ASEAN ECONOMIC COOPERATION:
AFTA AND THE COMPETITIVENESS
OF THE ASEAN 5

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Abstract

The growth in export competitiveness in the ASEAN-5 can be traced to the extensive presence of MNCs in the region, especially before the advent of the Asian Financial crisis. It has been postulated that trade liberalization at a regional level can serve to attract vertically integrated FDIs while an enlarged regional market can also attract market-seeking FDI. The objective of this paper is to assess the contribution of tariff liberalization under AFTA to inflows of FDI in the ASEAN-5, between 1993-2001. If indeed regional tariff liberalization has been instrumental in attracting inflows of FDI into these economies, this would provide an incentive for the ASEAN economies to extend their AFTA concessions and/or to further deepen ASEAN economic integration.

The findings of this paper indicate that macroeconomic stability, openness, market size, and labor productivity, individually exerted significant impact on inflows of FDI into the ASEAN-5 for the period studied. Based on these results, ASEAN must accelerate its efforts at both deepening and widening integration in order to restore FDI's interest in the region as host economies. However ASEAN must first be strong and cohesive if it aspires to be the hub of the widening efforts. Hence deepening is critical and widening should not proceed without deepening.

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I INTRODUCTION

In January 1992, ASEAN economic cooperation took a significant step forward as the ASEAN heads of government signed the Framework Agreement on Enhancing ASEAN Economic Cooperation, which provided the basis for the establishment of the ASEAN Free Trade Area (AFTA). The AFTA Agreement is to phase down intra-regional tariffs to 0-5 per cent, initially over a period of 15 years starting 1st January 1993. However AFTA was not launched on the original date of 1st January 1993 because administratively the members were not ready. It was thus 're-launched' on 1st January 1994. From the outset, AFTA is not just about tariff liberalization alone (Soesastro, 2002: 66). It is instead a training ground, an intermediate phase in the efforts of ASEAN members to integrate themselves into the world economy. AFTA is then about global competitiveness. In this regard, attracting investors through tariff liberalization under AFTA is deemed to enhance the competitiveness of ASEAN as regional integration is used to gain the upper hand in the increasing global competition for Foreign Direct Investment (FDI).

In turn, FDI is critical in enhancing the export competitiveness of the ASEAN-5 (Indonesia, Malaysia, the Philippines, Singapore and Thailand). These 5 economies have been identified as 5 among the 20 economies that have raised their world market shares of non-resource based technology manufactures by at least 0.1 per cent between 1985-2000, (UNCTAD, 2002a: 149). How did these economies manage to become global export winners given that global market shares are exceedingly hard to gain and even harder to sustain? In this regard, multinational enterprises (MNCs) play a crucial role in three ways: First, MNCs operations are export-oriented from the start due to the fragmentation and globalization of the production process, especially in the electrical and electronics industry. Second, MNCs, through their backward linkages with local firms, assist local firms to become "indirect exporters". Third, MNCs also indirectly promote export activities of local firms that manage to copy the operations of foreign affiliates, employ staff trained by foreign affiliates, and benefit from improvements in infrastructure and reductions in trade barriers undertaken in response to the demands of foreign companies. Thus UNCTAD (2002a: 153) reports the share of foreign affiliates constitutes a significant portion of the total exports of

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host economies and furthermore this share has grown considerably over time. For example, the share of foreign affiliates in Malaysian manufacturing exports grew from 26 per cent in 1985 to 49 per cent in 1995.

Given the important role played by FDI in enhancing the export competitiveness of the ASEAN-5, the objective of this paper is to assess the contribution of liberalization under AFTA to inflows of FDI in the ASEAN-5, between 1993-2001. If indeed regional tariff liberalization has been instrumental in attracting inflows of FDI into these economies, this would provide an incentive for the ASEAN economies to multilateralize their AFTA concessions and/or to further deepen ASEAN economic integration.

The paper is organized as follows: Section 2 provides a historical overview of economic cooperation in ASEAN, leading to the rationale for the formation of AFTA. It also discusses the salient features of AFTA and FDI in the ASEAN-5 while the analytical framework for testing the contribution of liberalization to inflows of FDI is presented in Section 3. The results are shown in Section 4 while the policy implications are discussed in Section 5. The conclusion in Section 6 summarizes the main findings of this paper.

II ASEAN ECONOMIC COOPERATION: AFTA

(i) Historical Overview: The Rationale for AFTA

AFTA is not ASEAN's first attempt at economic cooperation. Indeed the first attempt at cooperation in trade began with the Preferential Trading Arrangement (PTA) in the mid-1970s. The PTA scheme was piecemeal and voluntary, using a product-by-product approach towards integration. This was clearly inappropriate as it allowed for the exclusion of almost all items that would be important in stimulating trade (Naya and Plummer, 1997: 119). Consequently, this approach was later replaced with an across-the board approach as well as a deepening of the margins of preference but the change was ineffective in terms of intra-regional trade.

