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WORKING PAPERS ON INTERNATIONAL INVESTMENT

SOUTHEAST ASIA: THE ROLE OF FOREIGN DIRECT INVESTMENT POLICIES IN DEVELOPMENT

1999/1

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INTRODUCTION AND SUMMARY

The financial crisis in Asia has brought to the fore the question of the appropriate policies for recovery and for future sustainable development. One area of particular importance is the treatment of foreign investors. Foreign direct investment (FDI) has played a leading role in many of the economies of the region, particularly in export sectors, and has been a vital source of foreign capital during the crisis. The four countries reviewed in this study¹ — Indonesia, Malaysia, the Philippines and Thailand (referred to hereinafter as the ASEAN4) — have all to varying degrees welcomed inward investment for its contribution to exports. As a result, although only a small share of total investment or employment in each economy, FDI has been a key factor driving export-led growth in Southeast Asia. Foreign firms have by no means been the only actors, but they have played a leading role in those sectors with the fastest export growth such as electronics. Through such investment, host economies have rapidly been transformed from agriculture and the exploitation of raw materials into major producers and exporters of manufactured goods.

For many years, Malaysia and Thailand were among the most open in the developing world to foreign investment. They were quick to recognise the powerful role that foreign investors could play in fuelling export-led growth, and they were well-placed to attract such investment during the years of regional structural adjustment in the late 1980s. Partly as a result of FDI inflows, the two countries were among the world's fastest growing economies before the crisis. At the same time, however, the years leading up to the crisis revealed a growing disquiet in some ASEAN countries about their continuing ability to attract FDI in the face of competition from countries such as China. Related to the issue of possible investment diversion, questions were also raised about whether FDI inflows were contributing sufficiently to technology transfer and industrial upgrading.

In the wake of the financial crisis which has swept through the region, it is useful to look once again at the experience of various ASEAN countries and the role of foreign investors in their economic development. In all four countries, development strategies include a selective approach to investment promotion with a clearly circumscribed role for foreign direct investors. Such partial openness allows foreign firms to contribute to rapid economic growth driven by exports, but it has been less adept at delivering sustainable development. In many cases, indigenous capabilities have not been developed sufficiently in those export sectors dominated by foreign multinational enterprises (MNEs), leaving the host country vulnerable to changes in investor sentiment and to growing competition for such investment from other countries. This study draws on the experience of the ASEAN4 countries to suggest that a more balanced treatment of foreign investors which allows foreign MNEs to play a greater role in the domestic economy could yield substantial benefits in terms of restoring investor confidence and placing economic development in the ASEAN4 on a more sustainable basis in the future.

FDI trends in the ASEAN4

With the exception of the Philippines, which until the 1990s had not generally welcomed foreign investors, the ASEAN4 have all been major recipients of foreign direct investment (FDI). The period of most intense foreign investment activity occurred in the late 1980s when firms from Japan and the Newly Industrialising Economies (NIEs) were looking for production bases abroad to escape appreciating home currencies and the loss of preferential access to many OECD markets (for the NIEs). In all cases except Indonesia, FDI flows have held up remarkably well during the crisis, as foreign firms have responded to new opportunities to acquire local companies and to gain access to the local market.

At the same time, however, the continued success of the ASEAN4 countries in attracting foreign investment could not be taken for granted, even before the crisis. Japanese firms have been the most active investors in the region, and recent surveys suggest that they will be investing significantly less in the near future. Furthermore, other countries such as China and Vietnam now compete actively for labour-intensive investment. Annual foreign investments in China have recently been three times as high as those in the ASEAN4 combined. Even within ASEAN, Malaysia and Thailand may have been losing some export-oriented investments to Indonesia and the Philippines before the crisis, as these latter countries adopted more aggressive investment promotion policies.

The policy environment for FDI in the ASEAN4

FDI policies throughout much of ASEAN have formed an integral part of overall development strategies. Whether for import substitution or export promotion, foreign investors have been welcomed in certain cases, subject to strict criteria. Those firms wishing to export most of their output are often treated as favourably as investors in OECD countries. In contrast, foreign investors interested in providing goods and services to the local market face numerous restrictions on their activities, including an outright prohibition in some sectors. In many cases, these latter foreign firms may not acquire a majority stake in a local company or own the land on which the factory is built. They also often face various performance requirements related to the transfer of technology or the employment of local personnel, including directors.

The perceived threat of investment diversion away from ASEAN and towards China had begun to push ASEAN4 policies towards FDI in a more liberal direction even before the crisis. It was also at the heart of the decision to accelerate the process of regional integration through the ASEAN Free Trade Area and the ASEAN Investment Area. The crisis has added impetus to this liberalisation by allowing greater access to the domestic market for foreign investors, including through the acquisition of local firms. Although this openness is limited to two years, those investors which take advantage will continue to enjoy the benefits after that time.

Such liberalisation is to be welcomed, but it is unlikely by itself to foster greater foreign investor confidence or to put future development on a more sustainable basis. Sustainable development depends on the quality of investment received more than on the quantity. The experience of countless developing countries over the past few decades suggests that the benefits from inward direct investment are not automatic; they depend crucially on the overall policy environment in which the firm invests. Policies towards foreign investment in the ASEAN4 can be seen with hindsight to have created distortions which hamper the traditional mechanisms through which foreign investors transfer technology and other know-how to the local economy.

The limits to selective export promotion

Foreign investors have not been the only exporters from the ASEAN4, but they have been well-represented in those sectors with the fastest export growth. Through export-oriented FDI, ASEAN4 countries were able to shift quickly towards a manufacturing-based economy in which economic growth was driven by rapidly expanding exports. The record from this export performance speaks for itself, but so too does the manifest failure in many cases to translate this export success based on FDI into something more durable. Not only have exports been limited to a small number of products (usually intermediate ones) and sectors, but to varying degrees these export sectors have been virtual foreign enclaves within host countries. Investments in these enclaves have often been characterised by low value-added (principally from labour-intensive assembly operations) and a poor record of technology transfer. These shortcomings represented one of the growing structural problems leading up to the crisis.

This dualist policy of aggressively promoting export-oriented investment while protecting the local economy from both imports and market-seeking inward investment has ultimately undermined the very benefits it was intended to achieve. To export successfully to world markets, foreign investors have had to purchase inputs principally from abroad or from other foreign investors in the host country. Many of the most successful export sectors in the ASEAN4 are highly import dependent, and this has limited the impact of massive devaluations in these economies on exports. The primary interest of these exporters in the host economy is as a source of low cost labour.

Foreign investors oriented towards the domestic market frequently have closer links with local companies, and, as the world's most competitive firms in these sectors, they can provide useful know-how and other basic technology for local firms. Because these foreign firms produce goods and services for the local market which meet world standards, they can indirectly help domestic firms to become more competitive in world markets, thereby enhancing the export potential of indigenous entrepreneurs.

The intention here is not argue for one form of foreign investment over another. In an enabling environment in which private sector activity can flourish, each type of foreign investment can make a valuable and in many ways unique contribution to economic growth and to sustainable development more generally. A recent study of 69 developing countries found not only that FDI stimulates economic growth but that it has a larger impact than investment by domestic firms.²

Outward orientation through foreign investment promotion remains a viable development strategy which will continue to yield rapid economic growth in the future. Indeed, the potential role of foreign firms may have increased since the crisis. But at the same time, selectivity in incentives based on the degree of export orientation has been shown in light of the crisis to have created a dual economy in which technological spillovers were few. These spillovers, rather than exports per se, should be the focus of investment policies. It is argued here that such spillovers are enhanced in a policy environment in which foreign investors are permitted to establish and produce for both the domestic and export markets under similar conditions.

I. FDI TRENDS IN THE ASEAN4

The ASEAN4 countries have collectively been among the most important destinations for FDI outside of the OECD area. As a group, they have been the fifth most popular host to FDI world-wide in the 1990s, though a long way behind China (Table 1). The external environment has strongly influenced the overall level of inflows over time, but policies in each country have largely determined the distribution of inflows within ASEAN.

