Divergent Asian Views on Foreign Direct Investment and Its Governance

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This paper reviews recent trends and effects of FDI in developing Asia; domestic policy changes in six Asian host economies (People's Republic of China, India, Republic of Korea, Malaysia, Thailand, and Viet Nam); and how these policies and experiences influence their attitudes toward managing FDI. Not surprisingly, these countries have differed in their approach to the formulation of international regulations governing FDI. To simplify, their negotiating positions have ranged from strongly in favor (Republic of Korea) to strongly opposed (India); from viewing it as a helpful spur to domestic liberalization (Thailand) to a constraint on development policy options (Malaysia); and from acceptance if implementation is gradual (People's Republic of China) to concern over capability to address the difficulties and challenges of achieving compliance (Viet Nam).

The surge in flows of foreign direct investment (FDI) in the last two decades has had important effects on global value chains of production, developing countries, and attitudes toward such investment. Attitudes toward FDI and experiences with it in developing countries affect host economy policies, which in turn affect subsequent experiences. Both FDI policies and experiences, as well as their perceived feedback, influence attitudes toward negotiating a multilateral framework for investment. This paper reviews recent trends and effects of FDI in developing Asia, domestic policy changes in six Asian host economies, and how these policies and experiences influence their attitudes toward managing FDI.

The paper is organized as follows: Section I examines recent FDI trends, briefly reviews the general literature on the benefits and costs of FDI for host economies, and assesses progress on bilateral investment treaties (BITs). Against this backdrop, Section II investigates FDI regimes and patterns in six diverse Asian economies—People's Republic of China (PRC), India, Republic of Korea (Korea), Malaysia, Thailand, and Viet Nam. Particular attention is accorded to

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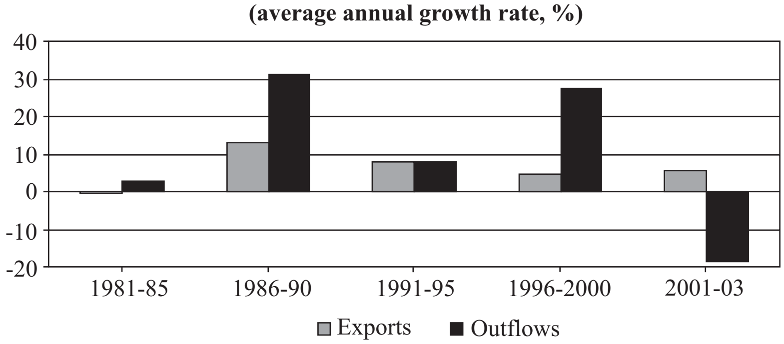
changing FDI policies in the context of broader economic reforms, including the adoption of more open trade policies, and the consequent shift from "rent-seeking" to "efficiency-seeking" foreign direct investment. Section III summarizes the principal arguments.

I. RECENT TRENDS AND EFFECTS

A. An Overview

From only $53.7 billion in 1980, global FDI outflows reached $1.2 trillion in 2000. The upsurge in FDI substantially changed the international economic landscape. From 1980 to 2000, the growth rate of world FDI outflows surpassed that of world exports (Figure 1). This swift expansion in FDI was more pronounced during 1986-1990, when many host countries began to relax regulations to attract FDI, and 1996-2000, when companies undertook scores of mergers and acquisitions (M&A) in the wake of the Asian financial crisis and privatization programs in Latin America. Since 2000, however, a weak global economy has considerably reduced outflows, which dropped by 41 percent in 2001, a further 9 percent in 2002, and remained flat in 2003.

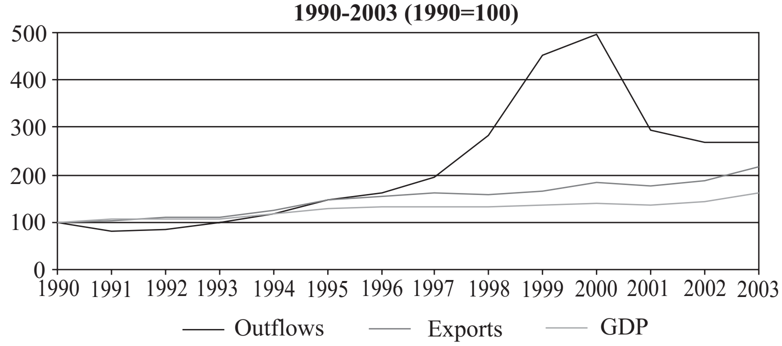
Figure 1
Growth of World Exports and FDI Outflows
(average annual growth rate, %)



Note: Data for outflows in 2003 are preliminary.
Sources: IMF (2004a), UNCTAD (2004).

Relative to world output and exports, FDI outflows have risen tremendously since the early 1990s (Figure 2). World FDI outflows increased five times from 1993 to 2000 before falling since 2001, while world exports and output grew at a more modest pace, with output not even doubling in value between 1990 and 2003.

Figure 2
Index of World Exports, Output, and FDI Outflows, 1990-2003 (1990=100)



Note: Data for outflows in 2003 are preliminary.
Sources: IMF (2004a) and UNCTAD (2004).

The geographic pattern of FDI outflows changed slightly during the 1990s. Europe and North America continued to be the largest sources of FDI flows in the world, supplying at least 75 percent since 1991. In contrast, the share of the Asian and Pacific region in total FDI outflows fell significantly beginning in 1998 due to the declining role of Japan as an FDI supplier.

While Europe and North America continued to be major recipients of FDI, the PRC emerged as another favored destination. Economies in the Asian and Pacific region received increasingly larger shares of world FDI inflows beginning in the 1990s, but the 1997 financial crisis temporarily reversed this trend. Foreign direct investment flows soon recovered, particularly in the wake of M&As after the crisis.

In terms of individual country destinations, there have been shifts in the preferences of foreign investors over the last decade. Argentina, Malaysia, Portugal, and Thailand, which were among the 20 largest FDI recipients during 1990-1992, were replaced by Brazil, Denmark, Germany, and Ireland during 2000-2002. In addition, Japan and Korea became preferred locations for FDI in the post-Asian crisis era (JBICI 2002).

Among the favored Asian destinations for FDI, there has not been as much change. Indonesia and the Philippines, two of the top 10 FDI destinations in the early 1990s, dropped from the list primarily due to uncertainties in their domestic economies and were replaced by India and Kazakhstan in the early 2000s. Meanwhile, Hong Kong, China overtook Malaysia and Singapore as a preferred FDI destination. While the total value of FDI inflows to the top 10 Asian destinations substantially increased during the last decade, the Asian and Pacific region's share in world total dropped. Average FDI inflows per capita showed remarkable increases in some Asian economies. In Hong Kong, China, for instance, per capita inflows increased 10.3 times to $4,836 between the early

1990s and 2000s and inflows were more than three quarters of gross fixed capital formation by the start of the decade. In other Asian economies, inflows amount to over 40 percent of gross fixed capital formation (Table 1).

Table 1. **Top 10 FDI Recipients in Developing Asia**

Rank	Host Economy	1990-92	Rank	Host Economy	2000-2002
	Average Annual Total Inflows, $ billion				
1	China, People's Rep. of	6.3	1	China, People's Rep. of	46.8
2	Singapore	4.2	2	Hong Kong, China	33.1
3	Malaysia	3.9	3	Singapore	10.4
4	Hong Kong, China	2.7	4	Korea, Rep. of	4.9
5	Thailand	2.3	5	Taipei,China	3.5
6	Indonesia	1.5	6	India	3.1
7	Taipei,China	1.2	7	Thailand	2.7
8	Korea, Rep. of	0.9	8	Malaysia	2.5
9	Philippines	0.6	9	Kazakhstan	2.2
10	Viet Nam	0.3	10	Viet Nam	1.3
	Total Asia-Pacific	25.2			111.7
	(Percent of World Total)	(14.2)			(11.7)
	Average Inflows per Capita, $				
1	Singapore	1,373	1	Hong Kong, China	4,836
2	Hong Kong, China	471	2	Singapore	2,534
3	Malaysia	213	3	Brunei Darussalam	2,035
4	Vanuatu	140	4	Macao, China	205
5	Fiji Islands	100	5	Taipei,China	156
6	New Caledonia	67	6	Kazakhstan	143
7	Taipei,China	57	7	Malaysia	107
8	Papua New Guinea	47	8	Korea, Rep. of	105
9	Thailand	41	9	Vanuatu	88
10	Solomon Islands	40	10	Azerbaijan	57
	Inflows as Percent of Gross Fixed Capital Formation				
1	Vanuatu	42.8	1	Hong Kong, China	76.1
2	Fiji Islands	37.6	2	Kazakhstan	48.4
3	Singapore	31.0	3	Singapore	44.7
4	Viet Nam	28.4	4	Cambodia	31.6
5	Papua New Guinea	22.7	5	Vanuatu	30.0
6	Malaysia	21.4	6	Armenia	24.7
7	Solomon Islands	20.1	7	Uzbekistan	24.6
8	Cambodia	17.0	8	Georgia	23.7
9	Hong Kong, China	11.5	9	Mongolia	16.3
10	Maldives	8.3	10	Papua New Guinea	14.8

Sources: ADB (2003a), UNCTAD (2004), UN Population Division (2004).

Distinguishing characteristics of FDI are its stability and ease of service relative to commercial debt or portfolio investment, as well as its inclusion of nonfinancial assets in production and sales processes. Aside from increasing output and income, potential benefits to host countries from encouraging FDI inflows include the following:

(i) *Foreign firms bring superior technology*. The extent of benefits to host countries depends on whether the technology spills over to domestic and other foreign-invested firms.

