THE IMPACT OF ASEAN TRADE INTEGRATION ON DIRECT FOREIGN INVESTMENT

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Abstract

A growing proportion of international trade within the Association of Southeast Asian Nations (ASEAN) occurs within multinational enterprises. This paper reviews the present trade and foreign investment environment within ASEAN members and analyzes the impact of an ASEAN free trade agreement (AFTA) on foreign investment in the region. We anticipate that a reduction of regional trade barriers will make South East Asia a more attractive investment destination to both service ASEAN consumers and integrate production processes within the region. Some indications about potential changes in the allocations of investment within the region are also provided.

1. Introduction

While conceived primarily as a forum to diffuse regional tensions, the Association of South-East Asian Nations (ASEAN) has grown into a vehicle to promote regional integration and cooperation on many fronts. Arguably, a primary goal of ASEAN is to support a regional effort to liberalize trade, but a concurrent goal is to attract inflows of foreign direct investment (FDI) to ASEAN by enhancing market access and creating a more vibrant, stable, and competitive regional economic climate. In the long run, it is hoped that FDI inflows will transfer foreign technology and enhance productivity and economic growth. Yet, the mechanisms by which regional integration will influence FDI are not well understood. The goal of this paper is to assess the theory and evidence on regional integration to gain insight into the impact of ASEAN trade integration on FDI to member countries and the region as a whole.

One of the challenges in analyzing FDI and regional integration is the multiple layers of distortion to trade and investment that are involved. While preferential trade areas (PTAs) do lower barriers to intra-regional trade, they also discriminate against non-members in complicated ways. Furthermore, regional integration efforts can easily overlook domestic distortions that inhibit efficient trade and investment. In section 2 we review the theoretical and empirical literature on regional integration and FDI. This analysis indicates that ASEAN trade integration will affect both the attractiveness of the region to outside investors and the current distribution and nature of investments already made in ASEAN. Thus, while investments in the region are not universally believed to be for the purpose of servicing the regional market, this could change if integration efforts are successful in freeing intra-regional trade. Existing investments may be rationalized, with various pieces of the regional production process consolidated and each located to exploit geographic advantages. This change in the nature of ASEAN FDI is likely to impact both horizontal FDI meant to overcome distortions in the trade of final goods as well as vertical FDI meant to take advantage of differences in input factor costs.

Section 3 provides an overview of the ASEAN economies and the economic diversity within the region. While the members do share similarly impressive rates of economic growth, ASEAN members vary significantly in the structure of their economies and thus in their patterns of comparative advantage. This suggests each individual member economy is best suited to attract a different piece of the production process undertaken by multinationals. ASEAN has been fairly successful in attracting FDI to the region because of favorable characteristics such as plentiful cheap labor of relatively high skill and good infrastructure and communications in some parts, notably Singapore. However, most ASEAN members still maintain regimes that heavily distort FDI inflows. We look at the pattern of FDI in the major ASEAN partners and thereby gain some sense of the impact of these distortions, which is essential in understanding how another set of distortions (i.e., on trade) will influence regional FDI.

We highlight some of the important pillars of ASEAN economic integration in Section 4. While internal trade is still a relatively small portion of ASEAN trade, it the potential to increase significantly as intra-regional trade is liberalized. ASEAN economic integration is also designed to attract FDI to the region and promote linkages between global and local firms. ASEAN integration is likely to see rationalization of existing investment, but this does not mean the relocation of entire industries. Rather, firms are likely to consolidate some production processes while at the same time geographically distributing these activities to reap the best benefit from member comparative advantages provided investment and trade in the region is substantially liberalized. Section 5 concludes with our predictions and proscriptions for capturing the most benefit from the natural behavior of multinational firms.

2. Regional integration and foreign direct investment: Theory and evidence

2.1 Theory

The sorts of integration that receive the most attention by economists are political agreements that shift the pattern of trade distortions in favor of member countries. These PTAs reduce or eliminate trade barriers between member countries and may or may not harmonize barriers to external trade. That such agreements should impact trade flows and patterns is unsurprising, and the literature analyzing the

[1] A free trade area such as NAFTA leaves each member free to unilaterally set its external trade barriers, while a customs union such as the European Union requires each member to adhere to a common external trade regime. However, this is not to say countries cannot or do not find ways to discriminate against foreigners.

trade effects of PTAs is quite voluminous.[2] However, until recently there has been little analysis of the impact of PTAs on FDI at either the theoretical or empirical level.

While PTA formation will obviously influence trade and investment patterns, the direction of these effects is far from evident as several layers of economic distortion are involved. Regional integration agreements are inherently second-best; expanding market size and liberalizing trade between participants, but also discriminating against non-members in rather complicated ways.[3] FDI tends to arise in imperfectly competitive markets in order to internalize economic distortions. Often, multinational firms are exploiting the services of a firm-specific, intangible asset that is non-rival in production across plants within a given firm (Caves 1996 and Markusen 1995). This asset, such as a production blueprint or managerial expertise, can be moved relatively easily across borders and so such a firm will have an incentive to jump barriers to the free flow of goods and factors of production provided the cost of setting up a subsidiary is not too high. In this way FDI can substitute for trade as local production supplants imports, or can complement trade through an increase in intra-firm trade in intermediate inputs (Konan forthcoming). Note that this implies that trade analyses of PTA formation, or any other change in the pattern of trade distortions, that neglect the possibility of multinational production will likely come to erroneous conclusions.

There now exist a few models that explicitly look at the effects of PTAs on FDI, each more appropriate to a particular sort of PTA arrangement between FDI source and host countries. We can broadly define three sorts of PTA: that between sources, such as might characterize the European Union; that between source and host, such as NAFTA which includes the U.S. and Mexico, or the many bilateral PTAs between the EU and its Mediterranean and Central European neighbors; and PTAs between host countries, such as MERCOSUR or the focus of this paper, ASEAN.

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[2] See Baldwin and Venables (1995) for an excellent survey of the theoretical literature. Frankel (1997) provides some empirical analysis of the relevance of regional trading blocs.

[3] Bhagwati and Panagariya (1996) offer a good discussion of these issues.

Motta and Norman (1996) employ a three-country model that highlights horizontal FDI between source countries, arising in an oligopolistic environment, with all firms and countries being identical except for formation of a customs union between two of the countries. Each country is assumed to have a single, indigenous firm which must consider the trade-off between incurring trade costs associated with exporting versus the cost of building a new production facility.[4] Perhaps the most significant result is the investment replacement effect. Regional firms face a reduced level of internal trade distortion and so rationalize their regional FDI, switching instead to intra-regional trade as firms seek economies of scale in production. This investment is replaced by the external firm, which establishes an export platform in the region and contributes to even greater intra-regional trade.[5]

Traditional analyses suggest that small countries may have little to gain, and may even lose, from contemporary regional agreements in which they link up with large countries and engage in mainly unilateral reforms. Ethier's (1996) model suggests small host countries gain from integration with a large source country when FDI flows are influenced. Marginally preferential access to the larger partner's final goods market can allow the smaller country to attract FDI for the purpose of exporting the finished product back to the large country.