Table 1. **Total FDI inflows by country, 1990-97** (\$ million)

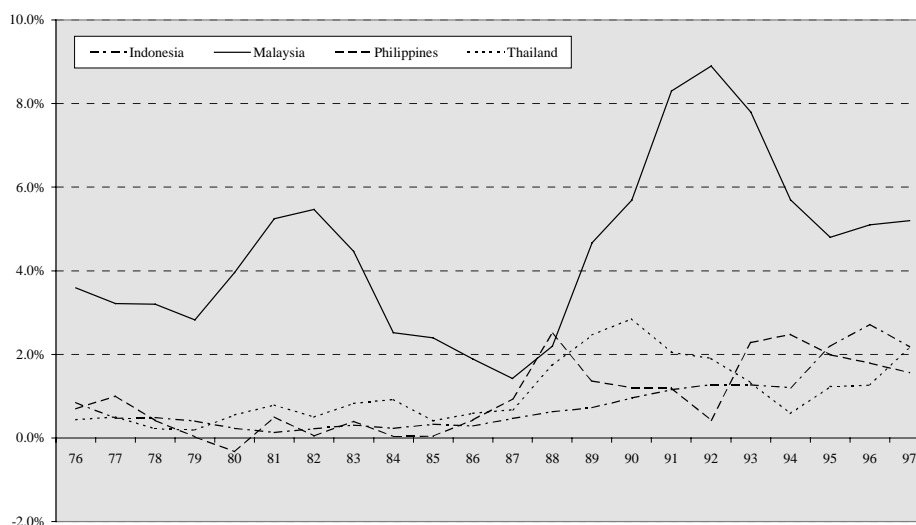
1	US	414 074	21	Denmark	18 177
2	China	200 578	22	Thailand	17 177
3	UK	176 889	23	New Zealand	17 083
4	France	149 587	24	Poland	15 882
5	BLEU	84 008	25	Colombia	15 798
6	Netherlands	70 743	26	Hungary	14 945
7	Spain	68 068	27	Norway	14 412
8	Mexico	58 850	28	Hong Kong, China	14 239
9	Canada	53 818	29	Portugal	12 909
10	Australia	52 212	30	Russia	12 774
11	Singapore	49 173	31	Venezuela	11 890
12	Sweden	47 546	32	Chinese Taipei	11 443
13	Brazil	44 228	33	Peru	11 215
14	Germany	40 358	34	Korea	10 534
15	Malaysia	35 177	35	Austria	10 438
16	Italy	30 394	36	Japan	10 310
17	Argentina	30 120	37	Nigeria	10 093
18	Indonesia	23 684	38	India	9 957
19	Switzerland	20 188	39	Israel	8 398
20	Chile	19 085	40	Philippines	8 379
				ASEAN4	84 417

Source: OECD, IMF

Malaysia has translated its early move to export promotion within the ASEAN4 into a sustained ability to attract inward investment by export-oriented firms. Indonesia owes its success principally to the oil and gas sector, while Thailand has attracted both market-seeking and export-oriented investors. The conversion of the Philippines to investment promotion is more recent and is only now beginning to affect its relative ranking.³

Figure 1 shows FDI inflows into the ASEAN4 over the past two decades. Inflows are divided by GDP in each case in order to remove the effect of market size, inflation and currency movements. The early and leading role of Malaysia in attracting inward investment is immediately apparent. With the smallest economy of the four countries, Malaysia was the first to reach the limits of import substitution policies as the market became saturated and economies of scale were limited. Malaysia also benefited from its proximity to Singapore, as the substantial foreign presence in the latter offered opportunities for Malaysia to attract labour-intensive manufacturing in which Singapore was rapidly losing its competitiveness.

Figure 1. FDI inflows as a percentage of GDP

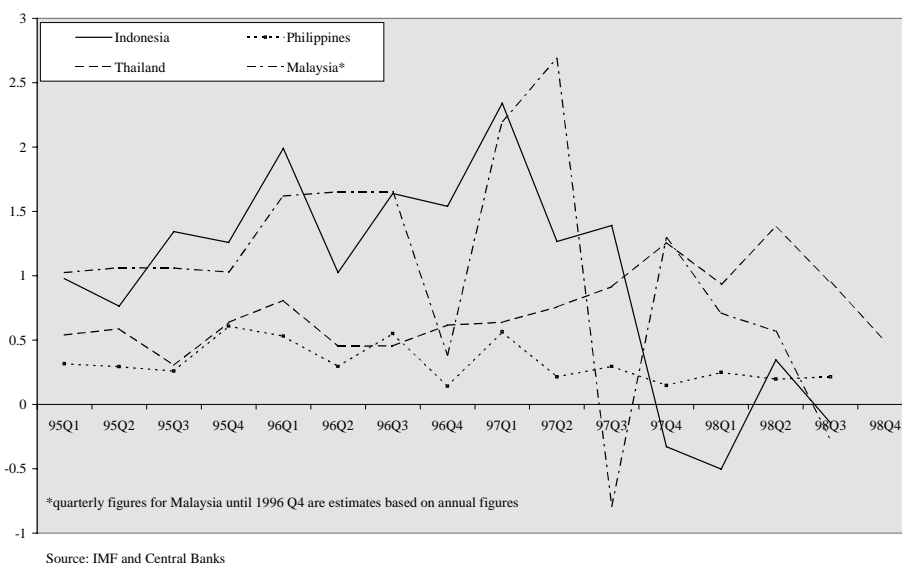


Source: IMF

FDI since the crisis

Figure 2 shows the most recent quarterly trends for inflows into each country in dollar terms. Inflows into Thailand grew rapidly after the onset of the crisis, in spite of the sharp depreciation against the dollar. They have fallen somewhat in the past two quarters, however. It remains to be seen whether this is a delayed reaction to the crisis or a temporary downturn. FDI in the Philippines has remained steady, if unspectacular, throughout the crisis. In Malaysia, the sharp drop in inflows in the third quarter of 1998 can probably be attributed to the immediate reaction of foreign investors to the imposition of capital controls on 1 September 1998, even if these controls were not intended to affect direct investment. Investments in Indonesia have been discouraged by the unstable political environment and were negative in three of the last four quarters for which data are available.

Figure 2. **FDI inflows by quarter, 1995 – 1998** (\$ billion)

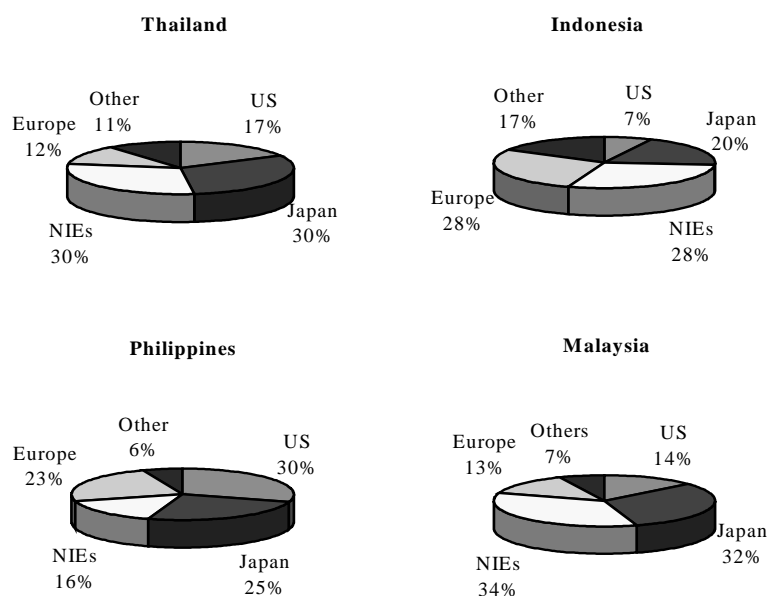


Figures for applications and approvals by various investment agencies also show continued foreign interest in investing in the ASEAN4, in contrast to the severe contraction of domestic investment. In Malaysia, applications by foreign firms fell 12 per cent in local currency terms in 1998, after declining 18 per cent in 1997. Given the depth of the economic slump in Malaysia, these declines can be considered moderate and contrast forcefully with the 68 per cent drop in investment applications by domestic firms. In Thailand, foreign applications to the BOI fell 29 per cent in the first half of 1998 compared with the same period in the previous year, while domestic applications dropped by 87 per cent. In Indonesia, foreign investment approvals in local currency grew in the first eight months of 1998 compared to 1997, although the implementation rate for such projects has been low in recent years. In the Philippines, total approved foreign investments in the first quarter of 1998 were significantly higher than in the same period of 1997, in contrast to the sharp drop in approved domestic investment projects. This growth is especially significant when one considers that total approvals by the Board of Investment were already at record levels in 1997. Investments in export processing zones also continued to expand in the first half of 1998.

FDI inflows by country of origin

The four countries differ markedly in terms of the origin of their inward investment, reflecting differences in their economic structure, as well as in their historical ties to investor countries (Figure 3). Thailand and Malaysia have a similar ranking of investors, with roughly two thirds of their investment coming from within the region itself (evenly divided between Japan and the NIEs). These two host countries were best placed to receive the massive outflow of investment from the rest of Asia in the late 1980s in search of lower wage costs and more competitive currencies exchange rates. The role of the petroleum sector in Indonesia explains the relative prominence of European firms in that country. The leading role of US firms in the Philippines relates partly to the close historical links between the two countries and the fact that the Philippines was relatively closed to inward investment when Japanese and NIE firms were looking for production locations abroad. In spite of the early prominence of US MNEs, the Philippines now has a relatively well-diversified pattern of inward investment.

Figure 3. **Inward investment in ASEAN4 countries by investor country**
(share of total inward investment stock)



Source: National governments

FDI inflows by sector

The four countries also differ in terms of the sectors favoured by foreign investors. Once again, Thailand and Malaysia are the most similar: in both countries, FDI in the manufacturing sector is dominated by projects in electronics, with significantly more investment in that sector than in any other manufacturing activity. In Thailand, however, manufacturing as a whole represents only one third of total inflows. A large share of the total goes into distribution and finance, as well as construction and real estate. In Indonesia, manufacturing investments have tended to be in resource-based activities such as chemicals and paper. Investment in the Philippines is more diversified, albeit involving a much lower total stock of investment. In both Indonesia and the Philippines, the electronics sector has been growing.