Apart from the PTA, there were also several attempts to promote industrial cooperation such as the ASEAN Industrial Projects (AIPs). Based on the "import-substitution" approach, the AIP projects were actually national projects involving government-owned entities. Again the AIPs failed to foster the economic integration that was envisaged. Another industrial cooperation scheme that also failed was the ASEAN Industrial Complementation (AIC) scheme that was supposed to support a vertical integration of industrial production in ASEAN. It was subsequently replaced with the "Brand-to-Brand Complementation" (BBC) scheme that was mainly participated by Japanese joint ventures in the automobile industry. A new initiative called the ASEAN Joint Ventures (AJIVs) was proposed in 1983. It was designed to be more flexible and more decentralized than both the AIP and the AIC. The basic rules of the AIJVs were modified over the years with increasing removal of restrictions and greater incentives in terms of the margin of preference. Nevertheless the impact of AIJVs on intra-regional trade and investment has also been negligible (Soesastro, 2002: 63). Soesastro further observed that these industrial complementation schemes have failed because ASEAN investors seem to prefer joint ventures with partners from outside the region while most of the joint venture projects among ASEAN investors are outside of the AIJV scheme. This is not surprising given the similarity in the stage of development especially among the older ASEAN members with the exception of Singapore.

The dismal performance of the various economic cooperation schemes fostered growing dissatisfaction within ASEAN itself. It gave rise to the belief within ASEAN that the regional grouping would no longer be an attractive and effective regional economic and diplomatic force if it did not embark on a new, bold, and credible initiative. At the same time, the prolonged years of negotiations under the Uruguay Round also furnished additional impetus for closer regional economic cooperation as the future of multilateral cooperation seemed rather uncertain then. Increasing globalization, on the other hand, encouraged many countries to try to strengthen their position by developing economic alliances with others thereby pushing ASEAN toward closer economic cooperation. Moreover the growing prosperity in the region in late 1980s and early 1990s seemed to indicate that ASEAN was ready for a closer form of economic cooperation that would contribute to the

common prosperity of the region. Thus AFTA was born on 1st January 1992 in the hope of creating a closely integrated market in which MNCs and domestic firms could minimize their transactions costs.

(ii) Salient Features of AFTA

Tariff liberalization under AFTA is to be implemented through progressive tariff cuts via the Common Effective Preferential Tariff (CEPT) scheme. Under the CEPT, member countries would set out comprehensive timetables for the phased reduction of intra-ASEAN tariffs on nominated goods. Tariffs on all manufactured and processed agricultural products are to be brought down to 0-5 per cent, initially over a period of 15 years starting 1st January 1993. The main difference between the PTA and CEPT lies in the fact that the PTA is only granted by the nominating country with no reciprocity (Soesastra, 2002:66). However, under the CEPT, there is reciprocity in that once a good is accepted under the CEPT scheme, all member countries must give the preferential tariff.

CEPT goods can be placed on the 'fast track' or 'normal track' timetables for tariff reductions. Under the 'fast track', tariff rates above 20 per cent are scheduled to be reduced to 0-5 per cent by 1st January 2003 while tariff rates below 20 per cent are scheduled to be reduced to 0-5 per cent by 1st January 2000. Originally 15 product groups accounting for almost 40 per cent of ASEAN trade were chosen for the fast track reductions but this has expanded over time. The 'normal track' also has 2 parts: tariff rates above 20 per cent are scheduled to be reduced to 20 per cent by 1st January 2001 and will subsequently reduced to 0-5 per cent by 2008, according to an agreed schedule. Tariff rates below 20 per cent will be reduced to 0-5 per cent by 1st January 2003. When Vietnam, Lao PDR, and Myanmar joined ASEAN, separate CEPT datelines were set for them in view of their economic structures (Table 1). However, in the wake of the Asian financial crisis in 1997, the original 6 signators agreed to advance the implementation of the AFTA schedule by one year from 2003 to 2002. Furthermore, a zero tariff target for AFTA was endorsed in 1999.

Table 1. Summary of CEPT Acceleration

	The first six members		Vietnam	Laos & Myanmar	Cambodia
	Fast Track	Normal Track			
Original Plan (1992)	2003*	2008**			
AEM Meeting (1994)	2000	2003	2006	2008	
Bold Measures (1998)	2000	2002	2003	2005	2010
Zero Tariff Rate (1999)	2010			2015	

*Note: ** for tariffs over 20 percent*
Source: Revised from Nattapong et al., 1999

The products covered under the CEPT are divided into four categories: Inclusion List (IL), Temporary Exclusion List (TEL), Sensitive List (SL) and a General Exception List (GEL). At the point of entry, all TEL products are temporarily excluded and are therefore not subjected to any tariff reduction. TEL products are to be transferred to the IL in 5 equal installments within a period of 5 years. The datelines for the ASEAN-6, Vietnam, Lao PDR, Myanmar and Cambodia are 2000, 2003, 2005 and 2007. The products in the SL are mainly unprocessed agricultural products such as rice, sugar, tobacco and meat products. Products in the SL are to be phased into the CEPT scheme by the years 2010 for the original ASEAN-6, 2013 for Vietnam, 2015 for Lao PDR and Myanmar and 2017 for Cambodia. Products in the GEL are excluded mainly on grounds of national security.

It should be noted there are allowances made for member countries to provisionally suspend the CEPT preferences in cases when an import surge causes damage to a domestic industry. At the same time, the CEPT scheme also includes an ASEAN content requirement of 40 per cent.