(ii) *Foreign investment increases competition in the host economy*. The entry of a new firm in a nontradable sector may increase industry output and reduce the domestic price, leading to a net improvement in welfare.

(iii) *Foreign investment typically results in increased domestic investment.* In an analysis of panel data for 58 developing countries, Bosworth and Collins (1999) found that about half of each dollar of capital inflow translates into an increase in domestic investment. However, when the capital inflows take the form of FDI, there is a near one-for-one relationship between the FDI and domestic investment.

(iv) *Foreign investment gives advantages in terms of export market access arising from economies of scale in marketing of foreign firms or from their ability to gain market access abroad.* Besides their contributions through joint ventures, foreign firms can serve as catalysts for other domestic exporters. The probability a domestic plant will export is positively correlated with proximity to multinational firms (Aitken et al. 1997).

(v) *Foreign investment can aid in bridging a host country's foreign exchange gap.*

If both labor and capital are fully employed before and after the capital movement, the total and average returns to capital increase, while total and average returns to labor decrease in the source country. While that country gains as a whole, income is redistributed from labor to capital. Meanwhile, in the recipient country, income is redistributed from capital to labor, as total and average returns to capital decrease and total and average returns to labor increase. The result is potentially a win-win situation for the two countries.

Under full employment, a capital inflow that reduces the relative scarcity of capital and raises the productivity of labor in the host country can raise real wages across the board and reduce income disparity within the host country. However, the question of distribution also arises with respect to the sharing of gains between foreign capital and host countries' factors of production. Traditionally, foreign investment was geared toward primary commodity exports. In some cases, this led to capacity expansion, productivity growth, declining prices of exportable commodities, and deterioration in the host country's terms of trade, possibly leading to welfare losses. In addition, there were generally little spillovers to the rest of the host economy from primary commodity production. The resulting view was that the gains from capital inflows favor the source economy more than the host economy.

Many new foreign investments in developing countries are in process manufacturing because of lower labor costs, such as sports shoe factories across developing Asia. The host countries often import unfinished components and export finished goods or refined components for further processing elsewhere. While wages may rise across the board in host countries and reduce income disparity, in practice wages are likely to rise only for a small fraction of the labor force employed by the foreign investor. By creating a favored local group, this can lead to greater income disparity within the host country. The result can be to improve the absolute and relative condition of workers within this favored group, in the process aggravating income inequality. Over time, however, and given a conducive policy environment, linkages and leakages emerge, creating a country reputation that influences other potential investors.

A capital inflow can lead to a rise in the prices of nontradable goods and services relative to those of imported goods and services. If world demand for the country's exports is perfectly price-elastic, the price of nontradables will rise relative to the price of exports as well. Consequently, the change will affect the returns to factors that are used intensively in either tradable or nontradable sectors. Thus, a capital inflow-induced terms of trade effect may affect real income for any given level of real output, which may or may not be affected. When capital flows to an industry in which an existing firm has monopoly power in the world market, an increase in output from the new competition lowers the price of the exportable, thus reducing the terms of trade and potentially lowering welfare in the host country.

When there are "lumpy" adjustment costs for new investment and there are economies of scale in the investment technology, trade openness can trigger discrete changes in the terms of trade and thereby lead to a discrete jump in the level of investment. However, it can also lead to boom-bust cycles of investment where multiple equilibria are supported by self-fulfilling expectations (Razin et al. 2002).

As foreign investors search for the location that will provide the highest returns on their investment, they are often drawn to countries with abundant natural resources but low-quality institutions. Weak and inefficient institutions allow the extraction of natural resources at a faster pace than that required for sustainable development. As a result, local communities are sometimes harmed as the environment, their main source of livelihood, is damaged or destroyed.

Foreign investment-led growth also promotes western-style consumerism, which could have serious potential consequences on the health and food security of the host population (French 1998).

Not all investments by multinational enterprises (MNEs) lead to technology transfer and positive spillovers. In their desire to protect the technology of the parent company, MNEs may limit the production of affiliates in host countries to low value-added activities, thereby reducing the scope for technical change and technological learning. The MNEs may also restrict vertical integration by relying completely on foreign suppliers for their inputs. In some cases, MNEs, by their sheer size, can even eliminate competition by crowding out domestic producers. As integral parts of global value chains, MNEs have a built-in advantage (e.g., economies of scale and scope) over their local competitors.

Increasing FDI across borders has increased the impact of FDI on national economies and the international economy as a whole, with the widely held perception in Asia that the net effect is positive. However, no absolute consensus on the positive effects of FDI has been reached by all governments or the general public, reflecting differences in economic conditions, specific histories of utilizing FDI, cultural variation, and ideological differences. In particular, the policy framework plays an important role in determining the effects of FDI on a recipient country.

B. Bilateral Investment Treaties

In the international context, bilateral investment treaties (BIT) have proliferated. By the end of 2002, there were 2,181 BITs and 2,255 double taxation treaties in effect (UNCTAD 2003). These BITs vary across countries but generally contain binding commitments on expropriation, transfer of funds, and compensation due to armed conflict or political instability. These commitments are sometimes provided on a national treatment or most favored nation (MFN) basis.[1] Disagreements between foreign investors and the host government are usually referred to private arbitration centers of the International Chamber of Commerce or the International Centre for Settlement of Investment Disputes.[2]

Bilateral investment treaties are intended to protect foreign investors against unpredictable host country actions that would negatively affect the profitability of

[1] In the context of international trade and investment negotiations, MFN treatment obliges the host country to offer equally advantageous investment conditions to potential investors from all treaty signatories. National treatment (nondiscrimination) requires the same treatment of both foreign and domestic investors.

[2] While private sector arbitration mechanisms have generally worked satisfactorily so far, it raises the potential for political disagreements in that a sovereign judicial system can be overruled by an arbitration panel that is unelected and usually operates with little transparency.

their investments. In this sense they guard against problems of dynamic inconsistency. However, their implementation may not always be effective in lower-income countries. Furthermore, their benefits for the host countries are not clear. Empirical evidence has not found a strong link between the existence of a BIT and an increase in FDI flows. Furthermore, BITs complement, rather than substitute for, institutional quality, including strength of property rights (Hallward-Dreimeier 2003). Tax treaties may even reduce FDI if the FDI includes an element of tax evasion. At the same time, BITs may reduce policy options for the host country government and leave it open to being sued for substantial amounts. Decisions handed down behind closed doors by the arbitration panels, which have no public accountability, cannot be amended by the domestic legal system.

Despite the possible asymmetry of BITs' benefits for foreign investors and host economies, these agreements have proliferated. By the end of December 2002, the PRC had signed bilateral agreements with 107 countries on protection of investment, and with 75 countries on taxes; India had signed 46 bilateral investment promotion and protection agreements. As some developing economies mature and their outward FDI flows increase, as in the case of Korea, they become more interested in protecting the rights of their investors. In the broadest international context, this has led to calls for a multilateral framework on investment.

The Trade-Related Investment Measures (TRIMs) Agreement in the World Trade Organization (WTO) recognizes that certain investment measures distort trade and that these distortions are not consistent with principles of the General Agreement on Tariffs and Trade (GATT). Export subsidies, import entitlements, minimum export requirements, and local content requirements directly affect volumes and prices of imports and exports, and in some cases the composition of trade. Local content requirements mean that imports are treated less favorably than domestic inputs, violating the GATT's national treatment principle. A trade-balancing requirement that limits the quantity of imported products that can be used if an MNE does not meet its export target also violates national treatment obligations. Incentives geared to attracting FDI, such as tax incentives, may influence trade flows by persuading firms to favor FDI over exports as a method of foreign market penetration.

All developing countries were to have implemented the TRIMs Agreement and eliminated their relevant regulations by 1 January 2000. Twenty-six developing country members with widely varying economic characteristics gave notice that at that time they still had a variety of policies in existence, however. Most of the policies related to the auto industry or the agro-food industry. The policies overwhelmingly adopted by these countries were local content schemes. The second most frequently notified type of TRIM was foreign exchange balancing requirements (Bora 2001).

In Malaysia, for example, TRIMs Agreement compliance was only completed at the end of 2003 with the removal of its local-content policy on motor vehicles for both new and existing firms. Local content requirements are also being phased out in Viet Nam as part of its moves toward WTO accession. Meanwhile, compliance with the TRIMs Agreement was instrumental in overcoming resistance to investment policy reform in Thailand, as TRIMs were gradually abolished.

A number of countries requested extensions of the TRIMs Agreement transition period. Argentina, Malaysia, Philippines, and Thailand cited financial crises that added to their structural adjustment problems as a major factor behind their extension requests. Colombia and Pakistan cited specific development reasons for their extension requests. Colombia detailed difficulties in transforming its economy, especially in terms of developing substitutes for illegal crops, arguing that this would require domestic absorption, or local content policy, to ensure that farmers are able to sell their produce. Pakistan argued that opening its economy to import competition rapidly would not allow it to exploit domestic resources optimally, to promote the transfer of technology, or to promote employment and domestic linkages. Another reason cited for an extension request was inconsistency between preferential trade agreements and multilateral obligations (Bora 2001).[3]

Bora (2001) also summarizes a few other areas where confusion might arise. The TRIMs Agreement covers measures related to foreign investment according to their impact on trade. However, since nothing in the TRIMs Agreement suggests that the nationality of the ownership of enterprises is an element in deciding whether that measure is covered by the Agreement, the TRIMs Agreement is not confined to policies targeting foreign firms. It is in fact ownership-neutral. However, some argue that the TRIMs Agreement is basically designed to govern and provide a level playing field for foreign investment, and that therefore measures relating to internal taxes or subsides cannot be construed to be trade-related investment measures.