Because the sectoral coverage and the way in which FDI is recorded in each country differs greatly, it is instructive to make comparisons of the ASEAN4 based on source country data. Table 2 looks at investment in the ASEAN4 and China by US and Japanese firms. These firms are not always the largest investors in each country, but they are probably fairly representative of OECD investors as a whole. In addition, unlike many investors from the NIEs, they are often among the world's largest MNEs and possess much of the proprietary technologies from which host countries would like to benefit.

Table 2. **FDI in the ASEAN4 and China by US and Japanese firms**
(Total stock, end 1997; \$ million)

	China	Indo.	Mal.	Phil.	Thai.	Total 5
<i>Japan</i>						
Manufacturing	10 822	12 380	7 104	3 176	8 914	42 396
Non-manufacturing	5 917	20 662	2 695	2 328	3 420	35 023
Total	16 739	33 042	9 800	5 504	12 334	77 418
<i>United States</i>						
Manufacturing	2 696	358	3 222	1 616	1 090	8 982
Non-manufacturing	2 317	7 037	2 401	1 787	2 447	15 989
Total	5 013	7 395	5 623	3 403	3 537	24 971
<i>Total (US, Japan)</i>						
Manufacturing	13 518	12 738	10 326	4 792	10 004	51 378
Non-manufacturing	8 234	27 699	5 096	4 115	5 867	51 012
Total	21 752	40 437	15 423	8 907	15 871	102 389

Source: US Department of Commerce; Japanese Ministry of Finance

As seen in Table 2, the stock of Japanese investment in the five countries is three times higher than that of American firms (although the two countries do not record investments in the same way). For both investor countries, Indonesia is at the top of the list and the Philippines at the bottom. In manufacturing, Indonesia is still first for Japanese firms while American manufacturing firms have invested very little so far in the country. Much of the Japanese investment in Indonesia is intended to serve the large and protected domestic market. US investment in the five countries is greater in non-manufacturing than in manufacturing. Taking US and Japanese investments together, Thailand and Malaysia are most similar once again, with roughly equal inward investments in both manufacturing and non-manufacturing. China has slightly more manufacturing investment than any of the ASEAN4, but much less than the four ASEAN countries combined. Indonesia, with its abundant natural resources such as oil, takes in more investment in the non-manufacturing sector than the rest of the ASEAN4 taken together. This may change if the service sectors in the other ASEAN countries are opened up as a result of the crisis.

External influences on the trend in FDI in the ASEAN4

Trends in FDI in the ASEAN4 have been strongly influenced by external events over which each country has had little control, notably currency appreciation in major source countries and the emergence of China as a competing location for investment. Those ASEAN4 countries with the most welcoming and stable environment have received a larger share of inflows, but any influence of policies in individual countries on FDI inflows has been circumscribed by these external influences. This explains certain similarities in the trend of FDI inflows into each ASEAN country over time, albeit at vastly different levels. In almost all cases, inflows accelerated rapidly in the late 1980s, fell sharply in the early 1990s and were rising again before the crisis. Indonesia is an exception within ASEAN. With a large internal market and abundant natural resources, it has been able to attract a more steady stream of investors than other ASEAN members.

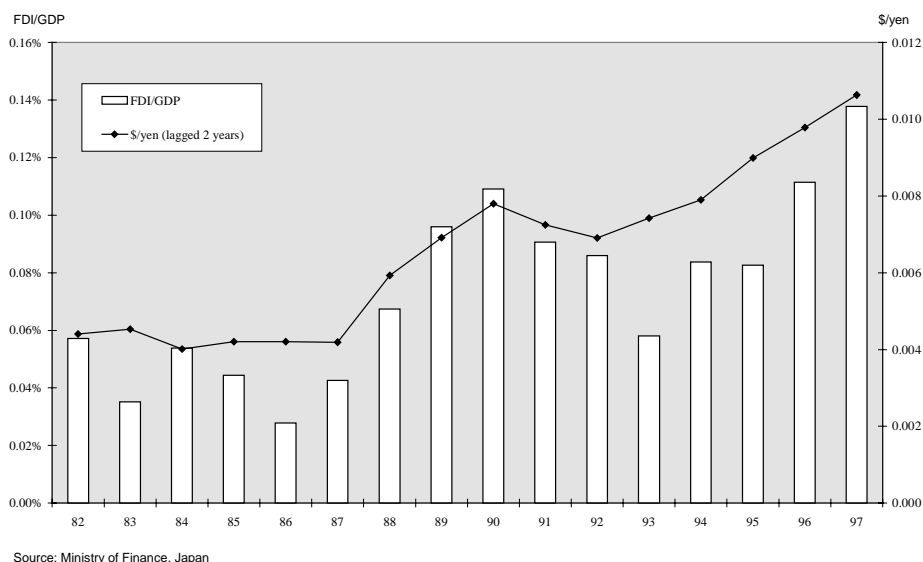
Faced with these external influences, individual host countries have had to adjust their FDI policies in order to benefit from opportunities offered by a copious supply of investment applications and to confront

threats to that supply at other times. For this reason, it is sometimes difficult to establish a direct link between changes in FDI policies and subsequent inflows of investment. To some extent because of the influence of external events, trends in FDI inflows into the ASEAN4 have driven policy changes in host countries and not the other way round. Policies towards FDI have tended to react to events rather than shaping them.

Japanese investment

To understand some of the external factors at play, Figure 4 compares Japanese direct investment in manufacturing in ASEAN4 with movements in the yen/dollar exchange rate. Japanese firms are the largest investors in Asia outside of China, so their decisions have a strong impact of inflows into individual Asian economies. The appreciation of the yen after 1985 pushed many Japanese firms to establish lower cost production bases within the region.

Figure 4. **Japanese investment in ASEAN4**



Firms adjust to exchange rate movements with a lag which varies by sector and according to the extent of exchange rate changes. By lagging the exchange rate by two years in Figure 4, it can be seen immediately that the two trends follow each other very closely. Japanese investors were quick to respond to the initial yen appreciation following the Plaza accord in 1985 when the dollar went from 250 yen at the beginning of the year to 201 at the end. The yen continued to appreciate sharply until 1988, at which point one dollar was worth half as many yen as at the beginning of 1985. Japanese investments continued to expand in Asia for another two years, with outflows over ten times higher as a percentage of GDP than five years earlier.

This surge in manufacturing investment into Asia by Japanese firms resulted in an unprecedented shift in productive capacity within the region. Some countries such as Malaysia and Thailand benefited handsomely in terms of a rapidly expanding manufacturing sector. Industrial restructuring by Japanese firms was mirrored to a lesser extent by investments from Chinese Taipei and other NIEs, faced with

currency appreciation of their own and the loss of their preferential access to OECD markets as developing countries.

By 1988, the yen had begun to depreciate slightly, while the structural adjustment of the Japanese and Asian economies as a result of the yen appreciation continued for another two years. Japanese outflows to Asia began to fall rapidly and by 1993 were only one half the level of 1990 (as a percentage of GDP). Once again, the lagged response to further yen appreciation encouraged a further resurgence in outflows to the region after that date.

On the basis of this past relationship between Japanese investment in Asia and exchange rate movements, one might expect to see a decline in such investment in the ASEAN4 over the next few years as a result of the sharp depreciation of the yen against the dollar beginning in 1997. This was borne out in an Eximbank survey of Japanese investor intentions from mid-1997 which found a declining Japanese interest in ASEAN4 countries offset by continued or rising interest in China, India and Vietnam. Paradoxically, the Asian financial crisis beginning in 1997 may actually have temporarily sustained Japanese investments in the region because of the difficulties experienced by affiliates in raising local capital and the need for parent firms to inject liquidity.

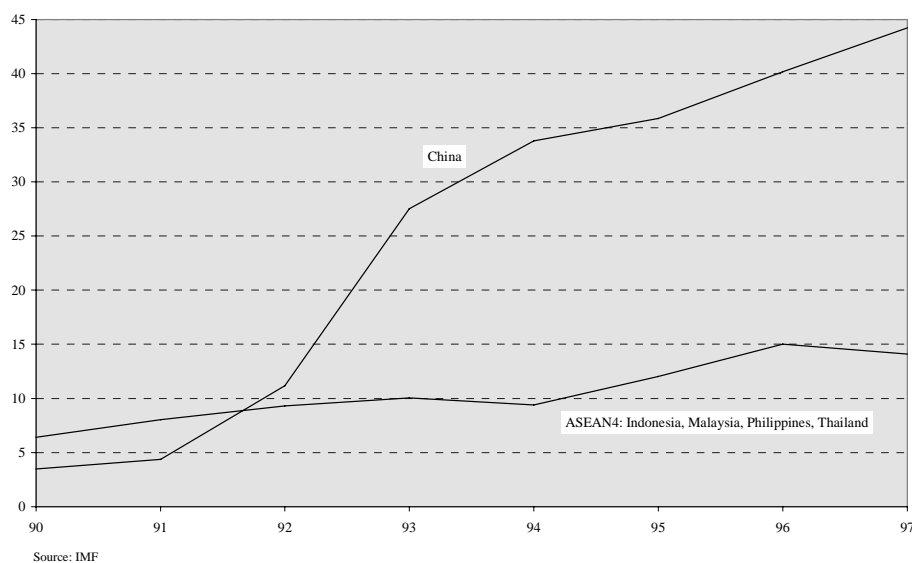
Several recent surveys of Japanese firms' investment intentions in Southeast Asia suggest that flows will decline in both 1998 and 1999, not only because of the crisis in host countries but also because of problems at home in Japan. Investments from Japan into each of the ASEAN4 fell in the first half of 1998, particularly in the transport equipment sector because of the sharp contraction in domestic demand. In China, in contrast, another survey finds that the crisis has not yet dampened Japanese interest.