By 1st January 2003, the 6 original signators have reduced the tariffs on 99.55 per cent of the products in the 2003 Inclusion List (IL) to 0-5 per cent so that AFTA is

by now virtually realized. The products in their IL that still have tariffs above 5 per cent are those that have been transferred from the Sensitive List (SL) and General Exception List (GE) in 2003. The average tariff for the ASEAN-6 under the CEPT scheme is 2.39 per cent as compared to the 12.76 per cent in 1993. Overall in 2003, 87.85 per cent of all products in the IL of the ten member countries have tariffs between 0-5 per cent and about 10.68 per cent of these products have tariffs of above 5 per cent. Products with tariff rates between 0-5 per cent are textiles and textile products (97.6 per cent), chemicals and allied products (96.8 per cent), machinery and electrical equipment (92.2 per cent), agricultural products (85.1 per cent), basic metals (82.2 per cent) and plastics and rubber products (82.2 per cent) (Table 2). Ultimately tariffs will be completely abolished by 2010 for the ASEAN-6 and 2015 for the newer members with flexibility on some sensitive products until 2018. Tariff elimination, however, does not cover unprocessed agricultural products in the highly SL and products in the GEL.

Table 2. CEPT Rates by Main Product Category for the Original Six Member Countries

Product Category	% of Products		
	0 %	1 – 5 %	> 5 %
Agricultural	44.7	40.4	8.7
Chemical and allied products	50.0	46.8	-2.8
Basic metals	37.3	44.9	17.8
Machinery and electrical equipment	41.9	50.3	7.8
Plastics and rubber	32.3	49.9	17.6
Textiles and textile products	30.4	67.2	2.3

Source: Malaysia, International Trade and Industry Report 2001:59

(iii) Foreign Direct Investment in the ASEAN-5

The watershed in the trends of FDI in the ASEAN-5 is actually the late 1980s when all of these economies experienced a surge in inflows of FDI. Both external and internal factors contributed to this extraordinary surge in FDI inflows. Externally, the Plaza accord and the subsequent appreciation of the yen as well as currency appreciation and loss of preferential access to major developed markets for the newly-industrializing economies (NIEs) of Asia played an important part in the relocation of labor-intensive production from Japan and the NIEs to these countries. Concurrently progressive trade and investment liberalization in the ASEAN-5 together with the relatively low labor costs enabled these economies to benefit from the outflows of capital in these countries (Tham, 1998:14).

Consequently in 1993, the ASEAN-4 (Indonesia, Malaysia, Singapore and Thailand) were listed as among the 10 largest developing host economies for both FDI flows and stocks (UNCTAD, 1995). Within ASEAN, Singapore is the largest recipient of FDI inflows, followed by Malaysia, Thailand, Indonesia, the Philippines, Mynamar, Vietnam, Lao PDR, and Brunei until 1992. Between 1992-94, Indonesia took over from Thailand as the third largest recipient of FDI inflows into the ASEAN economies.

However, increasing competition from China and other emerging economies together with the resurrection of Latin America after its debt crisis of the 1980s and bolstered by the formation of the Southern Common Market (MERCOSUR) caused a sharp drop in the share of ASEAN's FDI in world FDI. Based on Table 3, ASEAN's share dropped from an annual average of 7.5 per cent between 1990-95 to 6.6 per cent in 1997. In 1998, the economic turbulence in the region as a result of the crisis caused an even sharper drop of this share to 2.7 per cent. This fell further to 0.7 per cent in the year 2000 although it subsequently improved to 1.8 per cent in 2001 (Table 3).

Table 3: FDI Inflows, by Host Region and Economy, 1990-2001
(Millions of Dollars)

Host region/Economy	1990 – 1995 (Annual average)	1996	1997	1998	1999	2000	2001*
WORLD	225321	386140	478082	694457	1088263	1491934	735146
Developed economies	145019	219908	267947	484239	837761	1227476	503144
Developing Economies	74288	152685	191022	187611	225140	237894	204801
China	19360	40180	44237	43751	40319	40772	46846
ASEAN	16932	29370	30369	18504	19691	11056	13241
Brunei Darussalam	102	654[c]	702[c]	573[c]	596[c]	600[c]	244[c, d]
Cambodia	80[b]	586	-15	230	214	179	113
Indonesia	2135	6194	4677	-356	-2745	-4550	-3277
Lao People's Democratic Republic	33	128	86	45	52	34	24[d]
Malaysia	4655	7296	6324	2714	3895	3788	554
Myanmar	180	310	387	314	253	255	123[d]
Philippines	1028	1520	1249	1752	578	1241	1792
Singapore	5782	8608	10746	6389	11803	5407	8609
Thailand	1990	2271	3626	5143	3561	2813	3759
Vietnam	947	1803	2587	1700	1484	1289	1300[a]

Notes: * *Estimates*
   a. *Annual Average from 1992 to 1995*
   b. *Balance- of- payments basis, based on the International Transaction Reporting System (ITRS)*
   c. *Preliminary Data*
Source: World Investment Report 2002: Transnational Corporations and Export Competitiveness

The fall in the relative attractiveness of the ASEAN-5 as host economies can be attributed to several reasons: First the Asian Financial Crisis (AFC) affected corporate profits and retained earnings in 1998. Although Malaysia, Singapore and Thailand have since recovered from the crisis, Indonesia continues to struggle with growth, while net outflows of capital persist in this country from 1998-2002. Second, post-crisis developments indicate that growth in the ASEAN-5 is fuelled by demand rather than investment as these economies have been adversely affected by the cyclical downturn in electronics in 2000, September 11 in 2001 and the Bali bombing

in 2002 (Tham, 2003a: forthcoming). Third, the prolonged stagnation of the Japanese economy is another contributory factor due to its significant presence in the region (Tham, 2003b: 12).