In Konan and Heinrich (1997), we analyze integration among host economies in the context of horizontal FDI. We construct a general equilibrium model asymmetric countries and monopolistically competitive foreign firms who export to the region or produce within the region through multination subsidiaries.[6] We find that the level of external protection has a magnification effect. If the integrating

[4] This is a common approach in analyzing horizontal investment driven by distortions in the goods market, such as tariffs. See Horstmann and Markusen (1992) and Markusen and Venables (1994) for examples.
[5] These researchers also find the interesting possibility that the external firm may be excluded altogether. This happens when intra-regional pre-integration trade barriers are high enough and countries small enough that regional firms undertake no FDI and the external firm benefits from producing in the protected regional markets, but as internal barriers fall regional firms can become sufficiently competitive that the external firm is driven out of the region.
[6] In this model, it is not necessarily the case that MNEs be based outside the integrating region because an assumption of free entry drives profits to zero, and thus no repatriation of profits which might affect welfare computations. In the general equilibrium version, "home" will matter as that is where the firm must tap skilled labor for firm-specific headquarter services.

region provides a more favorable climate for investment then the higher is the external tariff the greater is the incentive for tariff-jumping FDI. However, if multinationals over-invested in the region prior to integration the PTA may lead to reverse tariff-jumping, which is exacerbated as external tariff rates increase. Second, any increase in FDI to the region tends to favor low tariff countries at the expense of high tariff countries. Before integration MNEs tend to flow disproportionately into high protection countries, which draws resources out of other sectors and increase factor prices. Integration permits a more regionally-efficient distribution of multinationals as firms can service high-tariff members by intra-regional exports from subsidiaries in low-tariff members. Third, there is no clear relationship between a country's comparative advantage relative to other PTA members and PTA-induced FDI. The PTA favors the country with a regional comparative advantage in the industrial sector as a general rule, but other factors tend to be more telling when considering the impact of the PTA on FDI flows. Fourth, as is the case for national firms, the larger is the region relative to non-member countries, the greater is the responsiveness of regional multinational activity to integration. Finally, the PTA favors small members in terms of FDI inflows as they gain improved access to large countries upon integration.[7]

2.2 Evidence

There is relatively little evidence indicating what might happen to FDI flows upon regional integration, with the exception of the European experience. The long history of European integration has allowed for a fair amount of empirical study, but most other integration efforts are too new to provide sufficient time series data and consequently rely more on the compilation of stylized facts.

European integration from the inception of the Common Market to the mid-1980's was a period distinguished mainly by reduced tariff barriers on intra-European trade. Studies on FDI during this period found that EC formation was a significant factor in attracting FDI from the United States. Additional support for this conclusion comes from evidence that the ascension of Ireland to the EC lead

[7] These studies also look into the welfare impacts on individual members upon integration, particularly as to how these effects contrast with those found in integration models that exclude FDI. However, as our focus in on the effect of integration on FDI patterns, we suppress the discussion of welfare effects.

to a significant inflow of FDI from without and within the EC, though the UK did not see such an increase in FDI inflows when it joined.[8] These flow effects were largely due to reduced barriers to intra-European trade. The advent of the Single Market program saw a larger surge in FDI destined for Europe, particularly from Japan and the United States (World Trade Organization 1995). Balasubramanyam and Greenaway (1993) suggest this later surge in Japanese FDI toward Europe was more as a response to the promise of a larger European market rather than the threat of a "Fortress Europe." While perhaps of limited relevance to ASEAN, this evidence suggests that the "market expansion" effect enhances a region's attractiveness to potential MNEs. Blomstrom and Kokko (1996) cite evidence that the earlier stage of European integration did prompt a shift in the pattern of production by EC-based MNEs, suggesting that regional MNEs may be more influenced by the "rationalization"effect, with a similar effect found to occur in Canadian-US bilateral investment following the CUSFTA.

Blomstrom and Kokko (1996) also examine Mexico's ascension to the NAFTA and the formation of MERCOSUR including Brazil, Argentina, Paraguay and Uruguay. Mexico did experience significant FDI inflows following NAFTA, but these flows were notably from outsiders seeking to exploit Mexico's locational advantages at the same time as they gain access to the North American market. These authors also highlight an important contemporaneous effect that clouds the apparent effect of NAFTA on Mexican FDI inflows: Mexico was continuing a broad program of economic liberalization which may have induced increased FDI inflows in its own right, and it is exceedingly difficult to disentangle the effect of NAFTA from that of the larger liberalization program. Indeed, US FDI inflows to Mexico surged most notably when Mexico began liberalizing its investment regime in 1989, with little apparent effect on US FDI following NAFTA. Again, we see substantial impact on extra-regional FDI patterns following a PTA.

[8] See UNCTC (1993) and the citations therein. That the UK did not see a significant inflow in FDI when it joined the EC is suspected to be due to the fact that firms had already exploited its locational advantages before then. Blomstrom and Kokko (1996) provide data suggesting that the Canada-US Free Trade Agreement had a muted effect on FDI flows into Canada for a similar reason, particularly since Canada-US bilateral trade had been substantially liberalized before the CUSFTA.

In the case of MERCOSUR, the pattern of trade and investment policy distortion in and among the member economies has been in a high state of flux since the bloc's inception. Argentina attracted investment by finally achieving a measure of macroeconomic stability, and through a large privatization program that attracted foreign buyers. With the other hand, it increased external barriers to automobile imports. Brazil is in similar circumstances, but saw a less steady increase in inward FDI following the formation of MERCOSUR. However, one reason that a substantial impact of MERCOSUR on inward FDI was not found by Blomstrom and Kokko (1996) could be that the level of investments in the region was fairly steady, but how investments were organized across the region changed. Bannister, Primo Braga and Petry (1994) present evidence suggesting that firms rationalized their production across all of South America by concentrating particular activities in one location, though the different stages of production would be broken up and presumably located to the best benefit of the multinational.