Investment in China

A second external factor which might have impinged on FDI inflows into ASEAN is the prominence of China as a host for foreign investment. For the most part, the notion that countries compete for FDI is a misconception. Foreign direct investment is not a zero sum game with investors choosing one country at the expense of all others. Indeed, it is more likely that investment into one country in Asia will spur further investments throughout the region over time. Singapore, for example, may have acted as a magnet for foreign investment into the whole of Southeast Asia, often involving vertically-integrated activities. Nevertheless, the spectacular rise of China as a host to FDI in the 1990s has been perceived within parts of ASEAN as a threat to its own continuing success in attracting FDI. Beyond China, other potential rivals such as India loom on the horizon. Because of this perceived threat and the impact it has had on ASEAN policies, notably towards regional integration, it is worth exploring in more detail what the rise of China implies for ASEAN and in what ways it might have affected the prospects of the ASEAN4 in attracting investment in the future.

Figure 5 shows FDI into ASEAN4 and China in the 1990s. The rapid growth in inflows into China between 1991 and 1994 is immediately apparent, as is the relative stagnation in inflows into the ASEAN4 as a whole. Actual inflows continue to expand into China, but when measured as a percentage of GDP, inflows peaked in 1994. Contracted investment in China is declining, with continued inflows sustained by the steady stream of realised investments as already approved projects come into operation. As a result, the Chinese share of FDI inflows into the developing countries of the region has stabilised following a rapid rise in 1992-93.

Figure 5. FDI in China and the ASEAN4, 1990-1997 (\$ million)



The question of investment diversion hinges on whether investment in China and in the ASEAN4 are substitutes. In terms of both the country of origin of the investor and the sector involved, FDI in the two areas has tended to be very different. Over one half of investment in China comes from Hong Kong, China, with Japan, Chinese Taipei and the United States contributing another one quarter. Although firms from these four economies also invest in ASEAN countries, the ranking is very different, with Hong Kong Chinese firms much less prominent.

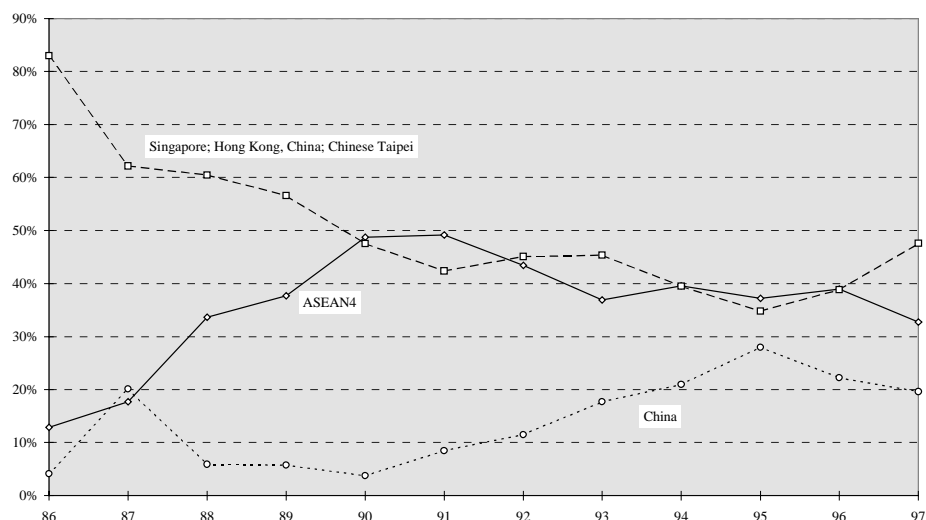
Many of the investors in China from Hong Kong, China and Chinese Taipei are small and medium-sized enterprises. Such firms often have limited financial or administrative resources with which to invest abroad, except where, as with China, geographical proximity and cultural affinity are sufficient to minimise transactions costs. The same may not be true to the same extent for investments in ASEAN4 countries, although the overseas Chinese communities in these countries sometimes serve as a useful conduit for such investment. In contrast, investment in ASEAN4 countries is relatively more likely to be from large MNEs, often originating in OECD countries.

To understand more clearly the effect that the opening of China has had on FDI in ASEAN requires a discussion of the motives for investing and the strategies of investing firms. Surveys of both American and Japanese firms suggest that they invest in both China and the ASEAN4 primarily to supply goods or services to the local market. Almost two thirds of the output of Japanese firms in China, for example, is sold within China. Hence, the principal way in which China competes with ASEAN is as a market for investors. Although its lower level of development makes it a relatively smaller market, China is generally ranked as the most important market in the medium and long term by Japanese investors. An OECD study has predicted that China will have the world's largest economy by 2015.⁴

Some investments into both China and the ASEAN4 are for export platforms, with final sales destined for the home market or third countries. Such investments are particularly prominent in the electronics sector and often account for a significant share of total manufactured exports from host countries. Anecdotal evidence suggests that some firms have shifted such activities to China to take advantage of lower labour

costs. Figure 6 puts this shift in labour intensive production to China in the perspective of long-standing patterns of regional structural adjustment brought about partly through FDI.

Figure 6. OECD outflows to major Asian destinations
(percentage of total OECD outflows to all eight locations)



Source: *International Direct Investment Statistics Yearbook*, OECD

The late 1980s saw a shift in the relative share of OECD investment going to the ASEAN4 as the share in the NIEs fell by almost one half. In 1991, the ASEAN4 took in more OECD investment than the NIEs for the first time, but after that, the ASEAN4 share fell as OECD investors became increasingly interested in China. Since 1995, the NIEs have recovered somewhat at the expense of both the ASEAN4 and China which provides a useful reminder that the causes of FDI are complex and cannot simply be characterised as a gradual shift towards more labour abundant locations. Looking at shares provides interesting evidence of structural adjustment in Asia, but it should not give the impression that total investment is fixed in supply: OECD investment into all three groups has risen over time.

Much as the ASEAN4 benefited from the declining competitiveness of the NIEs and Japan in labour-intensive activities in the late 1980s, so too has China benefited from similar circumstances in the ASEAN economies. But while the NIEs and Japan moved successfully to higher value-added activities, certain ASEAN countries have encountered difficulties in effecting this transformation. The focus on investment diversion to China should not deflect attention from the domestic causes of this adjustment problem. As more and more countries compete for export-oriented investments, the period of time during which adjustment must be undertaken has shortened. At the same time, the speed with which countries can transform their economies into manufacturing powerhouses has also increased. Globalisation offers substantial opportunities for participating countries, but it also requires an ability for rapid adjustment to benefit the most from these opportunities.

Summary

To explain the record of individual countries in attracting FDI inflows requires an understanding not only of policies and events in each host country but also of factors influencing the potential supply of such investment in home countries and of changes in other major host countries. The ebb and flow of Japanese FDI and the rise of China have had a significant impact both on inflows into ASEAN4 and on perceptions concerning future inflows. But at the same time, these external events have not operated within a vacuum. The ASEAN4 countries would never have attracted Japanese investment in the first place if they had not had a competitive workforce and relatively accommodating policies towards foreign investors. Countries such as Malaysia and Thailand were in the right place at the right time in the late 1980s, but they also had the regulatory environment to attract export-oriented investors.

Will existing policies be enough to sustain inflows in the future? The financial crisis has made this question even more pertinent given the sharp drop in other forms of capital inflows. The answer depends partly on whether European and American investors will take up the slack left from declining growth in Japanese investment in the region and on whether the gold rush into China has abated. But the answer will also depend on whether the ASEAN4 countries have the appropriate policies in place in the new, more competitive environment for global FDI flows. Policies towards inward investors in each of the ASEAN4 are discussed below.

II. THE POLICY ENVIRONMENT FOR FDI IN THE ASEAN4

The role of FDI policies in overall development strategies

Import substitution policies were pursued in all four countries in earlier decades, in keeping with the prevailing development view that government intervention was necessary to promote industrialisation. Strategic sectors were protected from foreign competition through high tariffs. In some sectors foreign investment was proscribed, and in most it was heavily circumscribed. Foreign investors were limited to minority shares of companies, could not own the land on which their factories were built, were required to transfer technology and sometimes to divest after a number of years. Many foreign MNEs nevertheless invested during this period to participate in the economic rents resulting from import protection.

The switch to export promotion began at different times in different countries, with the timing dictated partly by the size of the local market and the availability of natural resources. Small markets limit the scope for economies of scale and hence raise the cost of protection, while natural resources provide export earnings to alleviate balance of payments difficulties. External factors were also important: the example of successful, outward-oriented NIEs, the prolonged commodity slump in the 1980s, and opportunities offered by exchange rate realignments after 1985. Currency realignments, the switch to export promotion, including FDI liberalisation, and the rapid inflow of FDI from Japan and the NIEs all combine to account for the dramatic export-led recovery of the ASEAN4 economies after 1985 following a decade of secular decline (Figure 7).