However, the relative importance of Japanese investment differs in each of the ASEAN-5 economies. Malaysia and Thailand share a common ranking of investors before the crisis as investment from Japan and the NIEs are relatively more than that from the United States (US) and the European Union (EU). In contrast the role of the petroleum sector in Indonesia explains the greater prominence of European investment in the country while historical links with US and the Philippines gives rise to the relative importance of US firms in that country. Table 4, however, shows a decline in Japanese investment post-crisis and a converse increase in the relative importance of investments from the US and the EU in Malaysia, Singapore, and Thailand. While European investment is predominant in the Philippines, North American investment is relatively more important in Indonesia.

In terms of sectors, Malaysia, Singapore and Thailand are similar in that FDI in manufacturing is dominated by electronics, with significantly more investment in that sector than in any other manufacturing activity (Thomsen, 1999: 10). At the same time, the electronics sector in both the Philippines and Indonesia is growing. However in Thailand, manufacturing absorbs only one-third of total inflows while a large share of the total also goes to distribution and finance, as well as construction and real estate. In Indonesia, manufacturing investments have tended to be in resource-based activities such chemicals and paper. On the other hand, investment in the Philippines is more diversified.

Intra-ASEAN investment constitutes the smallest component in each of the country's investment although an increase is observed from 1986-96 due to the prosperity of the region at that time, rising labor costs in the region, and the need to form strategic alliances (Tham, 2000: 6). In 2000, the major host country for inward intra-ASEAN investment flows was Thailand (US$389 million), followed by Brunei (US$217.5 million), Viet Nam (US$202.1 million), and Singapore (US$157.9 million) (Table 5). Malaysia is the second lowest recipient after Lao PDR.

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Table 4. Net FDI in ASEAN by Country of Origin 1999 (US$ million)

Home Country	Brunei Darussalam	Cambodia	Indonesia	Lao PDR	Malaysia *	Malaysia **	Myanmar	Philippines	Singapore	Thailand	Vietnam	Total
JAPAN	6.97	-	(1135.0)	0.84	220.02	420.20	18.80	303.27	606.29	488.40	400.47	910.07
NORTH AMERICA	17.76	-	264.0	0.61	633.88	1189.40	1.20	84.57	903.46	644.10	42.95	2592.53
USA	17.76	-	190.0	0.58	651.35	1204.43	0.80	84.42	473.00	641.20	42.29	2101.40
Canada	-	-	76.0	0.03	(17.47)	15.02	0.40	0.15	430.46	2.90	0.66	491.13
EUROPE 1)	265.29	-	(1071.0)	2.10	371.22	909.70	216.60	1200.82	3005.38	1428.90	208.59	5627.90
Denmark	-	-	(3.0)	0.08	0.09	0.54	-	1.00	3.40	9.40	-	10.96
Finland	-	-	(4.0)	0.06	2.24	3.73	-	-	4.09	2.00	-	4.39
France	0.83	-	(260.0)	0.89	2.05	8.51	33.00	12.15	47.78	240.10	94.51	171.31
Germany	4.47	-	(102.0)	0.13	124.70	280.40	7.00	23.84	82.12	288.40	21.26	449.93
Italy	-	-	(5.0)	-	1.15	1.87	-	0.10	1.20	10.70	0.60	8.75
Netherlands	0.50	-	(167.0)	0.03	25.06	50.35	0.50	384.58	2128.06	643.20	25.83	3040.76
Spain	-	-	(1.0)	0.01	0.11	0.18	-	0.08	0.57	4.50	-	4.28
Sweden	-	-	(15.0)	0.37	11.11	18.96	-	0.08	59.37	9.10	1.78	66.81
Switzerland	0.12	-	55	0.06	(58.67)	(48.57)	-	769.83	108.96	60.40	21.05	956.75
United Kingdom	259.37	-	(517.0)	0.46	263.39	593.72	176.10	9.18	544.70	186.30	23.56	946.06
OTHER ASIA 2)	1.31	-	(132.0)	1.15	0.35	1.94	0.03	114.05	32.97	(2.20)	7.19	22.85
China	-	-	(1.0)	1.14	0.82	1.92	0.03	111.41	18.63	(2.20)	6.97	135.80
India	1.31	-	(6.0)	0.01	(0.47)	0.02	-	2.64	10.91	-	0.22	8.62
ANIEs	7.86	-	(101.0)	3.00	207.15	345.49	22.60	49.77	418.64	360.80	421.33	1390.15
S. Korea	0.32	-	64.0	0.11	3.28	5.83	8.80	13.95	176.84	5.50	196.98	469.78
Hong Kong	7.16	-	(144.0)	1.58	178.98	297.50	13.80	20.05	95.01	233.70	102.78	509.06
Taiwan (ROC)	0.38	-	(21.0)	1.31	24.90	42.16	-	15.77	146.78	121.60	121.57	411.31