3. The ASEAN region

3.1. Overview of ASEAN economies

Selected summary statistics on the ASEAN economies are presented in Table 1. As is well appreciated, virtually all of these economies have experienced remarkable growth over the past decade with an average GDP growth rate of nearly 7%. Much of this growth has been achieved by rapid input factor accumulation (Young 1995) and vigorous promotion of export expansion as a means to achieve some modicum of global competitiveness (World Bank 1993). A strong majority of ASEAN nations are intimately connected to the external environment as can be seen from the significant contribution of trade to economic activity. However, what is more remarkable about the ASEAN group is the differences among its members rather than the similarities. The group includes everything from the thoroughly modern, well-to-do economy of Singapore to the extremely poor economies of Vietnam and Lao PDR, and everything in between. Using illiteracy and the number of secondary level teachers as a portion of the population as rough measures of the education or skill of the workforce, there is likely considerable variation in the sorts of skills each member has to offer. Members also vary in the importance of external

Table Selected ASEAN Indicators for 1996

Country	GDP (billion US$)	GDP per capita (US$)	GDP growth 1990-96	Merch-andise Exports (% GDP)	Merch-andise Imports (% GDP)	Labor Force ('000)	Illiteracy [a] (1995)	Secondary teachers (% pop 1995)
Brunei	5.3	17,377	3.5	49	47	138	11.8	.426
Indonesia	225.8	1,129	7.7	22	19	78,300	16.2	.15
Lao PDR	1.8	375	6.7	17	38	2,030	43.4	.077
Malaysia	99.2	4,686	8.7	77	73	8,200	16.5	.23
Myanmar	121.0	2,655	6.8	<1	1.5	26,860	16.9	.067
Philippines	83.8	1,165	2.9	25	38	29,733	5.4	.125
Singapore	94.1	26,052	8.7	133	140	1,802	8.9	.277
Thailand	185.0	3,083	8.3	30	39	32,800	6.2	12
Vietnam	23.3	312	8.5	29	44	34,700	6.3	.2
Average ASEAN	93.2	6,315	6.9	42	49	23,840	14.6	.186
Total ASEAN	839.3	1,739		40	44	214,563		.146

Sources: Compiled from World Bank (1997, 1998), & ASEAN Secretariat

Note: (a) % of illiterate population aged over 14.

trade to their economies, and in the composition of that trade.

A selection of summary structural characteristics is presented in Table 2. This also illustrates that there are important similarities, but perhaps more importantly also significant differences. A large portion of merchandise trade throughout Asia is in manufactures, over three-quarters of trade in many cases. This is perhaps in spite of the fact that, with the exception of Singapore, ASEAN members tend to have moderately high tariffs on manufacturing imports. This apparent contradiction is circumstantial evidence that many layers of economic distortion are involved. For example, investment measures in these economies often favor manufacture for export by foreign firms, and simultaneously facilitate the importation of manufactured intermediate inputs for producing such exports. This occurs concurrently with policies that discourage foreign participation in the local market, with strong restrictions in foreign ownership of wholesale and retail activities.

Manufacturing is a significant portion of most ASEAN economies' production. An indication of differences is in the relative size of the service sector. The Singapore economy is clearly the most reliant on services which corresponds to a relatively high stock of human capital and infrastructure, and cheap communications. Survey evidence indicates this is an important motivation for MNEs to locate R&D and regional headquarter services there while they conduct production elsewhere [Dobson and Yue (1997)]. Table 2 also shows that aside from manufacturing, ASEAN economies do vary somewhat in the composition of their trade and manufacturing activities.

3.2. Historical FDI patterns in the region

One indication of the relative importance of multinational activity in the region is FDI inflows as measured by balance-of-payments statistics. This measure is an imperfect indicator for a couple of reasons. It represents only one form of firm financing (e.g., it excludes reinvested earnings) and thus tends to be more volatile then measures of subsidiary activities such as sales or employment. Financial statistics also do not fully characterize the actual activity level of multinational firms, such as their involvement in production, international trade, or employment. Other data on ASEAN firm operations, however, are limited and not necessarily comparable across countries.

The UNCTAD data on FDI inflows into ASEAN and other regions of interest are given in Table 3. The ASEAN region attracted about one third of FDI flows to developing countries in 1991 and has remained an important destination in the 1990s.[9] This is due largely to rapid regional growth, a skilled and cost-effective labor force, and a favorable political environment. Viet Nam experienced dramatic increases in FDI after the U.S. restored diplomatic relations in 1995 and currently rivals Thailand in FDI inflows. ASEAN's share of developing country inflows, however, dropped to 20.5% in 1996. This is, in part, due to the recent emergence of China as an important FDI host. As the recent financial crisis in

[9] It is important to note that inflows into Brunei, Laos, and Myanmar have remained quite small.

Table 2: ASEAN Structural Characteristics

Country	Output Structure[a,b] (ag/in/svc)	%GDP in manufacturing[b]	Composition of manufacturing[c,d]					Composition of merchandise trade (exports/imports)[b,d]					Weighted mean tariff (%) on manufactures[e]
			I	II	III	IV	V	A	B	C	D	E	
ASEAN													
Indonesia	16/43/41	25	23	19	15	9	34	11/11	6/5	26/9	6/4	51/71	20.9 (96)
Lao PDR	52/21/28	15	-	-	-	-	-	-	-	-	-	-	-
Malaysia	13/46/41	34	8	5	40	9	38	9/5	5/1	8/3	1/3	76/85	12.8 (97)
Myanmar	60/10/30	7	-	-	-	-	-	-	-	-	-	-	-
Philippines	21/32/47	23	30	9	17	17	26	10/8	1/2	2/9	3/3	84/78	27.9 (95)
Singapore	0/36/64	26	4	1	59	8	28	4/4	1/1	8/9	2/2	84/83	2.7 (89)
Thailand	11/40/50	29	-	-	-	-	-	19/4	5/4	1/7	1/3	73/81	43.7 (93)
Vietnam	27/31/42	-	-	-	-	-	-	-	-	-	-	-	
Other Asia													
China	21/48/31	38	14	14	25	10	38	8/6	2/5	4/5	2/4	84/79	21.1 (97)
India	28/29/43	20	11	13	25	19	32	19/4	1/4	2/24	3/7	74/54	29.5 (97)
Japan	2/38/60	25	9	4	39	11	37	0/16	1/5	1/17	1/6	95/55	2.3 (97)
R. of Korea	6/43/51	26	9	10	38	8	35	2/6	1/5	3/17	1/5	92/67	7.8 (96)
East Asia & Pacific	20/44/36	33	-	-	-	-	-	9/7	3/4	9/6	3/4	75/78	

Source: World Bank (1998)

Notes: (-) data not available; (a) percent of GDP in agriculture/industry/services; (b) data for 1996; (c) data for 1995; (d) percent of total; (e) average of applied rates weighted by product shares in world imports – year given in parenthesis.

I	Food, beverages, and tobacco	A	Food
II	Textiles and clothing	B	Agricultural raw materials
III	Machinery and transport equipment	C	Fuels
IV	Chemicals	D	Ores and metals
V	Other manufacturing	E	Manufactures

East Asia revealed, the region is also adjusting to problems of capacity constraints, rising labor costs, infrastructure shortfalls, and political transparency. The financial crisis involved a sharp decrease in private external capital flows, most especially in Indonesia, the Republic of Korea, Malaysia, Philippines and Thailand. Net private bank lending and foreign portfolio equity investment are estimated to be negative, making the financing of new projects more challenging. In spite of this credit crunch, FDI inflows are estimated to have risen slightly in 1997 and data on approved FDI projects indicate that this stability in FDI may likely continue into 1998 (UNCTAD 1998). This is not surprising as FDI flows represent long-term commitments and the fundamentals of the region are less disturbed by the currency crisis than nominal changes might suggest.