Because investment incentives and restrictions have often co-existed over several decades in these economies, the move towards export promotion usually reflects more a change of emphasis than a substantially new legislative agenda. Malaysia started to promote exports as early as the 1970s, although for both Malaysia and Thailand, the real export push began only in the mid-1980s. Indonesia and the Philippines are more recent converts to the export-oriented approach to development, but their policies in this area have now converged substantially on those in the other two countries.

Rather than replacing import substitution, export promotion was super-imposed on the pre-established structure. The restrictions on FDI for the domestic market remained largely intact; indeed, some of them are enshrined in national constitutions. There has nevertheless been some relaxation in the implementation of these policies over time. Local content requirements have been curtailed as a result of the TRIMs agreement, except in the automobile sector, and divestiture requirements — where they exist — are not rigorously enforced. There has been some further relaxation of policies, often on a temporary basis, as a result of the crisis, but the basic regulatory structure for domestic-oriented investment remains in place.

Figure 7. Average real GDP growth in the ASEAN4, 1968-96



Restrictions on FDI in the ASEAN4

Not all ASEAN4 countries regulate inward investment in the same way or with the same degree of efficiency, but there are nevertheless many similarities: all four countries routinely screen inward investment, often linked to the granting of incentives; some sectors are proscribed for foreign investors, usually contained in a negative list; equity limits often apply in other sectors and for acquisitions of local companies; and land ownership is sometimes restricted. The most important obstacles to inward investment are presented below.

Screening

A foreign investor wishing to invest in one of the ASEAN4 must usually go through a screening agency or Board of Investment (BOI). Although domestic investors must also usually apply to the same agency, the conditions applied to their investments are not necessarily the same. The screening agency serves a political purpose as well as an economic one. It demonstrates to a local population which may be hostile to, or suspicious of, foreign investment that such investments are actively monitored by the government. The principal aim of such an agency, however, is to further the development strategies of the host government. The agency will favour certain sectors on a priority list or those investors which fulfil pre-established criteria, usually related to exports.

In many cases, screening agencies are evolving from authorising bodies to investment promotion agencies. The criteria for approval have generally been simplified, and approval is now usually only necessary for those investors seeking incentives. The practical implications of this shift have not yet been great: because of distortions in the rest of the economy such as high trade barriers, most investors require some form of incentives if they are going to be able to produce profitably. Important incentives are the exemption from tariffs on imported components and the right to own the land under the factory. These types of “incentives” are likely to be important for both import-substituting and exporting firms.⁵

As part of the transition to investment promotion, Boards of Investment have attempted to set up a one-stop shop to facilitate the approval process. Success in this area has been hampered by other ministries keen to retain regulatory responsibility. Foreign investors sometimes exploit these rivalries by playing one ministry off against the other, and, in an attempt to avoid this, the BOI is often placed directly under the President or Prime Minister, rather than in a specific ministry. Malaysia is an exception in that its Industrial Development Authority is placed under the Ministry for International Trade and Industry. While the direct link to the President provides some assurance against ministerial in-fighting, it also reduces transparency by making the ultimate decision partly a political one. In addition to inter-ministerial rivalries, the Board of Investment may have internal difficulties evolving towards a more user-friendly approach. A study of screening agencies found that “the initiative for change rarely originates in the screening units themselves”.⁶ Sometimes a political commitment to speed up the time in which a decision must be made can force the BOI to limit the requirements for investors. In some cases, a new agency is created alongside the BOI to handle export processing zones or other incentive programmes.

Because of its dual developmental and political function, the screening agency is not likely to disappear in the ASEAN4. As long as decisions are based on a clearly defined set of criteria, transparent, free from political interference and rendered within a limited time period, a screening agency can be compared with an investment promotion agency which is responsible for monitoring compliance with the granting of incentives. In this way, the presence of such an agency need not be construed as an obstacle to FDI *per se*. In some cases such as Thailand investors may actually prefer to go through the agency, not least because it offers certain guarantees concerning expropriation.

In practice, however, it is the nature of many Boards of Investment which have evolved from an earlier, more protective era that decision making is still slow and lacks transparency. Both foreign and domestic investors in Indonesia have complained about cumbersome and time-consuming licensing procedures and high facilitation costs, and Japanese investors have ranked the complexity of administrative procedures as the principal problem encountered in their operations in Indonesia.⁷ These complaints are in spite of the considerable effort which the Board of Investment (BKPM) has already undertaken to streamline procedures.

Not all Boards of Investment face similar complaints. The Malaysian Industrial Development Authority, for example, is generally recognised to be one of the more effective agencies in the region. Even those which are slow and non-transparent are moving in the direction of greater efficiency. In Indonesia, a recent Presidential decree allows for approvals to be signed by the Chairman of the Board of Investment rather than the President for all joint ventures below \$100 million. As this process of streamlining continues, impediments to investment will become exclusively a function of legislation which lists sectors off-limits to foreigners or which prescribes certain equity limits by sector. These are discussed below.

Foreign equity limits

Screening agencies are concerned with new investment projects or the expansion of existing ones. Acquisitions of local companies by a foreign investor are a different matter. In most cases, until recently, foreign investors were limited to minority stakes in local companies, regardless of the specific sector. The foreign equity share ranged from 30 per cent in Malaysia to 49 per cent in Indonesia and Thailand. Some sectors, such as banking, had even lower limits. In some cases, these restrictions are enshrined in the Constitution.

Acquisitions of local companies are often the preferred mode of entry into a foreign market in both OECD and non-OECD countries. Foreign investors will sometimes not require complete control of a joint venture, but in many of the most technologically-sophisticated sectors and those where brand names are

important, full foreign ownership is preferred. A minority ownership requirement can thus act as a significant barrier to investment in these sectors, particularly for those investors wishing to sell principally in the local market.

In addition, the authorisation process in these cases is often different from the usual Board of Investment procedure. In Malaysia, for example, the investor must have the approval of either MIDA or the Foreign Investment Committee or both, depending on how the acquisition is financed. Among other requirements, the investor must demonstrate that the merger will lead directly or indirectly to net economic benefits in relation to such matters as the extent of indigenous Malay (or *bumiputera*) participation, ownership and management, as well as income distribution, growth, employment, exports, quality, range of products and services, economic diversification, processing and upgrading of local raw materials, training, efficiency and research and development. Economic needs tests are not uncommon for acquisitions in some sectors within the ASEAN4.

Since the onset of the crisis, Indonesia has relaxed its horizontal equity limits for acquisitions, except in the financial sector. Malaysia has, at various times, allowed firms to exceed legal foreign equity limits. The Thai government has proposed amendments to the Alien Business Law, but efforts have been stalled in Parliament. Foreign investors have nevertheless been allowed to acquire ailing local companies. In the Philippines, equity limits remain as part of the “Filipino First” clause of the Constitution.

Negative lists

A complement to horizontal equity limits for acquisitions is the use of negative lists of those sectors in which foreign investment is not permitted or in which there are specific sectoral foreign equity limits, including for greenfield investments. Negative lists add to transparency in FDI regulations by permitting foreign investors to ascertain quickly whether their sector of activity faces any restrictions. At the same time, a negative list is not necessarily exhaustive. Some sectors may still face the horizontal limits mentioned above, while others may not appear on the list because they involve a sector which is not under the responsibility of the agency compiling the list. Nevertheless, negative lists provide a useful benchmark of the degree of openness of each economy, as well as of the extent of liberalisation over time. Only Malaysia does not have a negative list, although there are some sectors in which foreign investment is not permitted. The absence of such a list may stem from the special nature of Malaysia equity restrictions which are intended to promote *bumiputera* ownership of domestic assets and which cover all sectors not promoted by MIDA.

Indonesia moved from a positive to a negative list as part of its liberalisation of its investment regime. The positive list mentions only those sectors which are open to foreign investment, as in the bottom-up approach of the GATS. Negative lists have been considerably shortened over time in Indonesia, the Philippines and Thailand. As a result of the crisis, the number of sectors with foreign equity limits has been drastically reduced in order to recapitalise industries. A proposed revision to the Alien Business Law in Thailand aims to reduce the number of sectors on the negative list from 63 to 34. The degree of foreign ownership allowed in the remaining sectors is also to be raised in some cases. Indonesia also shortened its negative list by means of a Presidential decree issued in 1998. The Philippines has also opened up several sectors to greater foreign participation.

Restrictions on land ownership

Another restriction which impedes foreign investment concerns the right of foreign-owned corporations to own land. Without the ownership of the land on which the factory is built, the foreign investor faces considerable potential insecurity about the future policies of the host government and is also unable to use

the land as collateral for local borrowing. Malaysia requires approval from state authorities before an investor may acquire title to land, except for investments in export processing zones. The three other countries have some form of general restriction on foreign land ownership, except for some promoted companies. In these three countries, investors may generally only lease land for a specific period of time, with only one opportunity for renewal. The period of the lease has been extended in some of these countries as a result of the crisis.