The current TRIMs Agreement relies on the state-to-state mechanisms of the WTO for dispute settlement and arbitration under which, for example, a dispute settlement panel is established and makes its judgment. Some argue that it is necessary to establish investor-to-state mechanisms to ensure investors receive a hearing (Moran 2002). Others believe inclusion of an investor-to-state dispute settlement mechanism would add an excessive burden on developing countries' legal machinery and imposes a threat to their national sovereignty (Tangkitvanich

[3] Argentina's request stated specifically that negotiations within the context of the MERCOSUR Common Automotive Policy were important. Mexico did not specifically mention NAFTA in their request, but it has been noted that there is an inconsistency in the phase out period for TRIMs between NAFTA and the WTO.

et al. 2004). Korea's preliminary position is that the dispute settlement of the multilateral framework for investment should not cover investor-to-state disputes.

More fundamentally, several developing countries are of the view that TRIMs and other investment measures are domestic investment issues that should therefore not involve WTO officials. This point was emphasized during the Fifth WTO Ministerial meeting in September 2003. India and others also assert that the mandate of the WTO is confined to trade and does not extend to investment. Some fear they would be deprived of a major means of exercising control over foreign firms operating locally if their right to impose TRIMs or other investment measures were removed. Some developing countries, including India and Malaysia, consider that policies such as domestic content requirements are essential policy tools for industrialization. At the WTO Doha Ministerial Conference, a number of countries stated that joint venture requirements encourage indigenization. They believe developing countries should be allowed to use TRIMs and other investment measures flexibly in pursuit of developmental objectives because each country's unique needs and circumstances require sufficient freedom and flexibility to pursue one's own policies. They are of the view that, although the TRIMs Agreement established uniform obligations for all members, it does not take account structural inequalities and disparities in levels of development, technological capabilities, or social, regional, and environmental conditions; and does not incorporate a meaningful development dimension. A legally binding treaty on foreign investment would reduce the degree of flexibility available (Ganesan 1998).

In a joint submission with Brazil to the WTO's Committee on TRIMs in October 2002, India argued that the TRIMs Agreement should be amended to incorporate provisions that provide developing countries flexibility to implement development policies. In particular, they proposed that developing countries should be allowed to use investment measures or performance requirements to promote domestic manufacturing capabilities in high value-added sectors, to stimulate the transfer and indigenous development of technology, promote domestic competition, and correct restrictive business practices (Kumar 2004). Despite its increasing trend of investment abroad, Malaysia also views multilateral rules on investment as impinging on development policy options and has called for clarification of the issues before negotiations commence (Tham 2004).

Conventional wisdom holds that developing countries engage in trade-distorting investment measures while developed countries do not. However, trade and investment figures clearly show that developed countries also use investment measures. Most developed countries make available location-based incentive packages for both domestic and international investors. Ireland reports that its special incentive packages have attracted more than 1,200 foreign firms to its economy, and these contribute 70 percent of the country's industrial output and three quarters of its manufactured exports (O'Donovan 2000). German grants to both domestic and foreign firms to settle in the economically depressed former East Germany have exceeded the already generous treatment EU member states used to attract investment to regions lagging behind. The Organisation for Economic Co-operation and Development (OECD) found that almost 90 percent of all domestic support programs in the EU were available to foreign investors (OECD 1996, Moran 2002). Any multilateral effort to create a level playing field for national and international companies among home and host countries around the world would be seriously deficient if it ignored the proliferation and escalation of location-based incentives by developed countries.

II. FDI REGIMES AND PATTERNS IN SIX ASIAN ECONOMIES

Having surveyed general patterns and issues, this section assesses FDI inflows (and outflows), patterns, and policy regimes in six diverse Asian countries, namely PRC, India, Korea, Malaysia, Thailand, and Viet Nam, in the context of general economic trends, ownership structures, and policy reforms. A central argument is that trade reform alters production incentives for the domestic market relative to exports, resulting in a fundamental shift in the behavior of MNEs and in the FDI cost-benefit calculus.

A. Six Diverse Economies

Tables 2 and 3 present comparative statistics for the six economies, including some general economic indicators, as well as those relating to the trade regime and FDI. Also included are some indicators of the countries' attractiveness to foreign direct investment. Table 4 offers some summary stylized facts of FDI regimes.

The sample includes the world's two most populous nations, together with a range of intermediate-sized countries with populations in the range of 20-100 million people. The largest economy (the PRC) is more than double that of the next largest (India) and about 35 times that of the smallest (Viet Nam). Korea is a rich OECD member. Malaysia is an upper middle-income developing country. The PRC and Thailand are in the lower middle-income group, while India and Viet Nam are low-income. The range of per capita GDP from the richest (Korea) to poorest (Viet Nam) is about 30:1, or 7:1 in purchasing power parity terms.

All six have performed creditably for most of the past two decades. Their real per capita incomes in 2002 were at least double those of 1980, and more than five times higher in the case of the PRC. Since 1990, the PRC has consistently recorded spectacular economic growth, to the point where it is now the principal East Asian growth locomotive, and a major global economy. If its current growth rates are maintained, it will become the world's largest economy (in purchasing power parity terms) before 2020. Korea, Malaysia, and Thailand all grew at more than 6 percent until the crisis of 1997-1998; Thailand was the world's fastest growing economy in the decade from the mid-1980s. All three experienced a sharp contraction in 1998, but recovery has been fairly rapid. Viet Nam grew strongly for most of the 1990s, with slower (but consistently positive) growth during the crisis. India has never consistently achieved the very high growth rates of the others. However, reforms from the late 1980s have lifted its performance significantly, and it was largely unaffected by the recent Asian crisis.

All six have reasonably good macroeconomic management. Since 1990, all have averaged single-digit inflation. None is a heavily indebted economy. Malaysia and Thailand have the highest debt to GDP ratios. Both were running very large current account deficits precrisis, albeit in the context of very high investment rates, low fiscal deficits, and (owing to their outward orientation) moderate debt-service ratios.

B. Foreign Direct Investment Regimes

1. An Overview

In their FDI regimes, it is useful to divide the six countries into three groups. The first comprises those with historically very restrictive regimes, including outright prohibition, which have opened up during the past quarter century. This includes PRC, India, and Viet Nam. Second are those that have always been reasonably open, and become progressively more so. Malaysia and Thailand belong to this group. Finally, there is the special case of Korea, which was initially highly selective in its opening up to FDI, and which has become progressively more open, especially in the 1990s. There is no instance in our sample of countries becoming less open toward foreign direct investment.

The comparative FDI data reported in Table 3 illustrate these general characterizations. In 1990, Malaysia, the least populous of the six, had the largest stock of FDI after the PRC. Thailand was well ahead of the other three. The amount in Viet Nam was negligible. By 2002, the PRC had emerged as the dominant recipient, with more than seven times the stock of the next two, Malaysia and Korea. In 2002, it was the world's largest FDI recipient, overtaking the United States. India and Viet Nam still had the smallest stocks, though they had both increased quickly, especially Viet Nam. Relative to GDP, Malaysia was the largest recipient of FDI in both years, and India the smallest. The greatest absolute increase in these ratios occurred in Viet Nam, followed by Malaysia.

Table 2. **Annual Inflows of FDI, Portfolio, and Other Capital, 1990-2003 ($m)**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
PRC														
Total Capital Inflows	n.a.	9,431	7,467	30,585	36,214	41,676	43,834	64,107	35,230	41,908	58,045	41,557	50,031	n.a.
FDI	3,487	4,366	11,156	27,515	33,787	35,849	40,180	44,237	43,751	38,753	38,399	44,241	49,308	n.a.
Portfolio	n.a.	565	393	3,646	3,923	710	2,372	7,842	98	-699	7,317	1,249	1,752	n.a.
Other	1,070	4,500	-4,082	-576	-1,496	5,116	1,282	12,028	-8,619	3,854	12,329	-3,933	-1,029	n.a.
India														
Total Capital Inflows	n.a.	4,258	3,147	5,244	9,488	5,157	16,798	14,490	11,871	10,108	11,506	7,940	3,764	n.a.
FDI	n.a.	74	277	550	973	2,144	2,426	3,577	2,635	2,169	2,657	4,334	3,030	n.a.
Portfolio	n.a.	5	284	1,369	5,491	1,590	3,958	2,556	-601	2,317	2,774	2,041	967	n.a.
Other	6,139	4,180	2,587	3,325	3,024	1,423	10,413	8,357	9,837	5,623	6,075	1,566	-234	n.a.
Korea														
Total Capital Inflows	6,950	11,087	11,527	10,222	23,156	37,845	48,412	7,835	-7,681	18,744	20,713	4,106	12,449	n.a.
FDI	788	1,180	728	589	810	1,776	2,326	2,844	5,412	9,333	9,283	3,528	1,972	n.a.
Portfolio	662	2,906	5,875	11,088	8,713	14,619	21,514	13,308	775	7,908	12,697	12,227	4,940	n.a.
Other	5,500	7,001	4,924	-1,455	13,632	21,450	24,571	-8,317	-13,868	1,502	-1,268	-11,650	5,538	n.a.
Malaysia														
Total Capital Inflows	1,989	4,664	7,244	11,738	784	6,628	5,343	6,801	2,719	n.a.	n.a.	-942	4,235	n.a.
FDI	2,332	3,998	5,183	5,006	4,342	4,178	5,078	5,137	2,163	3,895	3,788	554	3,203	n.a.
Portfolio	-255	170	-1,122	-709	-1,649	-436	-268	-248	283	-892	-2,145	-666	-836	n.a.
Other	-89	496	3,183	7,441	-1,909	2,885	533	1,912	272	n.a.	n.a.	-830	1,868	n.a.
Thailand														
Total Capital Inflows	9,402	11,575	9,517	13,998	13,691	25,534	17,797	-8,851	-10,591	-8,970	-8,094	-3,530	-6,003	-6,140
FDI	2,444	2,014	2,113	1,804	1,366	2,068	2,336	3,895	7,315	6,103	3,366	3,892	953	1,800
Portfolio	-38	-81	924	5,455	2,486	4,083	3,585	4,598	338	-109	-546	-525	-694	356
Other	6,996	9,642	6,479	6,739	9,839	19,383	11,876	-17,344	-18,243	-14,964	-10,914	-6,897	-6,263	-8,296
Viet Nam														
Total Capital Inflows	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,942	2,237	2,183	1,844	1,773	1,568	1,466	n.a.
FDI	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,395	2,220	1,671	1,412	1,298	1,300	1,400	n.a.
Other	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	547	17	512	432	475	268	66	n.a.