Source: ASEAN Secretariat: Statistics of Foreign Direct Investment in ASEAN: 28

Table 5. Intra-ASEAN Investment Flows, 2000 (US$ million)

Home Country	Host Country										
	Brunei Darulssalam	Cambodia	Indonesia	Lao PDR	Malaysia	Myanmar	Philippines	Singapore	Thailand	Vietnam	Total
Singapore	145.0	-	(197.0)	0.5	48.5	57.3	70.6	-	355.7	90.7	571.3
Malaysia	54.6	-	0.9	3.2	-	1.3	15.2	89.9	21.3	84.0	273.4
Indonesia	15.2	-	-	-	7.7	7.5	2.8	44.9	4.3	7.0	89.4
Lao PDR	-	-	-	-	-	-	-	-	4.1	5.7	9.8
Philippines	0.9	-	-	-	0.6	-	-	3.5	0.5	1.5	7.0
Brunei Darulssalam	-	-	-	-	5.1	-	-	1.0	-	-	6.1
Thailand	1.8	-	(36.4)	8.7	(2.4)	3.0	-	16.5	-	13.2	4.4
Myanmar	-	-	-	-	0.4	-	-	1.8	0.6	-	2.8
Cambodia	-	-	-	-	-	-	-	0.2	2.3	-	2.5
Vietnam	-	-	-	1.5	0.6	-	-	0.1	0.2	-	2.4
Total	217.5	-	(232.5)	13.9	60.5*	72.1	88.6	157.9	389.0	202.1	969.1

Note: 1. All FDI data in table above cover only equity and inter-company loan components of FDI
2. Lao PDR's figures are based on real inflows of investments provided by Bank of Lao PDR.
Figures by soured countries are estimates
3. Myanmar's figures are in fiscal year, which ends in March of the following calendar year.
4. Singapore's figures are based on gross inflows of FDI into Singapore and exclude repatriation of dividends, royalties and loans. Figures for 2000 are preliminary estimates.
5. ( ) means disinvestment.
If reinvested earnings component of FDI is included, intra-ASEAN investment into Malaysia amounted to US$ 365.6 million in 2000

Source: : Malaysia, International Trade and Industry Report 2001:63

The above profile shows that while non-ASEAN investors are losing interest in the region, intra-ASEAN investment, though growing, is still miniscule. For the year 2000, total intra-ASEAN investment amounted to US$969 million or 8.8 per cent of the total inflows of FDI into ASEAN (Tables 3 and 5). Given that FDI is crucial for the export competitiveness of these economies, it is critical to consider whether increasing integration at the ASEAN level has contributed positively to inflows of FDI into the region. Therefore the next section will present the model that is used to ascertain the main determinants of FDI in the ASEAN-5.

III ANALYTICAL FRAMEWORK: AFTA AND FOREIGN DIRECT INVESTMENT

Standard neoclassical investment theory states that investment is a function of value added and real interest rate based on profit maximization. However this theory does not explain why investment can take place concurrently in several locations. On the other hand, Dunning's ownership, locational and internalization (OLI) model does that by providing the conditions under which a firm will engage in FDI (ESCAP, 1995: 2).

In the OLI framework, ownership advantages refer to proprietary rights to a product or production process that gives the firm an advantage over foreign firms. Internalization advantage confers refers to the advantage of buying or creating a subsidiary firm as opposed to licensing production and/or distributing the product to a foreign firm. It is, however, the locational advantages that explain why certain locations are chosen to host the subsidiary operations of MNCs. More importantly, the activities of MNCs can concurrently occur in several host economies due to differences in their locational advantages.

The locational advantages meet the motives of the MNCs in different ways. Market-seeking MNCs, for example, consider the most important locational advantage to be the size and growth of the host economy while MNCs that are seeking to "jump" the tariff barrier would consider trade barriers to be the most

important motivation for investing in a particular economy. Resource-seeking MNCs, on the other hand, seek to exploit the availability of certain resources in the host economy. These can be land and building costs, raw materials, components, parts as well as low-cost unskilled labor and skilled labor (Dunning, 2003: Exhibit 4).

However, with the fragmentation of the production process due to advancements in technology and the simultaneous reduction in transportation costs, the production process can now be sliced up and produced over several economies. The main motivation for the globalization of the production process lies, of course, in profit maximization. Thus efficiency-seeking MNCs choose to minimize the cost of production by locating different parts of the production process in different places. Cost competitiveness is the key determining factor in the locational choices of these MNCs. While the cost of resources listed under the resource-seeking FDI also counts in cost competitiveness, these costs relative to the productivity of labor are more important for efficiency-seeking FDI. Other input costs as in the case of transport and communication costs and costs of intermediate products are also important in the cost minimization efforts of the firm. Membership in regional integration agreements are also deemed to be conducive for promoting a more cost-effective and product upgrading inter-country division of labor (Dunning: 2003: Exhibit 4).