Summary

The restrictions mentioned above are not exhaustive. Other measures relate to the right of foreign investors to bring in expatriate staff or the number of foreigners permitted on the Board of Directors, among others. There are also restrictions specific to particular sectors which may or may not be included in a negative list. Taken together, these restrictions suggest that foreign investment outside of promoted sectors has been heavily circumscribed in the ASEAN4 — a finding at odds with the conventional view that these countries have built their development strategies largely on the backs of foreign firms.

These policies reflect a lingering suspicion of foreign MNEs in the four host countries. Although a number of liberalisation measures have been undertaken as a result of the crisis, it is sometimes surprising given the urgent need to bring in capital and to recapitalise local firms how difficult it has been to pass legislation through parliaments. Local business interests sometimes represent a powerful lobby against change.

The counterpoint to these restrictions has been an aggressive attempt to promote export-oriented investments. These incentives are described below. The implications of this dualist policy towards inward investment are discussed in a later section.

Investment promotion in the ASEAN4

Export-oriented firms, particularly those locating in export processing zones (EPZs), are given numerous incentives in all four countries, including automatic approvals, land ownership, full control of the affiliate, tax holidays and duty free imports of components. From a regulatory point of view, investors wishing to export most of what they produce will find the ASEAN4 countries almost as open as OECD countries.

All four countries have a priority list of activities for which both domestic and foreign investors receive special promotional privileges. Sometimes this list includes specific sectors which the government would like to promote, but in many cases the priorities relate to particular attributes of the investment rather than the sector itself. Thus, investors wishing to export most of their output or likely to transfer technology will generally be favoured. Incentives by the BOI in Thailand have evolved towards a regional development strategy in which projects are encouraged to locate in the most disadvantaged regions — a policy found in many OECD countries as well. Other ASEAN4 governments also include some regional incentives as well as part of the overall package of measures.

Incentives can take two forms. The first are tax incentives for a defined period. Malaysia, Thailand and the Philippines all offer such fiscal incentives. Indonesia has been more reticent in this area, although certain industrial sectors might benefit from incentives. The criteria for granting incentives are currently under consideration. Unlike the wealthier OECD economies, the ASEAN4 are less in a position to offer grants to potential investors. The second type of incentive represents exemptions from various restrictions on inward investment described above, as well as from import duties on capital goods and raw materials and other trade barriers. There is generally no analogue to such policies within OECD countries, and

indeed the idea that these policies constitute incentives in the sense of the term in OECD countries is misleading. They are instead selective removals of distortions.

Policy reform during the crisis

Short-term measures have been undertaken in each country and formalised in an ASEAN initiative to enhance the investment climate in member countries, known as the Hanoi Plan of Action. The measures are only for investment applications submitted between 1 January 1999 and 31 December 2000 but will still apply to those investments after that period. They include fiscal incentives for industries on the priority list, domestic market access and full foreign ownership, except in sectors on the negative list, and a minimum leasehold of industrial land of 30 years. Fiscal incentives include a minimum three-year tax exemption or a minimum 30 percent corporate income tax allowance and exemption of duty on imported capital goods. Restrictions on the employment of foreign personnel are also relaxed. Foreign firms that inject equity into existing companies during the same period are also entitled to the same benefits except corporate tax incentives and land use privileges.

In some cases, these incentives do not go beyond existing measures, but in other cases, they offer unparalleled access to the domestic market, including through the acquisition of local firms. These temporary changes represent a significant shift away from the traditional emphasis on export promotion and industrial or regional targeting and offer far greater access to the domestic market. Negative lists still remain in those countries adopting such an approach, but in many cases full foreign ownership is now possible to a much greater extent, albeit only during a limited period.

ASEAN Investment Area

The ASEAN Investment Area (AIA) is a binding agreement to foster investment liberalisation within the region. Under the Agreement signed in October 1998, several programmes for co-operation, promotion and liberalisation will be implemented in order to realise the AIA by January 2010. Investment barriers will be eliminated and national treatment granted for ASEAN investors by 2010 and for all investors by 2020. The Agreement also paves the way for members to provide transparent investment policies and administrative processes. The programme will initially focus on opening up the manufacturing sector but will later cover other sectors. Signatory countries expected the measures expressed in the Agreement to increase FDI inflows. Like the ASEAN Free Trade Area (AFTA), the AIA is seen as a way of countering the economic weight of China.

III. THE IMPACT OF FDI ON ASEAN4 DEVELOPMENT

The role of FDI in development is as multi-faceted as FDI itself. At one level, FDI makes a similar potential contribution to development and to global economic welfare as any other form of capital flow by channelling resources from countries where they are abundant to those where they are scarce. Thus, inflows of capital in the form of FDI allow host economies to invest in productive activities beyond what could be achieved by domestic savings alone. Unlike other forms of capital flows, FDI has proved remarkably resilient during the crisis.

At another level, the benefits of FDI resemble those from trade, especially in sectors producing goods and services which tend not to be traded internationally. Thus, foreign firms can potentially enhance the level of competition in an economy and bring in ideas, innovations, expertise and other forms of technology which the host economy could not necessarily have created on its own. Multinational enterprises (MNEs), with their global network of affiliates, can also channel exports from the host country to affiliates elsewhere in the form of intra-firm trade. Through this mechanism, FDI permits an international division of labour within the MNE which might not have occurred otherwise owing to high transactions costs.

These various channels through which foreign investment can potentially contribute to development are discussed below. With hindsight, it can be seen in those countries which have relied on FDI that the benefits are not necessarily automatic. Host countries may become prodigious exporters, but indigenous exporting capabilities sometimes remain poor. The reasons for this are complex and hinge on more than just investor strategies or FDI regulations. For this reason, it is often necessary to go beyond FDI regulations to look at a range of policies which might impinge on investor behaviour.

FDI as a form of development finance

The crisis has brought into relief the importance of FDI as a stable source of finance for development compared to other forms of international capital flows. Foreign direct investment in Asia has so far held up very well, in spite of the crisis, while other capital flows have reversed themselves (Figure 8). Indeed, in some ASEAN4 countries, inflows have actually increased. It remains to be seen whether this represents simply a lagged response of foreign investors to changing circumstances — which would suggest that inflows would fall dramatically in the future. The Mexican experience following the late-1994 peso crisis suggests that FDI inflows often hold up much better than other forms of capital flows in both the short and medium term.

Figure 8. Net private capital flows to Asia, 1991-97 (\$ billion)

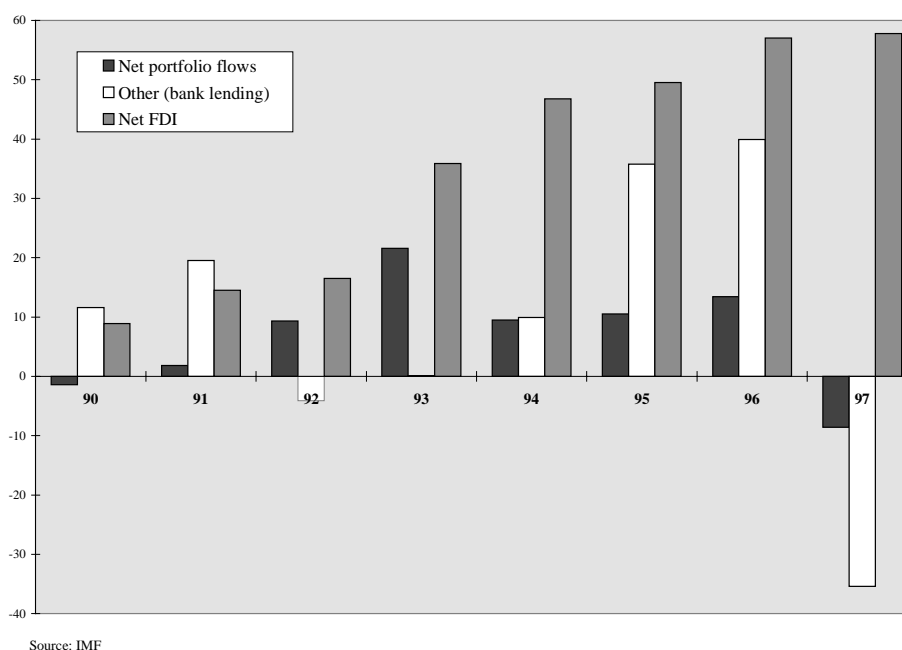


Figure 8 divides net private capital flows to Asia into FDI, portfolio investment and other flows, principally bank lending. The divergence in trends among different types of capital is immediately apparent. Total net private flows to Asia fell from \$110 billion in 1996 to only \$14 billion in 1997, while FDI flows to the region remained unchanged. One can only imagine the shock to the regional economy if such FDI flows had not been sustained in these circumstances.

Although sustained high levels of inflows are important in order to finance continued investment and as a source of foreign capital, a more significant development may be that the type of inflow is changing. Investments are originating in a far broader range of countries, with greater European and other OECD participation, and the sectors involved are also expanding. For almost the first time, the crisis has provided a window of opportunity for investors wishing to sell in the domestic market. Not only have FDI regulations been eased, but local firms are also more prepared to part with control in return for capital injections.

