

Completing the AIA: Road Traveled, Road Ahead

Executive Summary



With an outward-oriented development strategy, ASEAN has made attracting foreign direct investment (FDI) an important goal of economic cooperation. The ASEAN Investment Area (AIA), created in 1998, goes much further than any previous ASEAN initiative covering investment cooperation, facilitation, and liberalization. The AIA takes an “open regionalism” approach, in which FDI liberalization and facilitation are applied in a nondiscriminatory manner to partner and nonpartner countries alike and complement trade integration under the ASEAN Free Trade Area (AFTA). But eight years after its launch, has the AIA had a discernable effect on FDI inflow to ASEAN Member Countries? We use several techniques to answer this question.



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We began by examining the trends of FDI and the complex and varied factors influencing investment decisions. We found that although the Asian financial crisis reduced FDI inflows to ASEAN, the region as a whole has recovered, particularly in the 2005–2006 period, although the share of ASEAN FDI in total global investment flows has not reached the levels attained before the Asian financial crisis. This only-partial recovery is due in part to increased competition and regionalism in OECD markets.



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Our econometric analysis does not find a statistically significant ASEAN effect, but this result must be qualified because the modeling used was handicapped by problems with data, model specification, and timeframe. In studying the EU experience with integration for relevant lessons for ASEAN, however, we found that Europe’s deep integration programs have had an important effect, so although AIA has not had a discernable effect on FDI inflows yet, more comprehensive investment liberalization and facilitation in ASEAN could be highly productive. Moreover, the econometric results of our analysis underscore the critical link between trade and FDI, supporting the view that effective regional economic integration needs to focus on both trade and FDI liberalization and facilitation.

Given the clear trade–investment links established from both theoretical and empirical perspectives, we conducted a statistical analysis of changes in trade patterns—that is, the structure of ASEAN Member Country exports to OECD countries. We also looked at disaggregated data to determine the degree to which exports to key foreign markets and FDI inflows to ASEAN Member Countries are in the same industries and to identify significant changes over time. We found that

competitiveness in trade is not strong for most country pairs but is rising. In FDI, the structures for a number of country pairs (mainly the original ASEAN Member Countries and Vietnam) are very similar and appear to be growing more similar.

China has become a major host of global FDI inflows—in some years, the most important FDI recipient in the world—and has become a formidable competitor in trade. This has been particularly in evidence since the Asian crisis; FDI inflows to China have grown by leaps and bounds since the crisis, while inflows to ASEAN Member Countries have been less impressive. China's success has been the result of policy reforms that unleashed the potential of a large, expanding, and increasingly rich market. No doubt some of the FDI bound for China has come at ASEAN's expense; ASEAN investors themselves move to China to take advantage of inexpensive, relatively educated labor and China's newly prominent location in the regional production chain.

While China is large, ASEAN is a small, segmented market; regional economic cooperation and integration, however, can help overcome this drawback. The AIA and the AEC can help create a regional market of a half-billion people that will be better prepared to compete with giants such as China and India. After all, resource pooling and market expansion were explicit goals articulated by ASEAN's founders.

Although great diversity in socioeconomic and institutional structures throughout ASEAN Member Countries make economic cooperation difficult in many areas, a consistent approach to trade policy—i.e., a general desire to embrace lower barriers to trade and reduce bureaucratic costs—may facilitate cooperation in harmonizing trade policy in the future, even if significant diversity continues to exist in the structure of trade policy in Member Countries. The same is true of policies on FDI; although there is no common investment regime in the region and policies diverge significantly, the policy direction is ostensibly the same—that is, toward greater investment liberalization and facilitation. Moreover, symmetry in the structure of FDI inflows should buttress the economic case for policy harmonization, though perceived competition for FDI could complicate policy cooperation.¹ Several issues have to be addressed in the harmonization process, but policy reforms can be made without infringing on national sovereignty. Moreover, through the concerted adoption of best business practices, the region will be able to substantially increase its attractiveness to foreign investors.

In recent years ASEAN Member Countries have signed many bilateral investment treaties (BITs) with regional and nonregional partners. The existence of so many BITs between pairs of ASEAN Member Countries also suggests that an expanded AIA is advisable.

¹ This is a point that came up repeatedly during field interviews in ASEAN with private sector representatives and policymakers for this study.

Macroeconomic stability and robustness are prerequisites for strong domestic investment and FDI; without them, even the best microeconomic policy framework will fall short. ASEAN Member Countries have, on the whole, maintained a strongly favorable macroeconomic environment since the crisis, though there are a few problems in certain countries, particularly with respect to fiscal policy. But these issues are no worse than what Europe had to deal with in creating the Single European Market or the Economic and Monetary Union; in fact, ASEAN macroeconomic variables, at least for the original ASEAN Member Countries, tend to vary less than the European.

This symmetry will facilitate economic cooperation in the future. Moreover, deeper cooperation and integration will likely enhance macroeconomic symmetry in the region, increasing the incentive for closer policy cooperation, as was arguably the case in Europe. In fact, the contagion that spread from Thailand to much of the rest of Southeast Asia (and beyond) during the Asian financial crisis underscored the policy externalities associated with regional integration and present the case for closer cooperation, consultation, and perhaps even coordination.