Table 3: FDI inflows into ASEAN countries and other regions (Billions of Dollars)

	1985-90 Annual Avg	1991	1992	1993	1994	1995	1996	1997[a]
World	141.9	158.9	173.8	218.1	238.7	316.5	349.2	*na*
Developed Countries	116.7	114.8	119.7	138.8	142.4	205.9	208.2	*na*
Developing Countries	24.7	41.7	49.6	73	90.5	96.3	128.7	*na*
Africa	2.9	2.8	3.2	3.7	5.5	4.7	4.9	*na*
Latin America	8.1	15.4	16.2	18.1	27.0	25.4	38.6	*na*
Central-East Europe	.4	2.4	4.4	6.3	5.9	14.3	12.3	*na*
Asia	13.5	23.1	29.6	50.9	57.5	65.2	84.3	*na*
ASEAN	6.0	13.4	12.1	15.4	15.7	21.1	26.4	*na*
Brunei Darussalam								
Indonesia	0.6	1.5	1.8	2.0	2.1	4.3	6.2	*4.1*
Lao PDR					0.1	0.1	0.1	*na*
Malaysia	1.1	4.0	5.2	5.0	4.3	4.1	4.7	*3.8*
Myanmar		0.2	0.2	0.1	0.1	0.1	0.1	*na*
Philippines	.4	.5	.2	1.2	1.6	1.5	1.4	*2.9*
Singapore	3.0	4.9	2.2	4.7	5.5	6.9	9.4	*na*
Thailand	1.0	2.0	2.1	1.7	1.3	2.0	2.3	*2.5*
Viet Nam		0.2	0.4	0.5	0.7	2.0	2.2	*na*

Source: UNCTAD (1997), UNCTAD (1998).
Note: (a) estimates

Some insights on the relative importance of FDI in the overall economy may be gained by evaluating FDI inflows relative to gross domestic product, Table 4. Reflecting demand for fixed capital, FDI stock as a percentage of GDP is often slightly higher in developing countries than in advanced countries (15.4 percent versus 9.1 percent in 1995). In comparison, the role of

FDI in the ASEAN economies of Singapore, Malaysia, and Indonesia have been phenomenal with stock to GDP ratios from a quarter to upwards of 76 percent in 1995. Viet Nam has also experienced dramatic inflows of investment, with stocks reaching 32 percent of GDP by 1995. Due to restrictive FDI policies and a weaker economic climate, multinationals have had a more modest presence in Thailand and the Philippines, with FDI stocks representing close to a tenth of their GDP in 1995.

Table 4: Inward FDI stock as a percent of GDP

	1980	1985	1990	1995
World	4.6	6.4	8.3	10.1
Developed Countries	4.8	6	8.3	9.1
Developing Countries	4.3	8.1	8.7	15.4
Africa	3.2	6.4	9.2	13.3
Latin America	6.4	10.8	11.6	18.4
Central-Eastern Europe		0.1	1.3	4.9
Asia	3.5	7.3	7.3	14.2
ASEAN				
Brunei Darussalam	0.4	0.9	1.1	2.2
Indonesia	14.2	28.6	36.6	25.2
Lao PDR		0.1	1.6	11.9
Malaysia	24.8	27.2	33	52.1
Myanmar	0.1	0.1	0.3	0.7
Philippines	3.8	4.2	4.7	9.2
Singapore	52.9	73.6	76.3	67.4
Thailand	3	5.1	9.3	10.3
Viet Nam		0.2	3.7	31.9

Source: UNCTAD (1997).

There are significant data constraints on multinational activities within ASEAN, such as industrial composition, sales, exports, and employment. The data that are reported for one country are rarely comparable to those of other countries. We thus get an imperfect understanding of multinational activity by looking at case studies and third-country evidence.

One such secondary source is the United States Department of Commerce Benchmark (US DOC 1998) data, which reports a survey of U.S. firms on their foreign affiliate activities. The activities of U.S. subsidiaries give partial insight on the role of multinational activity in ASEAN. We cannot, however, assume that activities of U.S. firms are average or typical in the region. Although the U.S. is a major FDI source country, FDI from Japan, Europe, and within Asia are also important and firms from non-U.S. sources may differ from U.S. multinationals in important ways. In electronics production, for example, U.S. subsidiaries in ASEAN tend to be concentrated in the production of intermediate components for high technology industry while Japanese firms focus on producing final electronics goods for mass consumption. In addition, the DOC suppresses some data to protect the confidentiality of the investor.

Table 5 shows the industrial composition of sales by US headquartered affiliates in the ASEAN-5.[10] Investment by U.S. firms in ASEAN is concentrated in petroleum (27%), industrial machinery and equipment (18%), electronics and electrical equipment (14%), and wholesale trade (14%). The direct presence of U.S. firms is most concentrated in Singapore with over sixty percent of sales amongst the US affiliates in the ASEAN-5, with Singaporean affiliates engaging in sales in a wide diversity of sectors from machinery and electronics manufacturing to petroleum sales to wholesale trade. Singapore's natural deep harbor and conveniently central location has provided an historic role as a facilitator of trade. Complementing these roots, Singapore provides both a transparent, market-based legal system that supports property rights and encourages entrepreneurship and a sophisticated education system. As Chia Siow Yue (1997) notes, in addition to serving its traditional role as a regional entrepôt Singapore has become a base for multinational headquarter activities in the region. Sales by US affiliates in Indonesia are disproportionately concentrated in petroleum (63% of total Indonesian affiliate sales, Table 5). The drop in energy prices in the mid-1980s provided the impetus for liberalization of the economy which, prior to that time, was heavily regulated under the import-substitution development strategy. The tariff structure was rationalized and restrictions on

[10] Indonesia, Malaysia, Philippines, Singapore, Thailand.

Table 5: Host Sales by US Affiliates 1994 (US$ Million)

Industry	Indonesia $m	Indonesia share	Malaysia $m	Malaysia share	Philippines $m	Philippines share	Singapore $m	Singapore share	Thailand $m	Thailand share	ASEAN-5 $m	ASEAN-5 share
Petroleum	5,180	62.9	2,814		3	0.1	13,511		696		22,204	
Total manufacturing	1,549	18.8	6,684		3,053	58.6	21,512		3,838		36,636	
Food	72	0.9			649	12.5	12		325		1,058	
Chemicals	1,204	14.6	331	2.9	935	17.9	787		716		3,973	5
Metals							213		216		429	
Machinery					24	0.5	14,630		5		14,659	18
Electronics	51	0.6	4,368	37.7	,093	21.0	5,123		590		11,225	14
Transportation											0	0
Other manufacturing	181	2.2	631	5.4							812	
Wholesale trade	60	0.7	,033	8.9	410	7.9	9,069	19.3	1,241	12.9	11,813	14
Finance, insurance, and real estate	48	0.6	579	5.0			970	2.1			1,597	2
Services	128	1.6	347	3.0	152	2.9	1,311	2.8			,938	2
Other industries	46	0.6	121	1.0	131	2.5	417	0.9	9	0.1	724	

U.S. Department of Commerce (1998)

Table 6: Export propensity[a] of Japanese and US affiliates in select ASEAN countries, 1994

	Japanese Affiliates	United States Affiliates			
	Combined[b]	Indonesia	Malaysia	Philippines	Thailand
Primary	86.6	77.9[c]			
Manufacturing	42.8		62.1	37.3	62
Chemicals	11.3		11.2	1.8	3.8
Electrical machinery	74				
Transport equipment	9.7				
Services	18.8				
All industries	38.3	64.2	42.1	26	

Source: UNCTAD (1998) based on Japan MITI and United States Department of Commerce.