FDI and exports

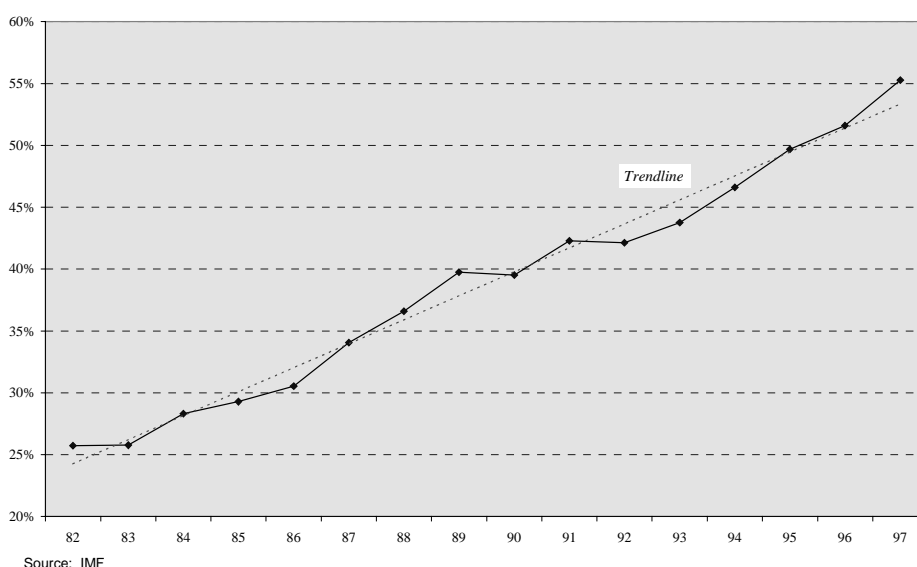
The experience of successful ASEAN countries amply demonstrates how FDI can play a leading role in bringing about rapid, export-led growth. Rapidly rising exports have fuelled the world's fastest growth rates in some of these economies which, until recently, had made them the envy of the developing world. But economic development is more than growth, as the crisis has made abundantly clear. The ASEAN countries have not always managed to translate economic growth through FDI into something more durable which builds on existing indigenous capabilities. This section describes the contribution of foreign investors to export-led growth in these economies and points out the weaknesses which were exposed in the recent crisis.

Exports have doubled as a percentage of GDP in all four countries since 1982, with very little annual variation along the long-term trend (Figure 9). Exports have nevertheless grown more at some times and

in certain sectors than in others. At a sufficient level of disaggregation, the correlation between export growth and FDI inflows is often strong. The fastest growth in Figure 9 is in the late 1980s when exports grew from 30.5 per cent on GDP to 39.7 in three years. Between 1989 and 1992, the comparable growth was only 2.6 percentage points. These variations correspond roughly to the rapid growth in FDI inflows in the late 1980s and relative stagnation of such inflows in the early 1990s.

Exports would have increased even without FDI, as can be seen in those sectors in which foreign investors are not important, but the ASEAN4 would probably not have experienced the rapid acceleration of exports in the past decade without the presence of foreign investors. In Thailand, exports have been the main engine of economic growth, particularly since the mid-1980s. Historically one of the world's leading rice exporters, it has become a major exporter of manufactured goods, rising from only one third of total exports in 1980 to over 80 per cent by 1997. This shift in exports is mirrored in the structural transformation of the Thai economy, from agriculture and to industry. While agriculture's contribution to GDP was three times that of manufacturing in 1960, by the early 1990s it was less than half as important as manufacturing.

Figure 9. ASEAN4 exports as a percentage of GDP

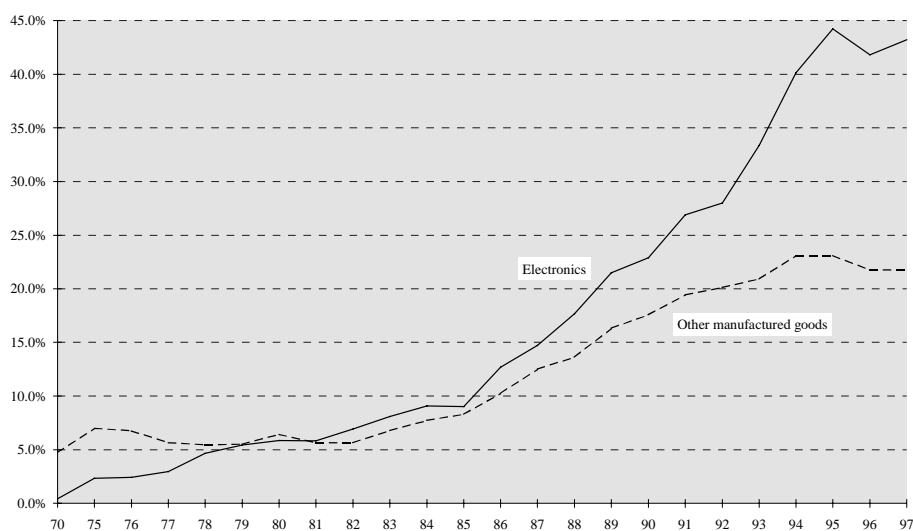


Foreign investors have played a key role in this process. Electronic products, particularly computer parts and integrated circuits, make up almost one third of total Thai exports. These sectors are dominated by foreign MNEs. Through inward investment, Thailand has become the ninth largest exporter of computers during the 1990s, with computer exports growing fourfold in the past five years. Significantly, however, Thai export success is not wholly contingent on inward investors: the export boom began as early as 1984, while inward investment surged only after 1987. Much of this export growth occurred initially in food products and other sectors in which Thailand has a comparative advantage.

The Malaysian experience is similar to that of Thailand, with exports growing quickly after the mid-1980s. Although the substantial depreciation of the ringgit at the time was a major catalyst, investment liberalisation was an important complementary factor. The role of foreign investors can be seen by distinguishing between exports of electronic goods — a sector dominated by foreign MNEs — and other

manufactured goods (Figure 10). Although all Malaysian exports have both increased over time, the driving force behind the rapid growth has clearly been the foreign-dominated export sector.

Figure 10. **Exports of manufactured goods from Malaysia, 1970-97**
(percentage of GDP)



Source: Bank Negara

Through export-oriented FDI, ASEAN4 countries were able to shift quickly towards a manufacturing-based economy in which economic growth was driven by rapidly expanding exports. The record from this export performance speaks for itself, but so too does the manifest failure in many cases to translate this export success based partly on FDI into something more durable. Not only have exports been limited to a small number of products (usually intermediate ones) and sectors, but to varying degrees these export sectors have been virtual foreign enclaves within host countries. They have often been characterised by low value-added (principally from labour-intensive assembly operations) and a poor record of technology transfer. These shortcomings represented one of the growing structural problems leading up to the crisis.

The import dependence of MNE-related exports can be seen in Table 3. Many of the most successful export sectors in the ASEAN4 are highly import dependent, and this has limited the impact of massive devaluations in these economies on exports. In some sectors, imports represent 80-90 per cent of the value of exports. The high import dependence ratio for MNE-related exports is symptomatic of the poor linkages between foreign affiliates and the local economy more generally. Poor linkages reduce the scope for technology transfers through FDI which could assist in local industrial upgrading. Arguably, the failure to upgrade production in light of greater competition in labour-intensive activities from China and Vietnam is one of the underlying structural problems which served to undermine confidence in the years preceding the crisis.

Table 3. **Imports and exports of electronics in four Asian countries, 1994**

	Singapore	Indonesia	Malaysia	Thailand
<i>Exports of electronics products (\$ million)</i>				
All electronics products	34 262	1 665	14 768	6 387
Automatic data processing equipment	21 878	193	4 726	3 680
Communication equipment, semiconductors	12 385	1 473	10 042	2 707
<i>Share of finished goods in exports (per cent)</i>				
All electronics products	67.1	80.2	65.3	64.8
Automatic data processing equipment	66.6	49.9	30.9	57.5
Communication equipment, semiconductors	76.4	84.1	81.5	74.8
<i>Imports of parts as a percentage of exports of finished goods</i>				
All electronics products	32.7	26.7	38.5	60.1
Automatic data processing equipment	28.9	33.2	95.4	79.4
Communication equipment, semiconductors	39.3	26.2	28.4	40.0
<i>Imports of parts as a percentage of total exports</i>				
All electronics products	21.9	21.4	25.2	39.0
Automatic data processing equipment	19.4	16.6	29.5	45.7
Communication equipment, semiconductors	26.5	22.0	23.1	29.9

Source: UNCTAD, *Trade and Development Report*, 1996

Technology transfers

The most enduring potential benefit to developing countries from inward direct investment is the transfer of technology. Exports can drive rapid economic growth over long period, but technology transfers can do much more to promote sustainable development by enhancing indigenous capabilities. In this area, the record from decades of FDI in the ASEAN4 is not encouraging. Possible remedies for this situation will be discussed later.