The World Bank's Doing Business database shows great diversity in the microeconomic environments and business policies of ASEAN Member Countries. ASEAN includes some of the most business-friendly countries in the world, but also some characterized by a less-friendly environment. Cambodia, Lao PDR, and Vietnam (Myanmar is excluded from the Doing Business database) rank the lowest. Although some of these countries' rankings have fallen recently, it is generally because other countries are taking larger strides than CLV, not because CLV are standing still or going backward. This underscores the fact that competition demands that ASEAN Member Countries must liberalize faster than other countries to gain a competitive edge.

In an integrated ASEAN investment area, differences are possible (after all, EU member states also are diverse) but adopting best practices in a concerted fashion would be economically sensible. This will require reform at the national level, as well the adoption of ASEAN-regional policies to create a more efficient business environment in ASEAN.

What will be necessary for ASEAN Member Countries to thrive in an increasingly integrated world? Regional initiatives will be important, but more important will be a strong commitment to national investment liberalization and the reduction of transaction costs, from bureaucratic red tape within countries to transborder barriers. This will be no mean feat and will require tremendous political will, as did the creation of the Single European Market.

Has the AIA met its goals? In general the AIA has had a positive effect, particularly in the past few years, although a definitive answer is impossible because of the short

time since its creation and the setbacks ASEAN suffered from the Asian financial crisis. ASEAN's performance in attracting FDI since the signing of the AIA Framework Agreement, taking into account the impact of the financial crisis, has been reasonably good. The AIA agreement is, on the whole, liberal and open, and has contributed to opening up sectors and reducing impediments to investment.

The AIA is a necessary but not a sufficient condition for ASEAN to attract FDI, however. The AIA is based on the goals of greater efficiency and promotion, and there is no reason why it should not lead to greater inflows of vertically integrated production in the region and a more competitive environment. But ASEAN cannot expect the current AIA to lead to a significant increase in FDI. The AIA needs to be complemented by other policies and programs at the regional and national levels.

As ASEAN deepens the AIA and moves toward the AEC, it will have to harmonize certain investment measures and policies in line with best practices to ensure national treatment among ASEAN Member Countries and build a strong foundation on which to create a single market. Many of these policies will be part of the process of creating the AEC, so harmonization should be evaluated in light of the process of advancing ASEAN integration rather than just in the context of the AIA.

We make the following recommendations to facilitate economic integration in ASEAN in the context of the AIA.

ASEAN must take advantage of current regional developments and the process underway to establish the AEC and positioned itself for this more competitive environment. An enhanced AIA-Plus agreement could help strengthen the attractiveness of the ASEAN region for high-quality FDI. Work on an AIA-Plus agreement should take into account many issues. We recommend the following top priorities:

- 1 *Strengthen the AIA.*** The AIA agreement should introduce collective measures to be taken by all ASEAN Member Countries and encourage individual measures by Member Countries to lower transaction costs and strengthen market factors, thereby facilitating investment and promoting regional production networks.
- 2 *Widen coverage of AIA.*** The AIA agreement should cover a wider scope of industries. Without compromising the ASEAN Framework Agreement on Services (AFAS), mode 3 of services (commercial presence) should be transferred from the AFAS to the AIA.
- 3 *Create a comprehensive agreement.*** Combine the AIA, the 1987 Agreement for the Promotion and Protections of Investments, and appropriate provisions of bilateral investment treaties into a comprehensive "AIA-Plus" agreement.
- 4 *Harmonize certain policies.*** Consider harmonizing national provisions regarding equity ownership, land tenure, nondiscriminatory taxation, movement of skilled labor, and financial flows at the ASEAN regional level to ensure national treatment.

- 5 ***Facilitate investment.*** Take measures to promote public-private partnerships and to disseminate information on ASEAN's investment environment, opportunities, and products, such as outreach programs and easy access to information such as through the internet or "one stop" investment shops.
- 6 ***Engage the private sector in policymaking.*** The private sector in ASEAN and beyond should be engaged regularly to provide input, ideas, and information on investment and enterprise issues.
- 7 ***Rationalize timeframes.*** Timeframes for actions in the current AIA are too numerous and should be consolidated.
- 8 ***Remove investment impediments.*** Important programs, such as identification and removal of investment impediments, should be carried out with a clear timeline and specific procedures for their implementation.
- 9 ***Shorten the sensitive list.*** Member Countries should reduce the number of industries and sectors covered in the sensitive list and review those covered with a view to phasing them out.
- 10 ***Make the AIA-Plus an important part of the ASEAN integration strategy.*** AIA-Plus should not be a standalone instrument targeting FDI but an integral part of the ASEAN Economic Community as its provisions would cover investment as well as services, capital flows, and skilled labor associated with investment.
- 11 ***Establish a mechanism for monitoring progress.*** A mechanism that can measure the progress of an AIA-Plus arrangement in realizing the AEC in 2015 and beyond deserves close attention.
- 12 ***Expand the mandate of the ASEAN Secretariat so it can play a stronger leadership role.*** The ASEAN Secretariat should not only support but also give vision to the "AIA-Plus" agreement by deepening its technical and analytical capabilities and working closely with think tanks.

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