Source: IMF (2004b).

Table 3. **Comparative Statistics**

	PRC	India	Korea	Malaysia	Thailand	Viet Nam
General Economic Indicators						
GDP 2002 ($ billion)	1,237	515	477	95	126	35
GDP per capita PPP 2002 ($)	4,475	2,571	16,465	8,922	6,788	2,240
GDP per capita growth (1990-96) (%)	9.2	3.7	6.5	6.7	7.4	5.8
GDP per capita growth (1997-2002) (%)	6.9	3.5	3.9	0.8	0.0	5.1
Annual average inflation (1990-2002) (%)[a]	6.5	8.3	5.1	3.2	4.1	3.1
Total external debt/GDP 2002 (%)	13.3	20.5	27.1	51.2	46.7	38.0
GDP per capita 2002/GDP per capita 1980[b]	5.6	2.2	3.7	2.1	2.7	2.2
Openness						
Trade						
(Exports+Imports)/GDP 1990 (%)	31.9	15.7	59.4	147.0	75.8	81.3
(Exports+Imports)/GDP 2002 (%)[c]	52.2	31.3	78.6	210.1	122.3	111.5
Export growth (1990-2002) (%)[d]	16.6	12.5	13.6	10.7	9.9	25.6
Average tariff rate 1999	18.7	30.2	7.9	8.1	5.9	20
Index of Economic Freedom (2003)[e]	3.6	3.5	2.7	3.2	2.9	3.9
Investment						
FDI as % of total capital inflows 1990-96[f]	93	15	7	147	16	81
FDI as % of total capital inflows 1997-2002[g]	93	38	27	43	-58	84
Total cumulative FDI inflow, 1990-2002 ($ billion)	425.0	24.3	40.6	55.7	40.1	17.0
Total FDI stock, 1990 ($ billion)	24.8	1.7	5.2	10.3	8.2	0.3
Total FDI stock, 2002 ($ billion)	447.9	25.8	43.7	56.5	30.2	17.1
Outflow / inflow FDI stock 1990 (%)	10.1	16.8	39.2	25.9	4.9	0.0
Outflow / inflow FDI stock 2002 (%)	7.9	9.7	99.6	35.7	9.0	0.0
Total FDI stock as % of GDP, 1990	7.0	0.5	2.3	23.4	9.6	4.0
Total FDI stock as % of GDP, 2002	36.2	5.1	9.2	59.4	23.9	50.3
FDI as % of GDP, 1990-2000 (annual average)	4.1	0.4	0.8	6.4	2.2	6.6
Human Capital						
Years of education, 2000[h]	5.7	4.8	10.5	7.9	6.1	3.8
Tertiary enrolment as % of age group, 2000[i]	7.5	10.5	77.6	28.2	35.3	9.7
R&D expenditure as % of GDP, 2000[j]	1.0	1.2	2.7	0.4	0.1	n.a.
Number of internet users as % of total population, 2001	2.6	0.7	51.5	27.3	5.8	1.3
Public spending on education as % of GDP, 2000[k]	2.9	4.1	3.8	6.2	5.4	2.8

continued.

Table 3. *continued*

Physical Infrastructure[l]	**44**	**56**	**18**	**29**	**32**	**60**
Institutional Quality & Risk						
Corruption (Corruption Perceptions Index, 2003)[m]	3.4(66)	2.8(83)	4.3(52)	5.2(37)	3.3(75)	2.4(105)
Country risk (composite risk rating, 2001)	74.3	65.3	79.3	76.0	73.8	69.5
Property rights index, 2003[n]	4	3	2	3	3	5
Bureaucratic quality (Public Institutions Index, 2003)[o]	4.33(52)	4.26(55)	5.03(36)	5.12(34)	4.97(37)	4.11(61)
Fiscal/Finance						
Stock market capitalization, 2002[p]	13	23	43	129	37	n.a.
Average corporate tax rate, 1999 (%)	33	35	28	28	30	25

Notes: [a] Data for the PRC are for the period 1990-2001 and for Viet Nam, 1996-2002.
[b] Data for Viet Nam are for 1984 and 2002.
[c] Data for Viet Nam are for 2001.
[d] Data for Viet Nam are for the period 1990-1997.
[e] Index of Economic Freedom ranges from 0 (mostly free) to 5 (highly restricted).
[f] Data for PRC and India refer to the period 1991-1996; for Viet Nam, 1996.
[g] Data for Malaysia for 1999 and 2000 are missing.
[h] Average years of schooling of population aged 25 and over. Data for Viet Nam are for 1990.
[i] Tertiary enrolments (regardless of age) as percentage of 20-22 age group. Data for the PRC and India are for 1999.
[j] Data for India, Malaysia, and Thailand are for 1996, 1998, and 1997, respectively.
[k] Data for India and Viet Nam are for 1999 and 1997 respectively.
[l] Growth Competitive Index, 2003, 1-102 ranking, 1=best.
[m] The index ranges from 10 (highly clean) to 0 (highly corrupt) for 133 countries. The maximum is 9.7 and the minimum 1.3. Numbers in parentheses are the country rankings.
[n] The property rights index is a composite from the Index of Economic Freedom. This index ranges from 0 (very good) to 5 (very poor).
[o] The public institutions index is based on survey data and ranges from 2.28-6.56 across 102 countries. The higher the index the higher the quality. Numbers in parentheses are the country rankings.
[p] Data for India are for 2001.

Sources: Barro and Lee (2000), IMF (2004b), Miles et al. (2004), Transparency International (2003), UNCTAD (2002 and 2003), World Bank (2003), World Economic Forum (2003).

Table 4. **FDI Regimes—Some Stylized Facts**

	PRC	**India**	**Korea**	**Malaysia**	**Thailand**	**Viet Nam**
Ownership Structures	Dominant but declining SOEs, rapidly rising private and foreign firms	Large SOE sector; reservations schemes for small firms	Predominantly private; *chaebol* important; high concentration; small SME presence	Always large foreign presence; active *bumiputra* promotion	Predominantly private; Sino-Thai dominance	Dominant SOEs, actually rising post reform
FDI History	Closed to 1978; rapid increase from 1980s, especially in south	Very restrictive pre-1991, then gradual opening	Restrictive until 1990s; then gradual opening; major 1998 reforms	Consistently open	Consistently fairly open	Closed to late 1980s; rapid rise from early 1990s
FDI Presence	Modest but rising	Modest, no clear trend	Low, rising gradually	Very high	Substantial, and rising	Low, but rising quickly
Trade Regime	Closed to 1978; then progressive opening, especially for exports; 2002 WTO accession	Very restrictive pre-1991, then gradual opening	From 1960s, open for exports, otherwise restrictive; major 1990s reforms	Consistently open	Consistently fairly open	Closed to late 1980s; then major opening, especially for exports
International Connections	Hong Kong, China important; large diaspora	Large and active diaspora	Large US diaspora; reverse brain drain in 1990s	Singapore ties historically strong	No special features	Large diaspora, still regarded with suspicion
FDI Regime in Practice	Continuing though declining SOE preference; rapid decentralization; much corruption	Reforming, in context of dirigiste history; states are powerful; much corruption	Business climate becoming more predictable and open; powerful nationalist sentiment	Predictable commercial environment	Reasonably predictable commercial environment	Continuing SOE preference; north-south differences; private firms insecure
Institutional Quality	Uneven, though improving	Well developed, though cumbersome	Generally high, though legal system still evolving	Generally high	Generally quite high	Weak; very limited investor protection
Human Capital	Pockets of excellence; uneven, rapid catch-up	Pockets of excellence; continuing high illiteracy	Extremely strong education; R&D base, though not very international	Generally quite good; major affirmative action program; continuing non-*bumiputra* brain drain	Historic under-investment in post-primary education	High literacy, though limited international commercial know-how and entrepreneurship

Note: SOEs means state-owned enterprises.

In some cases, it is possible to date the opening up to FDI as part of a package of major general reforms. In Korea, there was gradual liberalization from the late 1980s, with major reforms in 1997-1998 in the wake of the economic crisis. In the PRC the reform process commenced in 1978. It was further consolidated in the late 1980s, and again in 2002 upon accession to the World Trade Organization. In India, 1991 is regarded as the key reform year. In Viet Nam it was the late 1980s' *Doi Moi* reforms, with further liberalizations around the turn of the century.