Studies attempting to measure technology transfers to the ASEAN4 resulting from FDI have tended to find that such transfers have generally been limited. In Indonesia, a number of studies find that technology transfer has taken place mainly through on-the-job training and has been limited to basic technological capabilities.⁸ Otherwise, FDI and its related technology transfer have not generally been effective at developing indigenous industrial technological capabilities.⁹ In Thailand, technology transfers from FDI have been moderate, according to several studies.¹⁰ One finds some evidence of transfer through foreign firms' training of high level staff, while another finds little evidence of transfer through the training of local suppliers. These studies generally cover the period of the 1980s when FDI was relatively recent and when certain sectors were still heavily protected. A more recent analysis suggests that technology transfer has arisen to some extent through relations between foreign companies and local suppliers.¹¹

IV. FDI POLICIES AND INVESTOR PERFORMANCE

The evidence from several decades of FDI in ASEAN4 countries presented above suggests clearly that foreign firms have played a leading role in successful export-oriented development strategies. At the same time, however, there is general consensus that the presence of foreign investors has not always contributed greatly to indigenous capabilities. While few would disagree strongly with this assessment, the question still remains of what host countries could have done differently and what should be done now. Because attracting foreign investors has now become more important than ever as a policy priority, it may be an opportune moment to reassess policy approaches to inward investment in order to improve the linkages with the local economy in the future. This section sets out a general policy agenda in this area.

One reason for the poor performance in technology transfer is that the capacity of local workers to absorb foreign technologies is weak. Because much of the technology and know-how which has been transferred has tended to come through on-the-job training, policy initiatives in this area could have a significant impact. Local capabilities are fostered in the long run by educational policies which enhance the capacity of local workers to assimilate foreign technology and know-how. Reforms in ASEAN4 are occurring in this area, but any improvement will take a long time to filter through the economy.

A second and more important mechanism for technology transfer arises through the linkages between firms, as local firms co-operate with foreign investors either as joint venture partners or as suppliers. An analogy can be made with the need to enhance the skills and absorptive capacity of local workers. One way to enhance the ability of local firms to absorb technology is to improve the level of training of the workers themselves. But government policies can also influence this exchange more directly by increasing the scope for collaboration between foreign and domestic firms. As will be seen, many policies in this area may well have had the opposite effect to that intended.

FDI policies to enhance technology transfer

Many of the policies adopted in the ASEAN4 towards foreign investors are designed, implicitly or explicitly, to develop indigenous capabilities. These include any or all of the following requirements: local joint venture partners; divestiture of foreign control after a certain period of time; local content levels which force investors to purchase a high share of inputs locally; expatriate personnel limits, including on the board of directors; and compulsory licensing and other forms of mandatory technology transfers. The ASEAN4 countries have adopted most of these strategies at different points in time. Some remain in place, particularly for domestic market oriented investment.

Such policies may have several unintended consequences. First, they might discourage potential inward investors not willing to abide by such conditionality. Proprietary technologies and other intangible assets are the backbone of most firms, and they are understandably reluctant to share them with others who might one day become potential rivals. Thus, the more technology required to produce an item, the less likely the investor will be to locate in a country which imposes the types of restrictions mentioned above. This is implicitly recognised by the ASEAN4 countries in their efforts to attract export-oriented firms. Such investors typically face few restrictions on their activities. Local content requirements sometimes encourage FDI by components producers, but the fundamental problem of linkages with local firms remains.

These policies might also actually limit the eagerness of those firms which do decide to invest because of the risk of leakages to potential rivals. The most common policy in the ASEAN4 countries concerns joint venture requirements. A large body of research has found that such requirements do not achieve the

objective of enhancing technology transfers. According to FIAS (1995, p. 30), “Limits on foreign investor ownership have also had the perverse effect of reducing the investor’s incentive to make a success of the project.” Such limits have only served to weaken the quality of FDI. In a recent survey of the literature, Moran (1998, p. 121) reaches the same conclusion: “Direct evidence is not promising on the use of joint ventures to try to enhance technology transfer, penetrate international markets, or even expand and strengthen backward linkage to the domestic economy”. Mansfield and Romero (1980) find that parent firms transfer technology to wholly-owned subsidiaries in developing countries one-third faster, on average, than to joint ventures or licensees.¹²

Similar conclusions have been reached for other policies designed to increase technology transfers. Kokko and Blomström (1995) observe a negative relationship between technology inflows and the host-country technology transfer requirements. In Indonesia and the Philippines, divestiture requirements reportedly have reduced investment and product- and process-technology flows and have done little to enhance domestic capabilities.¹³ These broad studies corroborate the description earlier of the poor performance of technology transfers into the ASEAN4.

The limits to selective export promotion

Technology transfer requirements and other regulations concerning FDI are just the first layer of policies impinging on technology transfers. At a much broader level, the emphasis of host countries on export promotion may also have presented an obstacle. Export-oriented investors are often less willing to establish links with local companies because the need for high quality inputs at competitive prices in order to compete in world markets. Most of these inputs come from other foreign firms, either through imports or from home-country suppliers which have also invested in the host country. This tendency is exacerbated by the fact that host governments often promote sectors such as electronics in which there are no pre-existing indigenous capabilities and hence no potential local suppliers.

Local firms are more likely to benefit from interactions with foreign investors if they are already active in that sector or if the competencies developed by local firms in other areas can be applied to the new type of activity. In concrete terms, this means that host governments should promote those activities which build on existing comparative advantage. Attempts to develop wholly new sectors through FDI which are unrelated to the existing industrial structure of the host economy reduce possible linkages between foreign and domestic firms because local firms do not have the relevant expertise. In the absence of industrial targeting, foreign firms would naturally seek out those sectors in which the host economy already possessed the specialised skills.

Links between local firms and exporters are also sometimes hampered by the special treatment accorded to foreign exporters. Because of heavy government regulation and import protection which still prevail in many sectors in ASEAN4 countries, export promotion can only succeed if investors are offered ways of overcoming these distortions. Hence, special operating conditions have been created for exporters, such as duty free imports, which allow exporters to employ host country labour without having to face the otherwise high costs of doing business in the economy owing but which also have the effect of divorcing the export sector from the rest of the economy. The creation of export processing zones may have exacerbated this tendency because they usually constitute separate customs areas from the local economy. As argued in an OECD study of FDI in Malaysia, “if a customs barrier must be crossed [by a foreign affiliate operating in a Malaysian EPZ] to reach suppliers, it might as well be an international barrier to reach already developed suppliers in Singapore”.¹⁴

Local market orientation and technology transfer

Evidence from a wide range of developing countries suggests that domestic market-oriented investments might sometimes be better placed to transfer relevant technologies to the host economy. An early but comprehensive study by Reuber et al. (1973) found that export-oriented projects purchased only one half as large a share of their inputs locally than other projects. In addition, technology adaptation was much less in the former than the latter, in large part because local market-oriented firms had to adapt their products to the specific demands of local consumers.

Even for foreign affiliates selling in the domestic market, however, technology transfers are not automatic. Much of the FDI in the automobile sector in the ASEAN4, for example, has not provided abundant evidence of extensive local linkages. Foreign investors in this sector are more likely to be interested in rent-seeking behind high import barriers than in competing aggressively in the local market. Kokko and Blomström (1995) find that foreign affiliates in their study were most likely to transfer technology if they felt competitive pressures in the host economy. The intuition behind this outcome is clear: when foreign investors face stiff competition within a market, either from imports or from other investors, they are compelled to transfer more technology to their affiliate in that market in order to be able to compete more effectively.

Regional integration, with its commitment to removing barriers to trade (AFTA) and investment (AIA) within ASEAN, will help to stimulate competition within each economy. But it should not occur at the expense of FDI from OECD countries. Most of the world's largest MNEs are headquartered in OECD countries, and these firms are repositories of the lion's share of the most advanced technologies. In addition, an UNCTAD (1993) study found that smaller firms are less prone to transfer technology from the parent company: foreign affiliates of smaller firms in developing countries obtained frontier, state-of-the-art technology in fewer than half the cases surveyed, while around two thirds of the foreign affiliates of larger MNEs received such technology.

A neutral approach to FDI regulation

The arguments presented above suggest that technology transfers are enhanced in a neutral policy environment which permits equal access for foreign investors to both domestic and export markets. The gradual elimination of barriers to imports will, by itself, help to alleviate the most adverse effects of the existing dualist FDI policy by removing one of the principal distortions within the ASEAN4 economies. But this would still not eliminate the differential treatment between types of foreign investors found in FDI regulations in most ASEAN countries. The reassessment of development strategies in light of the crisis provides an opportune time to switch to a more open and balanced regulatory framework for FDI.

NOTES

1. The four case studies will be published shortly by the OECD as Recovery in Asia: Enhancing the Role of Foreign Firms.
2. Borensztein et al. (1995)
3. Definitions of FDI and reporting methodologies differ greatly from one country to another so the exact ranking of countries cannot always be assessed with certainty given the number of countries clustered around the same level of inflows.
4. Maddison (1998).
5. FIAS (1991), p. 18.
6. FIAS (1991), p. 15.
7. Thee (1998), p. 5.
8. Saad (1995), p. 212.
9. Thee (1998), p. 14
10. See TDRI (1994) for a survey.
11. TDRI (1994).
12. Cited in Moran (1998), p. 122
13. Conklin and Lecraw (1997)
14. OECD (1991), p. 100.

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