Notes: (a) Exports as a percentage of sales; (b) Indonesia, Malaysia, Philippines and Thailand (Thai majority-owned affiliates only.); (c) Petroleum only foreign ownership relaxed (though still heavily regulated). The industrial structure of FDI in Indonesia is beginning to respond, with manufacturing now comprising just under a fifth of US subsidiary sales (concentrated in chemical output for regional consumption). According to Pangestu's (1997) review of FDI approval data, the highest growth in FDI was experienced in chemicals, paper and metal goods. Multinationals in Indonesia are largely externally oriented, with export propensities of over 77 percent in oil and other primary products and roughly 64 percent for US subsidiaries overall (Table 6). Manufacturing FDI activities also appear to be characterized by high import propensities. A survey of electronics investors revealed more than 75 percent imported over two-thirds of their inputs [Pangestu (1997)].

In comparison, Malay, Thai, and Filipino affiliate firms are much more focused on manufacturing activities. Foreign investment in Malaysia grew rapidly since the 1980s (Table 3). By 1995, the stock of inward FDI surpassed fifty percent of Malaysian GDP (Table 4). Foreign investors in Malaysia are heavily concentrated in the electronics sector (Table 5) and tend to be very export oriented (Table 6). Malaysia is amongst the world's largest producers of semiconductors, videocassette recorders, and room air conditioners, these accounting for 44 percent of manufacturing output in 1994 (Ling and Yong 1997). Although not reflected by U.S. firm activities, auto production for domestic consumption (80-87 percent of sales) also attracts investment from Japan and Europe. This is largely due to domestic protectionism and stringent local content provisions in the local automobile market. As discussed in the next section, Malaysia restricts foreign operations through a variety of ownership restrictions and performance requirements and generally favors export-oriented manufacturers.

Foreign investment stock in the Philippines and Thailand are a much smaller share of their overall economies than is the case elsewhere in the ASEAN-5 (Table 3: FDI stock share of GDP reached roughly one-tenth by 1995). Philippine and Thai multinational production is concentrated in the manufacturing sectors of electronics and textiles and apparel, though

Thailand's subsidiaries are more export-oriented than is the case in the Philippines (Table 6). Just as in Malaysia, Thai FDI policy has explicitly been to promote exports and suppress local market participation. Due to a long historical relationship, U.S. firms are more tolerated in the Philippines where they do sell to the local market.

Table 7: Gross Product of U.S. Affiliates by Component 1994

		Employees (thousands)		Employee Compensation	
	Total $m	Total	R&D	$m	share of GP
Indonesia	4,649	52.2	0.1	684	14.7
Malaysia	3,579	120.8	0.3	1,042	29.1
Philippines	1,803	66.4	0.4	482	26.7
Singapore	5,750	93.8		2,106	36.6
Thailand	2,644	70.3	0.1	587	22.2

U.S. Department of Commerce (1998)

The U.S. Department of Commerce survey data also provides information on the components of labor in the gross product of US foreign affiliates (Table 7). Employee compensation represented the largest share of gross output in Singapore (36.6 percent) and the smallest in Indonesia (roughly fifteen percent). Throughout the ASEAN-5, employees in research and development activities were rare, comprising at most one percent (Singapore) of total employees. This gives some indication that, at least for U.S. multinationals, ASEAN firms have not contributed significantly to very high-end firm activities.

3.3 Investment measures in select ASEAN countries

Major efforts to deregulate, liberalize, and privatize the economies of ASEAN began in the mid-1980s.[11] The relatively rapid switch to more liberal FDI policies reflected the growing awareness that FDI contributes to industrial performance, economic growth and competitiveness, and human capital development. Prior to that time, the FDI regulatory regime was somewhat restrictive in all but the unusual case of Singapore. Reform has proceeded along several fronts (Konan and Yue 1994, UNCTAD 1998). Governments have deregulated and privatized many aspects of the economies The administration of FDI has also been streamlined, with simpl and prompter approval procedures and greater the of incentives and performance requirements. Where governments have expressed the desire to influence the direction of FDI, they increasingly positi incenti rather than punitive restricti Yet, several performance requirements persist, most notably foreign employment and ownership restrictic and technology transfer requirements Finally the trend has also been ard greater equality the treatment of foreign and domestic in

In many respects, remarkable le el of gional vergence has emerged in ASEAN's regulatory environment from this uncoordinated reform process Table For on-sensitive sectors. 00 percent foreign equity is permitted all ASEAN countries. Linked to issues of sovereignty and security foreign participation often prohibited restricted in strategic sectors as telecommunicati transportati energy mass media and financial services and sensitive sectors such agriculture and retail trade FDI is also generally ubject to restrictions and performance requirements pertaining to local content, local employment, export performance technology transfer, and locati of investment. To offset these disincentives, ASEAN nations offer incentive packages generally higher rate than typical of developing and newly industrialized (Konan 995 For example, fiscal incentives, tax holida and import duty exemption rebates widely used to promote desirable FDI projects and each has agreements with maj vesting nations void double taxation

Since 959 Singapore has maintained liberal foreign regime With minimal performance requirements, superb infrastructure, free and open trade and financial markets, highly educated workforce, generous tax and other incenti packages, and

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For review of this historical process see 'ue 1993, Tang 993 and Togashi and Imada 992

Table 8: ASEAN-5 FDI Regulatory Framework

	Indonesia	Malaysia	Philippines	Singapore	Thailand
Equity Restrictions	100% foreign equity permitted in some sectors for firms that export minimum 80%.	100% foreign equity permitted in some sectors for firms that export minimum 80%.	Majority equity permitted for firms not on negative list	100% foreign equity except in mass media, telecommunications, public utilities, and domestic finance.	Foreign equity heavily regulated under the Alien Business Law.
Local Content Requirements	For some sectors.	For some sectors.	For some sectors.	None.	For some sectors.
Transfer of Profit	No restriction.	No restriction.	No restriction.	No restriction.	No restriction.
Employment Restrictions	Work passes issued liberally.	Restricted, depending on local conditions.	Restricted, depending on local conditions.	Work passes issued liberally.	Restricted, depending on local conditions.
Entry Limits	Negative clause; over 35 sectors are closed.	No negative clause; mass media closed.	No negative clause; certain sectors closed.	No negative clause.	No Negative clause; certain sectors closed.
Tax Incentives	Tax deferrals, depreciation allowance.	Income tax holiday to 5 years; investment tax allowance. Export, R&D, and sector incentives.	Investment tax credits; income tax holiday up to 6 years. Regional and employment incentives.	Income tax holiday 5-10 years in approved enterprises.	Income tax holiday of 3-10 years for some locations.