By contrast, Malaysia especially and Thailand have always been quite open to FDI, and over time have become progressively more so. In neither case have there been major swings in the policy pendulum. In the decade up to the 1997 crisis, Thailand was a huge capital importer, in some years running a current account deficit of more than 8 percent of GDP. While FDI increased to record levels, an increasing proportion of the flow was portfolio and other short-term capital. The government's objective to promote Bangkok as a regional capital market center in competition with Hong Kong, China and with Singapore was a factor here, as virtually all restrictions on capital flows were removed. Following the 1997-1998 capital flight and consequent collapse of the baht, the government maintained its open posture toward FDI, despite a growing nationalist backlash, and FDI flows actually increased for a period.

In Malaysia, the principal ownership issue has arguably been the political imperative to redistribute toward the indigenous (bumiputra) community (Gomez and Jomo 1997), rather than the foreign presence per se. Under the New Economic Policy (NEP), announced in 1970, the bumiputra share of the corporate sector was to rise from 2 to 30 percent. Reaching about 20 percent in 1990, albeit through sometimes controversial share allocations, the scheme has been somewhat deemphasized, especially in the wake of the mid-1980s recession and the economic crisis of 1997-1998. In fact, the very high foreign presence at the outset of the NEP facilitated this transformation, as the major redistribution occurred not from non-bumiputra to bumiputra groups but rather from foreign to domestic. The non-bumiputra share actually rose throughout the period, while the foreign share fell continuously until recently.

This is not the place to analyze in any detail the dynamics of these reforms and why they took place. But it is worth pointing out that a range of internal and external factors were typically at work. At an intellectual level, these factors include a recognition that outward-oriented economies grow more quickly, and that it is possible to achieve "nationalist" objectives in an open economy context. Competitive liberalizations—keeping up with one's neighbors—have been a factor. Foreign pressures, including a desire to join international agencies (the GATT/WTO and, for Korea, the OECD) have often coaxed countries along. Conversely, the demise of an international benefactor (the former Soviet Union) was a major trigger in Viet Nam's reforms. Coalitions of key bureaucrats and political figures have often accelerated progress once the environment for reform was judged to be favorable.

Obviously, "policy reform" has very different connotations across the six. In traditionally open Malaysia and Thailand, it has implied a gradual shift of the pendulum. In other cases, reform has constituted a major change in policy emphasis, even a U-turn, in which FDI liberalization has been important. The PRC and Viet Nam are both cases of a transition from a prohibitive to a quite open FDI regime.

2. "Dual Policy" Regimes

While FDI regimes have become more open among the six, there remains considerable selectivity across sectors and firms. Governments have typically been slower to open up the services sector to foreign direct investment. All countries have "national projects" where a range of noneconomic considerations intrude. Among the sample, for example, even the most open economy, Malaysia, has consistently protected its uneconomic automotive industry, and restricted foreign equity participation in it.

More generally, countries typically have a mix of both "rent-seeking" and "efficiency-seeking" FDI, reflecting partial reform of their trade regimes, and the political economy of dispensing patronage. Consequently, all the country studies draw attention to what may be termed "dual policy regimes." For example:

(i) Foreign direct investment policy may differ between regions. Three of the six (PRC, India, Malaysia) feature quite high levels of decentralized economic policymaking. Thailand has been pursuing a policy of "industrial decentralization" for some time. In all but Malaysia, economic authority is being progressively devolved away from the center in varying degrees and speed.
(ii) There are large interindustry differences in protection, and thus incentives, in all six.
(iii) State-owned enterprises (SOE) typically receive preferential treatment, especially in PRC, India, and Viet Nam, and so therefore do their MNE joint venture partners.
(iv) Most countries offer some sort of fiscal or financial incentives to foreign investors. These vary by sales orientation, technology introduced by the foreign investor, location of investment, and other factors.
(v) The regulatory regime frequently offers more than one entry option for potential foreign investors, especially in recently reformed economies.

Not surprisingly, this phenomenon of dual policy regimes is particularly pronounced in the most recently reformed economies, the PRC and Viet Nam. On one hand, there is FDI flowing into joint ventures with SOEs, often in protected, uneconomic sectors, possibly producing negative value added at international prices. Foreign direct investment also typically flows into nontradables such as real estate and hotels where, in thin markets for international-quality assets, asset-price bubbles may occur. Meanwhile, another group of foreign investors enters "comparative advantage" sectors (SMEs, labor-intensive, export-oriented activities). Often the latter locate in special zones that are free of the regulatory and bureaucratic complexities found elsewhere in the economy. Thus, for example, the PRC's initial export orientation was confined to the four southern coastal zones. Most of the labor-intensive FDI originated from Hong Kong, China, and later Taipei,China. This FDI co-existed with that going into joint ventures with SOEs, much of it in uneconomic and protected heavy industry. Firms from OECD countries were the dominant investors in these cases. The domestic welfare implications of different types of FDI are fundamentally important. Clearly, therefore, there is not a single "FDI model" in these economies. A major feature of the reform process is the diminished importance of the former type of FDI, as the latter becomes progressively more important.

Even among the relatively successful late reformers, policy progress is invariably uneven and unpredictable, as is the response of investors. Viet Nam in the 1990s illustrates both these propositions. Following Doi Moi, growth accelerated and there was an initial period of euphoria among foreign investors. By the mid-1990s, however, foreign investors became more wary as the reality of doing business in a transitional, partially reformed communist state sank in (see Freeman 2003). The prolonged commercial isolation and prevailing ideology permeating much of the bureaucracy and the Communist Party meant that policymakers frequently had very little understanding of how to manage a foreign commercial presence. Moreover, many of the general problems associated with the business environment had not been addressed in the first round of reforms: red tape, corruption, insecure property rights, ill-defined legal environment, poor physical infrastructure, limited financial development; and the huge, inefficient, and privileged SOE sector. Finding private sector business partners was difficult, especially as much of the non-SOE business sector was either neglected or harassed.

The PRC is an excellent illustration of the political economy proposition that, in some circumstances, partial reform is desirable if it can be a precursor to successful economywide liberalization. Evidently, the latter was not politically feasible during the early years of reform. As the coastal zones began to grow at a spectacular rate, they became the model for the rest of the economy to emulate, and reform progressively extended to other regions and sectors (Lardy 1996).

3. Reform—Rhetoric versus Reality

In any evaluation of policy regimes, it is crucial to distinguish between formal FDI and trade regimes, and their operation in practice. Nominally "open" regimes may in fact be highly complex and corrupt. Widespread physical and technical smuggling and unrecorded capital flows are present in all six, especially the less reformed ones. For example, smuggling renders irrelevant much of Viet Nam's formal trade regime. The value of investment incentives is significantly eroded by administrative complexities and corruption.

Reform at the center does not necessarily ensure that liberalization will proceed smoothly. This is illustrated in the case of India, where power is diffused and the vested interests and philosophical predisposition toward planning and intervention built up during decades of dirigisme cannot be quickly overturned.[4] Under India's federal structure, the states wield considerable power. Moreover, while the reforms have been "positive sum game", since growth has accelerated, there have been losers: among the bureaucrats who dispensed power and patronage, the SOEs sheltered from competition, and the unions in feather-bedded (especially state-owned) industries.

In Korea, too, there seems to have been considerable ambivalence about recent reforms in sections of the bureaucracy that are reluctant to relinquish control. Considerable sectoral restrictions on FDI remain, while business surveys report that foreign investors find the business environment quite difficult. To overcome these difficulties, reformers have proposed the establishment of "free economic zones", where liberalization can proceed more quickly than elsewhere. Partial reforms of this nature illustrate the strength of the opposition to continuing reform.

One general lesson from the reform experience is that authoritarian states like the PRC and Viet Nam can reform very quickly, once key leadership figures are convinced of the case for change. Democratic states such as India invariably move more slowly. Conversely, it may be that the reforms are likely to be more durable in democratic states: greater persuasion is required to get the reforms through, potential losers are more likely to be compensated, and therefore opposition ameliorated.

Frequently, the investment boards charged with regulating FDI have little general authority. "One-stop-shops" may simply refer to their operations and not the regulatory complexities of many other, more powerful agencies. Moreover, the rationale for these boards continues to be ill-defined. Over a decade ago, there was

[4]To quote Joshi (2003, 565): "In practice, however, the system [i.e., the FDI regime] is more restrictive than it sounds, because there still remain numerous hurdles to jump, erected by State governments if not the Centre." Athreye and Kapur (2001, 422) note that the irony that "…even in sectors where foreign investment is readily allowed, firms must secure 'automatic approval'!" On the Indian reforms, see also Joshi and Little (1997) and Krueger (2002).

concern in the literature over how Asian investment boards married their (potentially conflicting) promotion and regulatory functions.[5] Such a concern appears to be even more valid today, in the wake of the transition to outward orientation, and the region's economic crisis (Buckley 2003).

Especially in larger states, subnational policy regimes matter increasingly. In well-established federal structures like those of India and Malaysia, states do compete for investment, and the division of fiscal and regulatory responsibilities between them and the center is reasonably clear. But decentralization is proceeding rapidly in most of East Asia's nominally unitary states (Hill 2002). Regional authorities are now offering a range of incentives, some only quasilegal. The general presumption is that this intranational competition for FDI (and investment in general) is desirable, since it will spur improvement of quality of governance at the local level. However, there are dangers, especially moral hazard concerns of local governments offering excessively generous incentives secure in the knowledge of central government bail-outs. Moreover, as international barriers to commerce are declining, paradoxically subnational barriers are sometimes rising.