Finally, there are also asset-seeking FDIs. These can be tangible as well as intangible assets. Tangible assets take the form of physical infrastructure such as ports, roads, power and telecommunication while intangible assets are technological, innovatory, managerial, relational and other created assets (for example, brand names) embodied in individuals, firms or clusters of firms.

According to Dunning (1999 as quoted in Nunnenkamp and Spatz, 2002: 4), the motives for and the determinants of FDI have changed with the advent of globalization, that is FDI in developing countries have shifted from market-seeking and resource-seeking to efficiency-seeking. In other words, globalization-induced pressure on prices has induced some MNCs to relocate some of their production facilities to lower-cost sites in developing countries. However, unlike FDI in

developed countries, FDI in developing countries are still motivated by the availability of natural resources.

Current empirical evidence, on the other hand, does not necessarily capture the shift to efficiency-related variables. For example, Nunnenkamp and Spatz (2002: 6)'s survey of the major studies on the determinants of FDI in developing countries reveal that the role of market-related variables in attracting FDI did not decline from the 1970s to the 1980s. Similarly, market size related variables remained a dominant influence on inward FDI even in the mid-1990s, especially in the case of developing countries. The size of the host country's market was also found to be a significant influence on Japan's Foreign Direct Investment (JFDI) in a panel study covering 16 developing and developed host economies between 1984-95 (Farrell, Gaston and Sturm, 2001: 22).

In the case of trade-related determinants of FDI, Nunnenkamp and Spatz (2002: 7) found that most of the recent empirical work support a positive relationship between trade liberalization and FDI. Moreover, Farrell, Gaston and Sturm (2001: 22)'s finding of a robust positive relationship between imports and FDI points to the importance of liberalizing tariff barriers in the case of Japanese FDI due to the intra-keiretsu phenomenon. Nevertheless, Nunnenkemp and Spatz contend that the proxies used to capture trade issues in these studies are flawed as import tariff rates capture only part of the trade policy stance of host countries while the ratio of exports plus imports to Gross Domestic Product (GDP) suffer from large country biases. But Taylor (2000: 642) using survey data from the World Competitiveness Report, also found openness to trade to be positively related with the FDI in the United States.

Other cost-competitiveness factors such as human capital have also been found to be an increasing important determinant of FDI. Nunnenkamp and Spatz (2002: 14)'s study on the determinants of FDI in developing countries attempts to capture the role of non-traditional cost-competitiveness factors by incorporating survey data on complementary factors of production, average years of schooling, cost factors such as taxes, employment conditions, labor market regulations and the leverage of trade unions and restrictions of foreign trade. His results for a sample of

28 developing countries between 1987-99 shows that traditional market-related determinants are still dominant factors shaping the distribution of FDI. Moreover, the importance of non-traditional FDI determinants has only increased modestly over time.

While Dunning's model emphasized the locational advantages in the determinants of inflows of FDI, this does not imply that the policy framework for FDI in host countries is unimportant. On the contrary, the vast literature on FDI shows clearly the policy framework, especially in terms of economic, political and social stability does matter (UNCTAD, 2002a: 24). Thus for example, Farrell, Gaston and Sturm (2001: 16) found that JFDI is strongly linked to domestic macro-economic conditions. In addition, business facilitation measures such as investment promotion, investment incentives, bureaucratic red-tape as well as after-investment-service also contributes to the host country's relative attractiveness as sites for MNC production.

Both the OLI model as well as existing empirical evidence therefore suggest that FDI is a function of the size of the economy, trade openness, FDI openness, macro-economic and political stability, and locational cost competitiveness. Due to the limitations of data, the GDP per capita (GDPPC) is used to proxy the size of the economy, while openness is proxied by the standard sum of export and import to GDP (TR) (See Appendix 1 for the definitions of the variables and the source of data used). Macro-economic stability is proxied with the inflation rate (IR) while the locational wage competitiveness is proxied with the rate of growth of labor productivity (LP). Hence it is hypothesized here that FDI can be estimated by the following function:

$$FDI = f(GDPPC, TR, IR, LP) \qquad \text{-------- (1)}$$

where the dependent variable is measured by the FDI as a percentage of GDP. Based on the explanation of the OLI model, it is hypothesized that GDPPC and TR will have a positive impact on FDI while IR and LP will have a negative impact on FDI. In the case of the latter variable, an increase in the rate of growth of labor productivity will

raise wages and reduce the labor cost advantage. Therefore, it will diminish inflows of labor-intensive FDI.

Pooled data (1993-2001 for the ASEAN-5 economies) is used in order to increase the number of observations. Consequently the complete model will have both time and country dummy variables as shown in the following equation:

$$FDI = \beta_0 + \beta_1 GDPPC + \beta_2 TR + \beta_3 IR + \beta_4 LP + \beta_5 T_1 + \ldots\ldots + \beta_{12} T_8 + \beta_{13} C_1 + \ldots\ldots + \beta_{16} C_4 + \varepsilon$$

$$\text{-------- (2)}$$

where FDI, GDPPC, TR, IR, LP, are as defined in equation 1 and T_1, ..., T_8 are dummy variables for time (1993 as base year) and C_1, ..., C_4 are the dummy variables for country (Indonesia as base country).