Sources: APEC Guide to the Investment Regimes of Members and miscellaneous sources.

transparent and corruption-free legal system Singapore is consistently ranked in business surveys amongst the most attractive investment locations globally.[12] The foreign investment regime in Malaysia is somewhat mixed, reflecting the competing desires to attract technology inflows and yet preserve domestic social policies. The Malaysian Industrial Development Authority (MIDA) acts as a one-stop agency for foreign investors, providing a transparent application procedure. Tax incentives are generous for R&D, training, and headquarter activities and restrictions on land ownership are relatively few. Yet, perhaps the most obvious constraint on FDI has been restrictions on foreign equity participation. With the New Economic Policy of 1970, Malaysia required a minimum 30 percent equity participation for indigenous Malaysians (Bumiputera) and a 30 percent maximum for foreigners. These ownership restrictions were liberalized somewhat in the mid-1980s. Full foreign equity is granted to firms that export more than 80 percent of production, but the percentage of foreign participation permitted declines rapidly with the export ratio.[13] Malaysia has responded to the recent economic crisis in Asia by relaxing foreign shareholder limits somewhat as well relaxing the Bumiputera policy to allow acquisition by domestic non-Bumiputera. In addition to those on exports, performance requirements and incentives still exist to encourage pioneering activities, technology transfers, involvement in manufacturing and mining, and domestic employment.

The Philippines has also undergone a significant regulatory reform. The deregulation and privatization efforts under the Ramos regime have served to attract FDI and stimulate the economy. The Foreign Investment Act of 1991 removed many restrictions on foreign equity participation and liberalized performance requirements. Fewer sectors are on the 'negative list' that prohibits FDI. General fiscal incentives and tax treatment are also ensured by the Omnibus Investment code of 1987.

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[12] The business survey of the World Economic Forum (1998) has consistently given Singapore the premier ranking as the most competitive economy in the world (above Hong Kong and the United States).

[13] Full foreign equity ownership may only be granted on for those operations exporting over 80 percent of total production. For projects exporting between 51% and 79% of production, foreign equity may reach a maximum of 79% depending on other criteria. Projects that export less than 20% of production may only involve foreign equity participation up to a maximum 30%.

Indonesia also introduced a significant foreign investment deregulation package in 1994. Essentially, this legislation liberalized foreign equity restrictions and divestment requirements and simplified procedures. Indonesia, however, still excludes FDI from a wide range of activities including retail trade and various manufacturing industries. National treatment has not been granted to multinationals, and former president Suharto personally approved every FDI project. In response to the recent financial crisis, Indonesia introduced several reforms in fall 1997. Foreign shareholding limits of 49 percent in firms other than financial firms were eliminated and full ownership of non-bank financial firms, such as insurance firms, granted. Wholesaling by foreign manufacturing affiliates was removed from the negative list and retail trade will be permitted in 2003.

Thailand's basic legislative FDI framework has remained largely unchanged since the 1950s and entails wide ranging measures. For example, majority foreign shareholding was restricted in all but export-oriented projects until the 1997 financial crisis when the Board of Investment raised the ownership limit to 51 percent. The Investment Promotion Act of 1977 introduced investment incentives for projects in desirable sectors such as energy and manufacturing while the Alien Business Law of 1972 restricted foreign entry into sensitive sectors such as agriculture and fishing, mining, and services.

While investment measures almost certainly tend to distort multinational activity and international trade, there is little empirical evidence on their significance in the region or elsewhere (Maskus and Eby 1990, Konan and Yue 1994). One problem is that descriptive data on investment measures is rather weak and generally not standardized across countries. Statues concerning FDI may not fully describe the investment climate as regulations may be negotiable, redundant, or non-binding. Several survey studies have relied mainly on voluntary reporting of multinationals operating under these measures. These firms reflect a selected sample of those deciding to enter in spite of restrictions or perhaps because of incentives and may not portray a full picture of the FDI environment. Surveyed MNEs may also have the usual incentives to misstate the extent to which they are influenced by investment measures. Finally, investment measures may influence firm behavior on many complex levels including not only the entry decision but also firm size, composition of employment, intra-firm international trade, and technology transfers.

Nonetheless, we can gain a limited understanding of the presence of investment measures in the region from available survey data. The World Economic Forum (1995) surveyed international business regarding the FDI regulatory practices of various countries (Table 9). Singapore's FDI regime ranks especially well relative to nearly any economy, and often above the average for developed countries. Other ASEANs did not rate nearly as well in some categories relative to non-Asian developing countries. There is apparently a preference in much of ASEAN for minority participation of foreign investors, most notably in Malaysia and Thailand as described above. Foreign investors are sometimes perceived as receiving less than equal treatment relative to domestic companies. With the exceptional case of Singapore, immigration law hampers the ability of investors to employ foreigners and limits accessibility to those skills. In addition to visa restrictions, employers in Malaysia are taxed on their employment of foreign workers and the levy generally rises with skill level.

On the other hand, ASEAN nations are well perceived in terms of their support of strategic alliances between domestic and foreign firms as well as cross-border ventures. While the overall assessment of the ASEAN DFI environment is viewed as weaker than that on average in developed countries, it is better than that elsewhere in Asia and not perceivably different from non-Asian developing economies. The World Economic Forum (1995) survey also included questions on transactions costs related to FDI, Table 10.

4. ASEAN integration

Until fairly recently economic cooperation was not high on the agenda of ASEAN policy makers, with more effort made towards preventing regional differences from erupting into armed conflict. ASEAN did adopt a PTA in the mid-1970's, but the coverage of this agreement was too narrow to be meaningful. As the benefits of trade-driven economic growth became apparent, meaningful regional trade liberalization became more seriously discussed. In 1992 at the Fourth ASEAN Summit in Singapore it was agreed to form and implement an ASEAN Free Trade Area (AFTA).

The core feature of AFTA is the Common Effective Preference Tariff (CEPT), which envisions for each member state a staggered reduction in tariff rates to be applied to intra-ASEAN trade.[14] Ultimately, this effort aims to reduce tariffs on manufactured items to a range of 0-5% by the year 2003 (moved forward from the original target year of 2008, with calls to move the target year forward to 2000). More recently, raw agricultural goods are to be phased in by a target date of 2010. Members submit tariff lines to be included or excluded from the CEPT scheme, with upwards of 90% of intra-regional trade (ASEAN Secretariat). The exclusion list is composed of General Exceptions made for reasons of security and/or social policy in a manner consistent with Article X of the GATT, and a Temporary Exclusion list meant for sensitive products to be included in the CEPT scheme by the year 2000. The scheme includes an ASEAN- wide content requirement of 40% for a product to be eligible for CEPT concessions. While AFTA originally targeted tariff reductions, subsequent efforts liberalize other forms of border protection such as quantitative restrictions, import surcharges, and disparate customs procedures which impede trade. Some non-tariff barriers are to be eliminated 5 years from the enjoyment of concessions. Harmonization of standards has entered the agenda, with priority to be given to heavily traded manufactures.