C. Ownership Structures and Foreign Presence

Rising FDI flows in the six economies have generally been associated with an increased foreign presence, as measured by MNE shares of output, employment, and exports. However, it needs to be emphasized that rising FDI inflows do not necessarily result in increasing foreign ownership (see Ramstetter 1999). This is so for a number of reasons. First, especially in high-growth economies, increased FDI flows have been accompanied by rising domestic investment rates, and thus the share of foreign-owned firms has not necessarily risen. Second, much FDI takes the form of reinvested earnings rather than capital inflow, especially in countries such as Malaysia with a long established foreign investment presence.

More generally, the foreign presence is always recorded imperfectly. Foreign direct investment flows are poorly recorded. Disaggregated FDI flow data by sector and source country are mostly incomplete. Accurate stock estimates of the foreign presence are rarely available, while census statistics on foreign ownership are irregular and patchy. Data on other dimensions of foreign presence (e.g., portfolio investments, some of which may be "FDI-like"; licensing and franchising; human capital flows) are even weaker. Moreover, the nationality of ownership is often an empirically slippery concept, especially where there exist

[5]See Wells and Wint (1991). In their sample of countries, only Singapore appeared to have an effective separation of responsibilities.

large diaspora communities abroad. These are present in all six countries, particularly PRC, India, and Viet Nam.

Bearing these caveats in mind, it is useful to briefly highlight some salient ownership patterns in the six countries.

Accurate economywide ownership data are not available for the PRC. The best documented sector is manufacturing, where the major ownership feature has been the rapidly diminishing importance of the once dominant SOE sector (Garnaut and Song 2003). Its share of industrial output declined from 49 percent in 1994 to just 18 percent in 2001. Over this period, shares of the non-SOE domestic sector and foreign firms rose by approximately similar amounts: 38 to 53 percent for the former, and 13 to 28 percent for foreign firms. Among the latter, firms from Hong Kong, China; Macao; and Taipei,China account for 40-45 percent of the total. There has been some, but limited, privatization of SOEs. The major change has been the unshackling of the nonstate sector, which has been the source of the country's economic dynamism since the late 1980s.

In India, too, while economywide ownership data are patchy, in contrast to the PRC, all estimates point to minor ownership changes over time and a modest foreign presence. As would be expected, foreign shares declined prior to liberalization, from around 30 percent of industrial output in the early 1970s to about 25 percent in 1990, according to unpublished data from the Reserve Bank of India (RBI) cited by Athreye and Kapur (2001). These figures overstate the foreign presence since they refer only to medium and large public companies RBI surveyed. As Athreye and Kapur (2001, 409) note, the decline is explained by "…the restrictions placed on foreign firms by the overall regulatory framework. Greater selectivity in industrial licensing restrained the growth of many multinationals [which] were unable to compete against well-organized domestic industrial lobbies." Post-liberalization, this trend appears to be slowly reversing. For listed companies on the Indian stock exchange—a data series that cannot be directly compared with the source above—the share of foreign firms in manufacturing output has risen gradually toward the end of the century: 9.5 percent in 1990, 9.3 percent in 1995, and 12.8 percent in 2000. It could be that the foreign presence has risen more sharply in other sectors, especially the newly opened service industries. The foreign presence in India's manufactured exports is miniscule, especially compared to East Asian norms.

Foreign presence has always been modest in Korea. Within manufacturing, at the onset of the economic crisis, foreign firms produced about 10 percent of manufacturing output and employed 5.5 percent of the industrial workforce. Liberalization and M&A activity raised these shares to 13.3 and 8 percent respectively by 1999. Over the period 1997-1999, foreign firms accounted for about 15 percent of the country's manufactured exports.

The Malaysian data confirm the historically large foreign presence in the economy. Foreign firms owned approximately one third of the nation's share capital in 1999, down from over one half in 1970. Within manufacturing, foreign firms generated about 44 percent of value added and 38 percent of employment in 2000. They also accounted for 73 percent of manufactured exports and 65 percent of total exports in 1995.

Ownership statistics for Thailand are the weakest of the six countries. There are no economywide estimates, while even for manufacturing the first reasonably comprehensive data were prepared only in 1996. They report that firms with a foreign presence (i.e., a foreign share greater than zero) produced about 50 percent of the country's industrial output and employed 41 percent of its workforce. Estimates for 1999 suggest little change in the immediate aftermath of the crisis.

Ownership structures in Viet Nam are unusual. As FDI flowed in from the late 1980s, the share of the SOE sector actually increased. The explanation is that the SOEs retained their privileged access to secure land titles and the domestic banking sector for much of the reform period, and thus many foreign investors were forced into joint ventures with them. Meanwhile, the policy regime suppressed the emergence of a domestic SME sector (Freeman 2003). This trend began to reverse slowly, as the monopoly privileges of SOEs have been eroded. One important milestone in this respect was the granting of 100 percent foreign ownership in certain circumstances (principally for firms in export zones), and the formal recognition that foreign firms are no longer part of the "state capitalist" sector. Another was the passing of the Law on Enterprises in 2000, which provided a more secure environment for the domestic private sector. Over the period 1995-2001, there were no major changes in economywide output shares by ownership, apart from a doubling of foreign firms (6 to 13 percent). The state sector remained virtually constant (39-40 percent), while collectives (10 to 8 percent) and the private/household sector (39 to 36 percent) declined slightly. The small mixed sector remained unchanged (4 percent). In these respects, Viet Nam is yet to experience the far-reaching ownership changes evident in the PRC. The foreign share of Viet Nam's manufactured exports has been rising sharply, from 17-19 percent in 1993-1995 to 57 percent in 2000, emphasizing the importance of FDI in the country's labor-intensive export drive.

D. Flows and Patterns of Foreign Direct Investment

Having drawn attention to differences in ownership patterns among the six, it is also important to draw attention to some common features, and some trends worthy of note. At least five deserve comment.

1. Inflows to the PRC and PRC–India Comparisons

Although the PRC was the world's largest FDI recipient in 2002, the size of the inflows is a subject of debate. The principal uncertainty relates to "round-tripping", that is, the PRC investments are being channelled through Hong Kong, China and returning as "foreign" investment to secure the greater privileges and security that foreign investors typically receive. As the PRC reforms progress, however, and the gap between the commercial environment in Hong Kong, China and adjoining southern regions narrows, this round-tripping FDI appears to be a diminishing proportion of total inflows.

These magnitudes have also triggered a recent debate about the comparative attractiveness of the PRC and India to foreign investors. On the face of it, the PRC appears to dwarf India, owing to its earlier reforms and faster economic growth. Its recorded FDI inflows are about 20 times greater than India's in recent years. However, these reported differences are exaggerated.[6] At least 20 percent of the PRC's FDI is still thought to be round-tripping, while Indian statistics until recently have significantly understated its FDI receipts. In addition, the PRC's economy is about double that of India's. Making these adjustments, the reported 20:1 differential in flows becomes perhaps 3:1 in terms of FDI/GDP ratios. Since the PRC's investment rate (relative to GDP) is at least one-third higher than India's, the FDI/GDI (investment) ratio for the two countries is about 2:1. Thus, in the PRC-India comparison, more generally, the PRC emerges as less of an outlier. Its magnitudes are extremely large as much owing to its size as its openness to foreign direct investment.

2. Changing Sectoral Composition of FDI Flows

Prior to the 1980s, most FDI in developing countries was in extractive industries and import-substituting (IS) manufacturing. The first major compositional shift was within manufacturing, from IS to export-oriented manufacturing. This transition commenced in the late 1960s, but really accelerated from the 1980s. A more recent shift has been toward services. By 2000, about half the total stock of FDI in developing countries was in services, more than double the figure in 1990 (UNCTAD 2002). Three factors principally account for this trend: the rising share of services in practically all countries, the increasingly tradable nature of many service outputs, and liberalized entry into many service industries previously closed to foreign businesses.

These global changes are evident in all six economies, as service industries have been opened up to foreign direct investment. The changes are particularly pronounced in the more recently reforming economies. In the PRC, FDI began entering the banking and foreign and domestic trade sectors in the 1990s. With its WTO accession, insurance, telecommunications, and other sectors are being progressively opened. Liberalization in India has resulted in a sharp decline in the earlier dominance of manufacturing in FDI flows, from 85 to 48 percent of the

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[6] For a recent summary of the debate, see *The Economist* (2003).

total. Most of the increase has gone into services. There is also a more even distribution of FDI across subsectors. In Korea, most service industries were closed to MNEs prior to the 1990s. Here too reform has led to a major reallocation of FDI flows.

3. Changing Modalities of Capital Flows

For a time in the 1990s, portfolio investment flows in Southeast Asia exceeded FDI (see Table 2). During and after the 1997-1998 crisis, this trend was dramatically reversed. Moreover, the nature of FDI is also changing. The old pattern of greenfields FDI, and durable, long-term joint ventures is increasingly being replaced by M&As and volatile, opportunistic, and short-term relationships. The extent of M&A FDI is poorly documented, but appears to be increasing in most countries. These activities certainly increased in the late 1990s in the crisis-affected countries, as exchange rates and stock markets collapsed, inducing so-called “fire-sale FDI”, to be discussed shortly. Korea’s experience clearly illustrates this phenomenon: in the wake of the crisis, portfolio and other short–term capital outflows were very large, while inward FDI flows rose strongly over the period 1997-1999. In India, the major compositional shift was the type of FDI, and it has more to do with policy changes than economic crisis. During the restrictive era, virtually all FDI was “greenfield” by government dictate; now about 40 percent is mergers and acquisitions.

