries is one way of acheiving competitive advantage. However, it would require quality products at reasonable price that suits the international buyers. Producing quality product that has competitive pricing requires huge investments in acquiring high tech plant assets and other infrastructure. Investing in high tech plant assets would facilitate the manufacturing processes thus efficiency can be acheived by increasing yearly production output. Once this stage is reached, then efficiency is irrelevant resulting to incremental profitability figures.

The utmost objective is to build similar facilities available or used by manufacturers in other foreign countries like Japan, U.S.A., Germany and other continental European countries. This is not impossible as there are still vast idle land that can be tapped as site for such developmental projects.

Assuming, further, that a business would not invest on high tech machines to produce the parts and components for a start then perennial problems would be faced on foreign exchange adjustments and high cost of parts and components. This would lead to higher costs which would be a negative factor of survival in this competitive scenario amongst the ASEAN countries.

Since other countries participating in AFTA can penetrate member country's market, it is then anticipated that a decrease in market share would be imminent should such country would not upgrade its facilities and infrastructure as vital ingredients in attaining competitive advantage. It is further envisaged that current part and compenent suppliers would not dare to continue its supplies as they would prefer to invest in other ASEAN countries that would give them huge sales volume and/or greater returns on their investments.

This would also serve as a buffer should supplier would rescind the agreement of supplying the technology and all other components required. This situation could materialise when demand for local cars declines if it fails to compete with other countries in the region. A hyphothetical scenario could happen should in case Thailand, Japan, South Korea, China and India ship millions of units of products into the local market at cheaper price. The foreign market share of the new product would certainly increase as every country in the region is at competive base. Clearly, companies that are hessitant to continuously developed and improved its products to cater to the current changing economic scene would certainly be in trouble alongside with their workers.

It is important to recognise that bigger neighbouring economies like China, Japan, India and South Korea are focused to continuously support influx of foreign investment in their respespective countries. This will afford multiple advantage thus stimulating stiff competition in the region. Thus it is them imperative that all ASEAN member countries should encourage foreign investments in the country. This enables them to sustain the acquisition of necessary resources, infrastructure and skills inorder to produce quality products of international standards.

Decline in selling prices of cars due to liberization of tariff

Reducing taxes and tariff to a staggered rate up to 5% - 0%, as conceived, would simultaneously reduce the selling price of imported cars. The following tables illustrate the pre and post AFTA selling price scenarios of a car.

Table 1.1 – Pre and post selling price scenario of a car under AFTA

IMPORTED CAR (CBU)

Pre –AFTA (RM'000)		Post-AFTA (RM'000)	
Basic cost	100	Basic Cost	100
Tariff taxes & duties (140%)	140	Taxes (20%)	20
Sales tax (10%)	10	Sales tax (10%)	10
Mark-up (40%)	40	Mark-up (40%)	40
Selling price	**290**	**Selling Price**	**170**

Table 1.2 – Pre and post selling price scenario of a car under AFTA

LOCALLY MANUFACTURED CAR (CKD)

Pre-AFTA (RM'000)		Post-AFTA (RM'000)	
Basic cost	100	Basic Cost	100
Tariff taxes & duties (42%)	42	Imp. duties (42%)	42
Sales tax (10%)	10	Sales tax (10%)	10
Mark-up (40%)	40	Mark-up (40%)	40
Selling price	**192**	**Selling price**	**192**

Based on the above pre-AFTAscenario, the current selling price of a locally manufactured is cheaper at RM 192,000 as compared to its counter part of RM 292,000. Imported cars command incremental price difference by 52% due to reduced tariff taxes and duties charged on locally manufactured cars. A valid reason to attaining favourable market share.

With the implementation of AFTA, locally assembled car at CKD basis will command a selling price of RM 192,000, the same price as pre-AFTA, assuming that CKD rates remain the same. The imported car, on the other hand, will offer a cheaper selling price of RM 170,000. It is them favourable to purchase imported car when AFTA is implemented. Readers must take note that the calculations above mainly consider the reduction on import duties and taxes. In practice, foreign car member country's manufacturers will have couple of advantages caused by its economies of scales. This scene may lead to unfavourable local car market share by year 2005.

Assume further that taxes and tariff rates on CKD cars are brought to the same level as that of imported cars thus resulting to the same selling price, local manufacturers may not have the competitive advantage as they lack flexibility on designs and other re-engineering advantage.

Recommendations

It is therefore recommended that local car manufacturers should devise a stringent efficiency measures in order to reduce non-value added activities in its manufacturing process so that production costs will be at reasonable level. Cost cutting measures without jeopordising locally manufactured car's quality and performance are important inorder to afford competitive selling price.
Good and appropriate costing techniques – i.e. Activity Based Costing, that would reflect the true costs of manufacturing process and other related activities including distribution, should be adopted so that the management would be able to monitor and implement corrective measures on activities that generates more costs but no added value to the products' performance and designs.

Production managers should be focused toward adopting modern and efficient production process and techniques so that manufacturing waste and defects will be ultimately reduced to zero.

Additional investmests on infrastructure, advanced technology, IT information, product research and development and human resource development should be implemented to keep abreast with the latest technology in car manufacturing processes and designs.

Local support industries required in car manufacturing should be established and initiated so that dependency on parts, components, engine and transmission systems from other countries will put to a reduced minimum level.

The future of AFTA implementation is something that is new and no one could foresee what would it be. No ASEAN activitiy of whatsover has been implemented where one can gauge the outcome as such economic integretation in the South East Asian region. Thus, everything is beyond forecast and quantification. However, it will certainly be there regardless a member participating country objects or not. Each country is compelled to follow through to arrive at AFTA's goal congruence.

(The author wishes to claim that the analysis and opinion stated above are purely her ideas and views and solely for discussion purposes).

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