The amount of trade that will be impacted by AFTA is not inconsequential. Member exports within ASEAN accounted for 23.2% of total member exports in 1996, a figure that has remained steady for the past several decades. This is the same magnitude as that for MERCOSUR (22.8%), but still less than the European Union (61.5%) or NAFTA (47.5%). US multinational affiliates hosted by the Asia Pacific region (excluding Japan) sold over half of their output within the region (U.S. DOC 1998). While

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[14] Information on AFTA is published by the ASEAN Secretariat in the *AFTA Reader*, various volumes.

Table 9: Survey Results on FDI regime (scale from 0 = least favorable to FDI to 10 = most favorable to FDI)

Economy	Acquisition of control (A)	Equal treatment (B)	Employment of foreigners (C)	Strategic alliances (D)	Cross-border ventures (E)	Investment protection (F)	Overall assessment (G)
ASEAN							
Indonesia	6.2	6.1	6.2	7.5	6.8	6.5	6.6
Malaysia	4.9	6.2	5.5	7.4	7.0	7.2	6.4
Philippines	6.0	7.0	6.9	7.5	6.8	6.7	6.8
Singapore	8.2	7.8	7.6	8.4	9.1	7.3	8.1
Thailand	5.2	6.6	5.9	7.8	7.4	6.4	6.6
Average ASEAN	6.1	6.7	6.4	7.7	7.4	6.8	6.9
Other Asian economies							
China	6.5	6.8	6.2	5.2	7.0	7.8	6.6
Hong Kong	9.3	8.3	7.0	8.5	9.2	5.1	7.9
India	6.6	7.9	6.5	6.6	5.0	5.7	6.4
Japan	6.5	4.2	4.1	7.0	7.5	6.9	6.0
Republic of Korea	4.8	5.1	4.4	5.3	5.0	5.9	5.1
Other developing Asia	6.2	7.5	5.8	6.8	6.3	6.5	6.5
Average other Asia	6.7	6.6	5.6	6.6	6.7	6.3	6.4
Developed countries[a]	8.1	6.6	6.9	7.3	8.4	6.1	7.2
Non-Asian developing and transitional countries[b]	7.7	7.2	7.3	5.7	7.4	5.6	6.8

Source: World Economic Forum (1995)

[a] Average for Australia, Canada, France, Germany Italy, Switzerland, United Kingdom, and the United States.

[b] Average for Argentina, Brazil, Chile, Colombia, Czech Republic, Egypt, Hungary, Mexico, Peru, Poland, Russia, and Venezuela

(A) Foreign investors may not (0) or are free to (10) acquire control in a domestic company.

(B) Foreigners are not (0) / are (10) treated equally to citizens in all respects.

(C) Immigration law prevents (0) does not prevent (10) your company from employing foreign skills.

(D) Strategic alliances are not common (0) are common (10) between domestic and foreign firms.

(E) Cross-border ventures cannot be (0) or can freely be (10) negotiated with foreign partners without government restraint.

(F) Investment protection schemes are not (0) / are (10) available for most foreign partner countries.

(G) Average assessment.

Table 10: Survey Results: transaction cost-related FDI hurdles (scale: 0 = least favorable to FDI to 10 = most favorable to FDI)

Economy	Cultural Barriers (A)	Country Image (B)	State Contro (C)	Trans-parency (D)	Bureau-cracy (E)	Corrup-tion (F)	Lobby-ing (G)	Local capital markets (H)	Distri-bution system (I)	Tele-com (J)	Techno infrast-ructure (K)	Overall rating (L)
ASEAN-5												
Indonesia	7.2	4.8	4.4	4.1	3.2	2.3	3.6	6.8	4.2	5.9	4.0	4.6
Malaysia	6.2	5.8	5.7	6.1	5.1	4.8	4.9	6.4	6.1	7.2	5.3	5.8
Philippines	8.7	2.9	4.7	4.1	2.2	2.0	3.6	6.7	3.9	3.7	3.1	4.1
Singapore	7.5	6.4	7.1	6.8	7.1	9.4	7.8	7.8	8.8	9.3	8.6	7.9
Thailand	7.3	5.7	5.1	4.4	3.4	2.6	3.7	7.1	5.3	4.9	4.3	4.9
Average ASEAN-5	7.38	5.12	5.4	5.1	4.2	4.22	4.72	6.96	5.66	6.2	5.06	5.46
Other Asian economies												
China	6.4	4.9	4.1	6.0	1.0	2.5	4.5	6.3	2.1	5.3	2.7	4.2
Hong Kong	8.7	7.0	9.0	6.6	7.1	6.9	6.5	8.8	8.3	9.3	6.3	7.7
India	7.4	3.3	4.0	3.5	3.0	1.9	3.9	5.7	5.1	4.0	3.8	4.1
Japan	5.7	4.1	4.4	3.5	2.9	5.5	3.8	6.3	6.2	7.1	7.1	5.1
Republic of Korea	4.9	5.6	4.6	4.7	2.7	4.6	5.3	4.1	3.7	7.4	5.5	4.8
Other Asia	8.0	4.9	5.9	5.0	4.8	4.4	4.1	5.6	6.0	6.3	6.3	5.6
Average non-ASEAN Asia	6.85	4.97	5.33	4.78	3.58	4.3	4.68	6.13	5.23	6.57	5.28	5.25
Developed countries[a]	7.1	5.6	6.1	4.8	4.2	7.0	4.5	8.2	7.6	7.8	6.5	6.3
Non-Asian developing and transitional countries[b]	7.4	4.5	5.1	3.6	3.0	3.2	4.2	7.0	4.7	4.9	3.5	4.6

Source: World Economic Forum (1995)

[a] Average for Australia, Canada, France, Germany Italy, Switzerland, United Kingdom, and the United States.

[b] Average for Argentina, Brazil, Chile, Colombia, Czech Republic, Egypt, Hungary, Mexico, Peru, Poland, Russia, and Venezuela.