Foreign direct investment has been the major source of capital flowing into the PRC, dwarfing portfolio investment owing to the semiclosed capital account, including restrictions on foreigners trading shares on the domestic stock market. A similar picture holds for Viet Nam, which has the least internationally integrated capital market among the six. In contrast to the other countries, and reflecting its consistently open regime, Malaysia has traditionally received most of its capital in the form of FDI, which declined during the onset of the crisis, but remained large. In the wake of the September 1998 imposition of capital controls, portfolio flows turned negative, but FDI held up.

4. Varying Major Sources of FDI across Countries

Europe, Japan, and US are typically the major investors. In some cases, much smaller, but very open, proximate, and historically connected economies are major players in much larger economies. Thus, Hong Kong, China is the largest investor in the PRC, given its traditionally important (though declining) role in connecting that country to the global economy. The round-tripping phenomenon alluded to above is also a factor. Singapore remains a significant actor in Malaysia, reflecting their historically close commercial and political ties. A major foreign investor in India is Mauritius where, in addition to historical connections, special taxation privileges have played a key role.

The 1970s and 1980s FDI debates about whether particular source countries matter, and whether some are more desirable than others, no longer resonate in these six countries, or more generally.[7] This is so for several reasons: the demonstrated evidence that well-managed FDI contributes to growth, regardless of its origins; international competition for FDI is more intense; there is a greater diversity of sources as compared to earlier periods of American and European domination; and even quite low-income countries are also investing abroad. Much of the "FDI differences" literature simply reflected the particular stages of development of the home countries. These alleged "unique" MNE characteristics generally faded as the source countries were transformed.

5. Behavior during Crises, Magnitude, and Composition of FDI Flows

Three of the six economies in the sample (Korea, Malaysia, Thailand) were severely affected by the 1997-1998 Asian economic crisis, and in another (Viet Nam) growth slowed markedly. It is therefore useful to examine briefly the behavior of FDI, and related policy responses, during this episode. Sudden capital flight is a central feature of modern economic crises. Crisis economies typically switch quickly from current account deficits to surpluses. On the current account, expenditure switching and absorption effects reduce imports and promote exports. In addition, slower economic growth and increased economic and political uncertainty result in the rest of the world being unwilling to finance a current account deficit.

Moreover, the behavior of different forms of capital diverge. Portfolio and other forms of highly mobile capital are more likely to exit a country. By contrast, FDI flows are typically much less volatile. In fact, post-crisis FDI may well increase, along the lines postulated in Krugman's "fire-sale FDI" thesis (Lipsey 2001). Asset prices are now cheaper, owing to depreciated exchange rates, demand contractions, and financial collapse. Policy regimes are typically liberalized as part of the government's recovery package. Athukorala (2003) demonstrates that this is precisely what happened in most of the five East Asian crisis-affected countries during 1997-1998. In aggregate, there was massive capital flight, principally portfolio investment and short-term debt. Yet FDI actually rose modestly.

[7]This debate included the assertions that Japanese and "Third World" FDI were superior to that from America and developed countries, respectively. Kojima (1996) was commonly associated with the former argument, while Wells (1983) was a major early study of the latter.

Foreign direct investment may also play an important role during the recovery of crisis-affected economies. The analytical connection between the two starts with the collapse in aggregate demand during a crisis: consumer confidence and therefore expenditure wanes; the capacity for governments to run fiscal deficits is often constrained; and domestic investment falls owing to financial fragility and weak domestic demand, and uncertainty. Exports are therefore the critical component in the immediate recovery period. Crucial to the latter are multinational enterprises. Given their global market networks and know-how, deeper pockets, and stronger connections to global capital markets, MNEs have the capacity to translate large increases in potential competitiveness (arising from the depreciated currency) into export growth, in turn facilitating economic recovery.[8]

E. Investment Outflows

Capital outflows are central to the process of globalization. Although occasionally the subject of mercantilist objections, to the effect that national savings are being employed for the benefit of foreigners, theory and empirical evidence point clearly in the opposite direction. Outward FDI benefits the home economy, since domestic factors of production are able to maximize their returns. It is also presumed to constitute a spur to better economic policy, to the extent that the option of "exit" for investors exerts a policy discipline on governments. Outflows present a mixed and imperfectly recorded picture, but it is clear that patterns vary across the six economies. In all but Viet Nam these investments abroad are sizeable. In all cases, there has been a general relaxation of controls on outflows, although in some cases quite onerous restrictions remain in place. However, with the occasional exception of Korea, all six are net FDI recipients.

Three general features of these outflows are worthy of mention. First, as noted elsewhere, many of the outward investment projects draw on the countries' overseas communities, to be expected given that this diaspora lowers the transaction costs of going abroad. Second, in countries with complex regulatory systems, outward FDI may be a means of exploiting firm-specific advantages in a less restrictive environment. This has been hypothesized in some of the Indian literature, though presumably it is now a less important motive. Third, it appears to be the case that increasing outward FDI has contributed to the liberalization of policies toward FDI inflows. The argument is that investing abroad does introduce an appreciation of the case for a more predictable and open regime. This has

[8] The 1997-1998 crisis also served as a reminder that restrictions on short-term capital flows may, in special circumstances, be compatible with an open FDI regime, at least in the short to medium term. This is the major conclusion of the controversial Malaysian policy experiment introduced in September 1998. See Athukorala (2001) for a detailed examination.

evidently been the case in Korea, particularly in the context of its OECD accession.

The Korean case, with its relatively low per capita income, becoming a large investor abroad with outflows often exceeding inflows is very unusual. This appears to reflect a number of factors. One is its traditionally restrictive approach to inflows. The second was the country's rapid loss of comparative advantage in labor-intensive activities during the 1980s and the consequent relocation on a massive scale of much of this industry to high-growth, receptive economies nearby. A third was the aggressive internationalization of the major chaebol from the late 1980s, with support from the government. A considerable proportion of the FDI was high-end investment in sectors where protection in the targeted markets necessitated investment rather than export from the home base (e.g., the automotive and consumer electronics industries). "Reverse engineering" type FDI, to obtain access to host country technology, has sometimes been a factor.

The PRC is also emerging as a major investor abroad. This phenomenon may appear surprising in view of its rapid growth, with the presumption that returns on capital would be higher at home than abroad. Three factors appear to be relevant in this story (Garnaut and Song 2003). One relates to macroeconomic policy. The PRC is running large current account surpluses and accumulating massive international reserves, currently estimated to exceed $400 billion. Most of these reserves are held abroad, albeit largely in the form of government securities rather than FDI. The second factor is the round-tripping phenomenon referred to above. This is not of course genuine FDI, and should be discounted from the outflows figure. The third are investments abroad by state-related entities in sectors deemed to be of commercial and strategic importance, such as natural resource projects.

For some countries, it is useful to distinguish between what may be termed "state-sponsored" and "market driven" investments. This is evident in Malaysia, for example. The government has sponsored several major investment projects abroad, including directly through its state-related entities. Some of these have been high-profile, quasipolitical investments in developing countries, with mixed commercial results. Alongside these have been straightforward efficiency-motivated investments, principally in neighboring countries and reflecting firms' competitive advantages.

F. Trade Regimes

Openness to the international economy varies significantly among the six. All have become more open to trade since 1990, as indicated by both trade reforms and rising trade/GDP ratios. The latter ratio has increased by more than 50 percent in three of the countries (PRC, India, and Thailand) and substantially in the others (Table 3).[9] Malaysia and Thailand were among a very small group of developing economies classified by Sachs and Warner (1995) as "always open." Both exhibit very high trade orientation, quite low average tariffs, modest interindustry tariff dispersion, and limited incidence of nontrade barriers.

Among the six, Korea's trade and investment regime has arguably been the most unusual. From the early 1960s, it achieved very rapid export-led growth, but in the context of (until recently) very restrictive policies toward imports (except those required by export-oriented firms) and foreign direct investment. Its adventurous industrial policy resulted in tremendous achievements but also high costs.[10] However, major reforms were enacted in the 1990s. In addition to tariff reform and the reduced incidence of nontrade barriers, these also included a reduction in the number of subsidy programs and customs simplification. As with its FDI regime, a desire to join both the GATT/WTO and the OECD, and the imperative to reform in the wake of the 1997-1998 crisis, drove much of the liberalization.

Notwithstanding recent reforms, PRC, India, and Viet Nam still have quite high tariffs, and a higher incidence of nontrade barriers. Smuggling remains rampant in the more protected economies. In particular, Viet Nam's reengagement with the international economy is of very recent origins. For much of the period following the commencement of its 1986 Doi Moi reforms, it was effectively shut out of the world's largest market. The US embargo was lifted in 1993, while the two countries signed a Bilateral Trade Agreement only in 2001. As is the case with late reformers, its official trade regime remains opaque and poorly documented. It is only quite recently that a formal tariff schedule was released. Viet Nam still retains very high levels of protection (several hundred percent) for its automotive, sugar, and garments industries. Much protection is firm-specific in nature, tailored to the needs of its inefficient SOE sector.