Equation 2 is estimated using Generalised Least Squares (GLS) with cross-section weights and White heteroskedasticity covariance as available in Eviews-4. This estimation method is robust to general heteroskedasticity.

IV PRELIMINARY RESULTS

The results of estimation are shown in Table 6. The equation estimated excluded the time and country dummy variables, based on the conclusion that coefficients for all dummy variables were not statistically different from zero at 1 per cent level under the Wald Test.

Table 6. Results of Estimation

Dependent Variable: FDI				
Method: GLS (Cross Section Weights)				
Sample: 1993 2001				
Included observations: 9				
Number of cross-sections used: 5				
Total panel (balanced) observations: 45				
White Heteroskedasticity-Consistent Standard Errors & Covariance				
Variable	Coefficient	Standard Error	t-Statistic	Prob(t-Statistic) (1-tailed)
C	1.254119	0.586393	2.138702	0.0193
TR	1.305754	0.783422	1.666731	0.0517
IR	-0.070452	0.017646	-3.992519	0.0002
LP	-0.034664	0.009859	-3.515987	0.0006
GDPPC	0.000180	7.48E-05	2.407100	0.0104
Weighted Statistics				
R-squared	0.627865	Mean dependent var		4.298866
Adjusted R-squared	0.590651	S.D. dependent var		3.069320
S.E. of regression	1.963763	Sum squared resid		154.2545
Log likelihood	-82.03954	F-statistic		16.87194
Durbin-Watson stat	1.47425	Prob(F-statistic)		0.000000

The signs for the independent variables were found to conform to the hypothesized relationship between these individual variables and the dependent variable. Thus a positive estimated coefficient was obtained for trade openness (TR), GDP per capita (GDPPC), and significant at the 10 per cent and 5 per cent level respectively. The coefficients for interest rate (IR), the rate of growth of labor productivity (LP) were found to be negative and significant at the 1 per cent level.

It was found that the equation performed reasonably well in terms of the adjusted R-squared (0.591), and the p-value of F-statistics indicated that the fitted equation is overall highly significant. Nevertheless, the problem of first order autocorrelation was untraceable as the Durbin-Watson statistic lies in the zone of indecision ($d_{L, 0.01} = 1.156 < 1.474 < d_{U, 0.01} = 1.528$).

The results of the Pearson correlation (see Appendix 2) showed that all the pair-wise correlation coefficient between regressors did not exceed ±0.8, except for TR and GDPPC. Since the R^2 was moderately high and all the partial slope

coefficients individually significant under t-tests (Gujarati, 1995: 335), it suggests that multicollinearity is not a serious problem.

V POLICY IMPLICATIONS

First of all, the results confirm that macroeconomic stability is important for attracting FDI. Apart from this variable, the market-size and openness variables are also significant. The variable for openness has to be interpreted carefully as it is not tariff data. Ideally, the effective rate of protection (EPR) would be a good proxy for capturing tariff liberalization under AFTA. Unfortunately this is not available and even nominal tariff is not available for all the years covered in this study. The alternative proxy for openness used captures to a large extent, the impact of trade liberalization, be it at the AFTA level or at the Most-Favored Nation (MFN) level, on the exports and imports of a country. Nevertheless due to lack of data, this is the best proxy that is currently available. Both the openness and market size variables imply that greater openness will enhance inflows of FDI into the ASEAN-5 while an increase in market size will also induce a similar effect. The first points to a need to deepen integration within ASEAN, while the second implies a widening of ASEAN liberalization will be required.

(i) Deepening Integration

The agenda to extend AFTA beyond the liberalization of barriers of trade in goods or the "AFTA-Plus" Program has included the elimination of non-tariff barriers (NTBs), a Framework of Agreement on Services, and ASEAN Investment Area (AIA), an Agreement on Intellectual Property, cooperation in customs as well as cooperation in tourism.

Of these the AIA, established in 1998, is of immediate relevance as the objective of the AIA is to attract greater FDI into the region from both ASEAN and non-ASEAN sources. Given this objective, the AIA grants national treatment (NT) to ASEAN investors by 2010 and to all investors by 2020. Moreover, MFN treatment will also be extended to ASEAN investors. It is important to note that an ASEAN

investor is defined as any company legally formed in any ASEAN country. Consequently a foreign-owned company duly constituted in Singapore may be entitled the status of ASEAN investor and hence benefit from both NT and MFN treatment.

AIA uses the same modality as in the case of the CEPT. Thus there is a TEL or SL for industries that are not yet ready for opening. The TEL is to be phased out by 2010 for most members while the SL is subject to periodic review by the AIA Council. In September 2001, the end date for phasing out the TEL of the manufacturing sector was shortened to 2003 for the original ASEAN-6 as well as Myanmar while the other members have until 2010. The full realization of the AIA was further accelerated from 2020 to 2010 for the ASEAN-6 and to 2015 for the new members. Liberalization is therefore selective and progressive under the AIA.