(A) National culture is closed (0)/open (10) towards foreign cultures.
(B) Image of your country abroad is distorted (0)/reflects reality accurately (10).
(C) State control of enterprises distorts (0)/does not distort (10) fair competition in your country.
(D) The government does not often communicate its intentions successfully (0)/is transparent towards citizens (10).
(E) Bureaucracy hinders (0)/does not hinder (10) business development.
(F) Improper practices (such as bribing or corruption) prevail (0)/do not prevail (10) in the public sphere.
(G) Lobbying by special interest groups distorts (0)/does not distort (10) government decision making.
(H) Local capital markets are not accessible to foreign companies (0)/are equally accessible to domestic and foreign companies (10).
(I) Distribution systems are generally inefficient (0)/inefficient (10).
(J) Telecommunications infrastructure does not meet (0)/meets business requirements very well (10).
(K) Technological infrastructure is developed slower (0)/faster (10) than in your competitor countries.
(L) Average assessment according to criteria (A) – (K).

small by the standards of regional blocs that include a developed nation, ASEANs 1996 percentage of internal exports is still greater than that of any other bloc among non-developed countries [World Bank (1998), Table 6.6]. However, intra-regional trade still accounts for a mere 9.2% of regional GDP. Furthermore, Singapore is the largest trading partner in terms of imports or exports of every one of the ASEAN-5, so it may be the case that these countries have similar enough comparative advantages that they are in competition with each other. Still, the pattern of trade distortion which the CEPT is meant to rectify could easily be the main culprit behind the observed trade flows (or lack thereof). Frankel (1997) does find a consistent positive intra-regional bias in trade flows for every year from 1965 to 1992, though as mentioned before Singapore could be largely responsible for this.[15] Looking at total bloc member exports as a percent of total world exports, ASEAN appears to be more important to the rest of the world than other non-developed country groupings, with the region accounting for 6.3% of world exports compared to MERCOSUR's 1.4%. This suggests ASEAN to be relatively important to the global pattern of trade relative to other groupings of developing countries.

More recently, there have been nascent moves to liberalize investment within ASEAN. A 1987 agreement for the Promotion and Protection of Investments made the initial effort, moving to accord ASEAN-based firm fair and equitable treatment in other member countries in the form of national treatment of such and prohibition on discrimination against firms from member countries. The agreement also protects regional firms against expropriation and guarantees the unhindered repatriation of capital and earnings. A protocol to amend the agreement was agreed upon in September 1996, which urged members to simplify their investment procedures and approval process and make transparent and predictable the laws and regulations pertaining to foreign investment in member countries. In the works is a Framework Agreement on an ASEAN Investment Area (AIA), expected to be signed in 1998. The stated objective of the AIA is to attract greater FDI into the region from both ASEAN and non-ASEAN

[15] In other words, on average ASEAN countries trade six times more than other countries of similar size and proximity. Though AFTA was only implemented in 1993, ASEAN has been a forum for regional consultation and cooperation for three decades.

sources. This effort essentially seeks to establish a "one stop shop" for investors that might be interested in the region. It should be noted that liberalization of investment mechanisms is only part of this effort. The AIA also aims to boost cooperation, facilitation, promotion and awareness. Sample projects include an ASEAN Supporting Industry Database to provide an "information mart" for supporting industries for manufacturers and suppliers of ASEAN countries, a compendium on investment policy and measures of ASEAN countries, and a Directory of ASEAN Technology Suppliers to facilitate intra-ASEAN sourcing of technology and promote local technology suppliers to third countries.

5. Prospects for FDI in the AFTA

A growing proportion of international trade within ASEAN appears to be conducted through multinational operations. Thus the potential responsiveness of foreign investors to deeper regional integration through AFTA is highly deserving of attention. As this analysis has indicated, however, concrete predictions regarding the direction, let alone the magnitude, of the effect of trade liberalization on FDI is exceedingly complicated for several reasons. First, FDI arises in response to multiple layers of distortions such as governmental policies and imperfect competition. As is commonly know, liberalizing one distortion such as intra-regional tariff barriers in a second-best setting with potentially offsetting distortions generally yield indeterminate comparative statics results. Second, the AFTA may introduce new distortions. The negotiators go to great lengths to assure that an AFTA would reflect guiding principles of 'open regionalism' and current practices of broad and non-discriminatory liberalization appear to bear that out. Still, preferential trade liberalization is itself a piecemeal and distortionary form of liberalization. Finally, we have an incomplete picture of the current microeconomics of FDI in the region due to data limitations and problems drawing comparisons across countries, as is evident from our review of descriptive statistics. While we may not be able to provide a conclusive analysis, we can certainly indicate the major forces that will influence FDI after AFTA.

[16] Joint Press Statement, Meeting of the Fourth ASEAN Heads of Investment Agencies, Singapore, 24 July 1998.

One of the most important motivations for FDI is that of servicing the regional market and we believe this will be enhanced under AFTA. This view differs from that of others such as Athukorala and Menon (1997) who recognize that import-substitute FDI is currently low in the region. This, in our view, is due to two important factors. First, barriers on intra-regional trade are currently relatively high, limiting the market platform for foreign subsidiaries. For example, Thailand has a weighted mean tariff rate of roughly 44 percent on manufacturing and similar barriers in Indonesia and the Philippines are well over twenty percent (Table 2). Relaxing barriers amongst trade within ASEAN should significantly increase the regions market appeal and stimulate import-substitute forms of FDI. The market size of ASEAN has grown rapidly over that past fifteen years, although the present economic crisis and currency devaluations have dampened consumer demand. As incomes have increased, so has the demand for a wide variety of consumer and capital goods. Second, foreign participation in domestic retail, wholesale and service activities has been heavily regulated in some ASEAN countries such as Thailand. That most FDI is export oriented is, in part, governed by the incentive and performance requirements of most regional governments who favor both exports and manufacturing activities. Unless these restrictions on foreign involvement in domestic sales change significantly, we would anticipate little growth in FDI oriented to servicing the post-AFTA ASEAN region in heavily regulated nations.

Our previous theoretical work (Konan and Heinrich 1997) has shown that such market stimulation should tend to increase investment most in economically small countries, such as Laos, Philippines and Viet Nam, as their firms will have access to a larger regional market. Investment will also tend to be redistributed from relatively high tariff countries (to the extent that multinationals have already entered to overcome this barrier) to relatively low tariff countries. The investment attractiveness of Singapore and Malaysia, for example, would be enhanced by AFTA as their subsidiaries can service nations with high barriers against non-ASEAN trade.

As do Athukorala and Menon (1997) and Dobson and Yue (1997), we also believe that multinational firms will also be attracted to the AFTA region because of an enhanced ability to efficiently locate different stages of production throughout ASEAN and coordinate these activities. Each ASEAN member has a distinct comparative advantage in particular production stages, with poor countries more suited to low value-added activities, such as assembly, and countries with relatively highly-skilled labor (e.g., Singapore) able to serve higher value activities, such as management and engineering. As evident by the Singapore experience, once low value activities have been mastered and skills and infrastructure accumulated a country can generally move up the value chain. ASEAN countries have tended to used investment measure to attract "desirable" sorts of investment. However, this effort has focused its attention largely on entire industries rather than on individual stages of the production process. We recommend such measures be liberalized to facilitate intra-regional linkages in production that will likely emerge in response to AFTA. Multinationals are also attracted to economies with skilled workers and good local infrastructure. The is no foreseeable limit to the amount of human capital that can be accumulated, so policy measures which focus on raising the skills of the local population such as education can really pay off for countries that are patient enough to stick with what is necessarily an inter-generational strategy. Providing good infrastructure would benefit and attract multinationals, but would have a much more significant positive impact on the competitiveness of local firms. Those factors that are good for MNEs are good for everyone, and this win-win approach could lay the foundation for a second East Asian miracle.

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