A central feature of trade reform in all six economies is that it was unilateral in nature. While four of the countries are members of preferential trading arrangements—ASEAN in the case of the three Southeast Asian economies and SAARC (South Asian Association for Regional Cooperation) for India—in practice these arrangements have meant practically no deviation from nondiscriminatory reform.[11] This may be changing, however. With the current US-

[9] Of course, the usual caveats have to be attached to the data in Table 3. Trade/GDP ratios need to allow for country size. Average tariffs need to take account of tariff dispersion and the presence of nontrade barriers. To varying degrees, all six countries maintain dual trade regimes as between export sectors and the domestic economy. Nonetheless, the picture presented here is a reasonably plausible characterization of the country differences.

[10] For contending perspectives on the impact of these interventions, see for example Amsden (1989 and 2001) and Smith (2000).

[11] That is, the AFTA liberalizations have almost always been multilateralized, while the SAARC concessions have been trivial.

led penchant for free trade arrangements (FTA), all six have been forced to follow suit, and explore FTA options. Among the six, Korea and Thailand in particular have been active. If these FTAs ever become significant, MNEs will certainly respond by including preferential access to selected export markets as a factor in their decision-making processes.

G. The Commercial Environment

The large variations in the foreign presence among the six economies are explained fundamentally by the attractiveness of the host economies to foreign direct investment. This in turn reflects the rate of economic growth in each, and the ease of entry for foreign investors. In addition to macroeconomic management and openness, a number of factors codetermine both economic growth and FDI attractiveness. Several proxies for these factors are presented in Table 3. Informed analytically by what may be termed the "three Is" (incentives, infrastructure, and institutions), these variables include proxies for human capital, quality of physical infrastructure, institutional quality and country risk, and financial development. As economies open up, governments have to make the transition from protectionist/regulatory regimes to a new emphasis on promotion and efficiency. Thus, there needs to be more effective industrial extension, R&D, and other support schemes; better physical infrastructure; legal reform; improved education; and administrative reform and simplifications. Broader still are issues of country risk and policy predictability. Hence, countries' performance according to a range of "competitiveness" variables listed in Table 3 (numbers 3-6) is central to both attracting FDI and to economic progress.

It also needs to be emphasized that domestic investors are invariably the key players in any economy and that domestic investor sentiment weighs heavily in MNEs' international location decisions. Therefore what matters is the host economy's commercial environment in general, and not especially as it relates to foreign investors. Indeed, FDI regimes that are significantly "pro-foreign" in their incentives or other provisions are unlikely to be fiscally or politically durable, and these incentives tend to be discounted by MNEs with long time horizons. It is important that any study of competitiveness and the business environment recognize this fact.[12]

The proxies and data in Table 3 are of course highly selective, and subject to numerous qualifications.[13] But they are illustrative, and generally accord with a

[12]Of course, there will always need to be some special provisions in any investment law tailored specifically for foreign investors, e.g., guarantees against expropriation, etc.

[13]Numerous data sources could have been selected. A useful series, with heavy emphasis on technological capacity and learning, is presented in UNIDO (2002). ADB (2003a, Part 3) provides a comprehensive review of various competitiveness estimates.

priori notions. Moreover, they effectively draw attention to the diversity of the six countries.

The PRC's human capital base is comparatively strong, with near universal literacy, and segments of technical excellence. It is also increasingly able to tap into a very large international diaspora. It has R&D strengths, some military related, or present owing to the past emphasis on heavy industry. It is rapidly opening up to foreign trade and investment. Its commercial institutions have been historically weak, and the country continues to score poorly in international comparisons of corruption and protection of property rights. But institutional quality is improving quickly, especially in regions most connected to the international economy. Physical infrastructure is being upgraded rapidly, although its quality is spatially very uneven.

The 1991 reforms and their aftermath have begun to transform India's commercial environment, but the unfinished agenda is large and complex.[14] Its human capital and R&D base has pockets of international excellence, most notably in information technology and in some defense-related heavy industry. Until recently, and in contrast to much of East Asia, its educational priorities resulted in centers of international quality alongside quite high levels of illiteracy. It also differed from East Asia until recently in that its inward-looking strategy meant that it was unable to exploit its human capital strengths in the global economy. Thus, in contrast to the PRC, its major intrusion into the international information technology industry has been via services rather than manufacturing. Its commercial environment is broadly predictable, and the legal system cumbersome but independent. Economic policy making is the most dispersed among the six countries. A large diaspora facilitates its connections to the international economy.

Korea's development strategy has been underpinned by exceptional strength in some areas. It reached OECD levels of educational achievement and R&D expenditure at comparatively low levels of per capita income.[15] Its Internet access and usage is one of the highest in the world. Its infrastructure and institutional quality are good though not outstanding. As with its trade and FDI regimes, the internationalization of its human capital strengths has proceeded more slowly (Dahlman and Andersson 2000). For example, its universities remain relatively unconnected to the international mainstream. Its postcrisis policy liberalizations

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[14]For a detailed review of these issues, see the contributors to Krueger (2002). Major issues in the reform agenda include fiscal imbalances, public sector enterprises, trade policy (especially in consumer goods industries), labor market rigidities, SMEs and reservation schemes, regulatory and licensing system, and center-state relations. Many of these of course intersect.

[15]For example, R&D expenditure rose from 0.3 percent of GDP in 1971 to 2.8 percent in the mid-1990s.

have been significant, but as recovery proceeds there are some doubts about the durability of some reforms.

Malaysia emerges as a country with comparatively high institutional quality, excellent physical infrastructure, and large public investments in education, much of it designed to redress past ethnic imbalances. It has had the most consistent commercial policy environment of the six. Nevertheless, there are concerns that the independence of its legal system may have been weakened over the past two decades, and there has been a persistent loss of high-level non-bumiputra human capital. Its very open international labor market has delayed the process of upgrading its technological capabilities, and it faces in particular competitiveness challenges from below (especially the PRC) and from above (the Asian newly industrialized economies).

Thailand scores well on most indicators, with the principal exception of human capital. Until recently, while achieving almost universal primary enrolments, its education retention ratios were very low. In consequence, during the 1990s, as real wages began to rise quickly in the wake of rapid economic growth, it experienced difficulty managing the transition out of labor-intensive activities. It has become progressively more open in its trade and FDI policies, although the pace of reform has been slower than several of its neighbors. Historically, its legal and commercial institutions were not strong, though its informal commercial rules of the game were widely understood and observed. Physical infrastructure is generally good, apart from Bangkok's congestion.

Having successfully completed the first round of macroeconomic and commercial policy reforms, the principal challenges in Viet Nam relate to establishing the infrastructure that underpins a market-based economy: property rights, legal system, financial intermediation, and physical infrastructure all remain poorly developed. Illiteracy levels are low, but so too is the stock of internationally experienced entrepreneurs. Many small and household enterprises operate in an insecure commercial environment. Reform of SOEs lags. There are pronounced regional differences (especially, still, between the north and the south) in the quality of the physical and commercial infrastructure.

Considering the wide variety of resource endowments, policy regimes, and experiences with FDI among the six economies, it is not surprising they have developed different views toward international investment agreements.

III. CONCLUSIONS

The experience of these six, diverse Asian economies illustrate the major challenges associated with managing FDI in an era of rapid globalization. All six have deliberately become more open to FDI and trade, and this openness has contributed to the strong growth experienced by most of the six for most of the past two decades or more. Outward FDI flows have also risen in all cases, consistent with rising global integration. The simultaneous liberalization of both trade and FDI regimes has profound implications both for the nature of FDI and government policies needed to maximize the benefits of the foreign presence for host economies. As trade and regulatory barriers come down, FDI motives typically shift from what may be termed "rent-seeking" to "efficiency-seeking." That is, as the rents associated with a highly interventionist regime diminish, MNEs assess potential investment locations on the grounds of costs and efficiency, frequently in the context of a multiplant and multicountry framework. Host country policy priorities therefore need to adjust accordingly, from dispensing rents and patronage to providing high quality institutions and infrastructure, which of course also benefit domestic investors. The faster the reform process, obviously, the faster this policy reorientation needs to proceed.

So much for the common features. There have of course been differences in the approach to FDI among the six countries in relation to speed of liberalization, modalities of capital inflow, and particular benefits sought from foreign direct investment. For Viet Nam, it is reengagement with the global economy in the context of "first-round" economic reforms. In the PRC, too, there is the transition from planned to market economy and progress toward a unified policy regime. Both processes started earlier, and are proceeding faster, than in Viet Nam. In India, the challenge is to build on the earlier reforms, and to become more "East Asian" in its labor-intensive export trajectory. Among the three crisis-affected economies, the immediate challenge since 1998 has been financial reform and recovery. In addition, Korea has sought to internationalize its human capital and R&D strengths, while Malaysia and Thailand face the challenges of upgrading supply-side capabilities as they lose comparative advantage in labor-intensive activities.

Not surprisingly, these countries have differed in their approach to the formulation of international regulations governing foreign direct investment. As with most developing countries, the six have liberalized their investment regimes independent of negotiations over a possible multilateral framework for investment. This has two possible implications. It might suggest that a multilateral framework is redundant. Or such a framework may become more necessary as policies converge, and a more comprehensive international agreement becomes increasingly possible and necessary for facilitating the liberalization process and for governing investment measures. Which outcome emerges will depend on the bargaining positions adopted by different countries and the attitudes they hold toward the process. Even among this sample of developing Asian economies there are clearly widely diverging views on negotiating a multilateral framework for investment. They range from strongly in favor (Korea) to strongly opposed (India); from viewing it as a helpful spur to domestic liberalization (Thailand) to a constraint on development policy options (Malaysia); and from acceptance if implementation is gradual (the PRC) to concern over capability to address the difficulties and challenges of achieving compliance (Viet Nam).

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