However the utilization of selective, albeit progressive liberalization, as in the case of AFTA and in the AIA has impeded effective implementation (Mahani, 2002:1271). While the use of exceptions or excluded sectors are common in FTAs, it is important to note that members can only capture the full benefits of a FTA if the degree to which exceptions are granted are minimized (Hoekman and Schiff, 2002: 552). Thus while the AIA represents a suitable response for regaining investors' interest in the region, its implementation lacks much to be desired. For the AIA as well as other ASEAN deepening initiatives to have teeth, the integration process must not be riding on exceptions. Rather, ASEAN must work toward substantial liberalization on all trade between member countries.

(ii) Widening Integration

Recent moves toward widening the integration in ASEAN include the ASEAN-China Free Trade Area as well as initiatives to explore possible FTAs with Japan, India and with the Closer Economic Relations (CER). There is also a proposal for an ASEAN Plus Three grouping, comprising China, Japan and the Republic of Korea.

According to Scollay (2003: 38), efforts to widen ASEAN integration such as the proposed ASEAN Plus Three is likely to lead to significant FDI diversion into the ASEAN region based on Mexico's experience in the North American Free Trade Area (NAFTA). However, given the perceived competition between ASEAN and China, it has been postulated that the main beneficiary may be China. However, most investors are not likely to put all their eggs in one basket and it is more likely that at least some ASEAN countries will also benefit.

ASEAN in forming FTAs should bear in mind that developing countries are more likely to lose by forming South-South FTAs, as opposed to a North-South agreement (Venables, 1999:12). In a South-South arrangement, trade creation is less likely. Further, in a South-South arrangement, there is a high probability that one of the members gain at the expense of other members, thereby entailing an income transfer from the less to the more advanced member countries. Such an asymmetric distribution of gains does not bode well for the sustainability of the group.

In contrast, if a FTA contains a high-income country (relative to the other members and to the world average), then the lower income members are likely to converge with the high-income partner due to the bigger scope for trade creation based on their very different factor endowment. Venables uses the experience of Mexico in the North American Free Trade Area (NAFTA) and the experience of the lower income countries in the EU as illustrations of convergence or the narrowing of the income gap between these countries and their higher income partners in the regional grouping.

VI CONCLUSION

The growth in export competitiveness in the ASEAN-5 can be traced to the extensive presence of MNCs in the region, especially before the crisis. It has been postulated that trade liberalization at a regional level can serve to attract vertically integrated FDIs while the enlarged regional market can also attract market-seeking FDI.

In the case of the ASEAN-5, using Dunning's OLI framework, it has been found that macroeconomic stability as proxied by the inflation rate, exerted a negative and significant impact on inflows of FDI into these economies as postulated. Hence maintaining macroeconomic stability such as low and stable inflation rates is fundamental for hosting FDI. At the same time, increasing openness and market size also yielded positive and significant impact on FDI in these economies while increases in labor productivity by increasing wages gave a negative and significant impact.

Therefore, deepening and widening integration will restore the relative attractiveness of ASEAN as host economies for FDIs. While there are several on-going efforts to deepen integration within ASEAN, as exemplified by the AFTA-Plus Initiatives, it is unfortunate that these initiatives continue to be implemented at a selective, albeit progressive level. Thus the continued use of the CEPT modalities in investment liberalization is unlikely to hasten the deepening of integration.

On the other hand, current efforts to widen integration will serve to enlarge the market-size effect, thereby increasing the potential to attract more FDI into the region. However, it is not likely that all ASEAN economies will benefit from the potential increase as these widening efforts may involve China. In the widening efforts, it is also pertinent to note that developing countries are found to gain in North-South type integration rather than South-South type integration. Finally, if ASEAN aspires to be the hub of all these ASEAN-Plus FTAs, then it would have to hasten the deepening and strengthening of integration within ASEAN as it is the stronger economy or group of economies in a FTA that will eventually succeed in being the hub. Without deepening, the ASEAN-Plus FTAs may end up as X-Plus 10 FTAs and that would not bode well for ASEAN.

Appendix 1.

1. FDI: Inflows of FDI measured as a percentage of GDP. FDI data is extracted from UNCTAD, *World Investment Report*, Various Years.

2. GDPPC: GDP per capita is extracted from East Asian Economic Perspectives (EAEP), *Recent Trends and Prospects for Major Asain Economies*, Vol. 13, February 2002.

3. TR: Openness to Trade is computed as export plus import as a percentage of GDP. Trade data is taken from the International Financial Statistics, various years while the GDP data is taken from the East Asian Economic Perspectives (EAEP), *Recent Trends and Prospects for Major Asain Economies*, Vol. 13, February 2002.

4. IR: Inflation rate is extracted from http:www.aric.adb.org. Accessed on 9/6/03

5. LP: The rate of growth of labor productivity where labor prodcutivity is defined as ouput divided by employment. Output and employment data is extraced from East Asian Economic Perspectives (EAEP), *Recent Trends and Prospects for Major Asain Economies*, Vol. 13, February 2002.

Appendix 2. Pearson Correlation Coefficient Between Independent Variables

	LP	TR	IR	GDPPC
LP	1.0000			
TR	-0.0144	1.0000		
IR	-0.4150	-0.3652	1.0000	
GDPPC	0.0388	0.8980	-0.3159	1.0000

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