

DEVELOPMENT CENTRE SEMINARS

ORGANISATION FOR ECONOMIC CO-OPERATION
AND DEVELOPMENT

INVESTING IN ASIA

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DEVELOPMENT CENTRE
OF THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT



Table of Contents

Preface	
<i>Jean Bonvin and Mitsuo Sato</i>	7
Opening Address	
<i>Jean Lemierre</i>	9
PART ONE: COMMON INTERESTS	
Introduction	
<i>Colm Foy</i>	15
The Context for Investment in Asia	
<i>Jean Bonvin</i>	19
The Asian Development Bank and Investment in Asia	
<i>Pierre Uhel</i>	23
Perspectives for European Investment in Asia	
<i>Supachai Panitchpakdi</i>	25
Asia: A Challenge Europe Can Win	
<i>Willy de Clercq</i>	29
Financing Reform in Viet Nam	
<i>Tran Xuan Gia</i>	33
The Benefits of Outward Investment	
<i>Xavier Musca</i>	37
Investment in China's Future	
<i>Zhang Xiaoqiang</i>	41
Foreign Investment from a Small-Country Perspective	
<i>Nicolas Imboden</i>	45
Opening Markets in Asia for Europe	
<i>Pierre Defraigne</i>	49
APEC and Investment	
<i>Ipppei Yamazawa</i>	53

Infrastructure Investment in Asia: A Private-Sector View <i>Hugh P. Barras</i>	57
Indian Specificities <i>Narayanan Vaghul</i>	65
The Nature of the MAI <i>William Witherell</i>	71

**PART TWO:
DYNAMICS AND OPPORTUNITIES**

Introduction/Overview <i>Charles P. Oman</i>	77
Corporate Governance in East Asia and Western Europe: Competition, Confrontation and Co-operation <i>Jean-Pierre Lehmann</i>	85
Globalisation and Corporate Strategic Alliances: A European Perspective <i>Jon Sigurdson</i>	129
Natural Resources, Economic Structure, and Asian Infrastructure <i>Douglas H. Brooks and Elizabeth E. Leuterio</i>	155
The Institutional Environment for Investments in China and ASEAN: Current Situation and Trends <i>Jesus Estanislao</i>	175
Economic Environment in Asia for Investment <i>Naomi Chakwin and Naved Hamid</i>	207
Programme	237
List of Participants	245

Economic Environment in Asia for Investment

Naomi Chakwin and Naved Hamid¹

In recent years there has been an acceleration in the restructuring of the world economy from nationally based production and division of labour towards a system based on global markets and relative endowments. The acceleration has been variously ascribed to the dramatic advances in technology, particularly in electronics, information processing and telecommunications; global political changes since the collapse of the former Soviet Union; and new perceptions of the opportunities for international trade following the successful completion of the Uruguay Round and the establishment of the World Trade Organization (WTO). However that may be, the primary instrument of this accelerated restructuring and relocation of world production is likely to be foreign direct investment (FDI), and its major beneficiary the developing world. This process is evident from the rapid growth in FDI flows to developing countries since 1990, as shown in Table 1.

In the developing world, Asia has a comparative advantage over other regions for attracting the industry being relocated and the associated investment flows. Asia is attractive to foreign investors because of its record of high growth, its huge potential market and its complementarity with the OECD countries in terms of endowments. Developing Asia is also likely to attract large amounts of direct investment in infrastructure because economic growth in the region is generating massive infrastructure investment requirements which are beyond the resources of most countries and are likely to provide profitable investment opportunities for foreign investors. At the same time, the required infrastructure is largely in place in OECD countries, where governments are removing controls from public utility firms which will be seeking to expand outside their national boundaries.

In view of these developments this chapter discusses the economic environment for investment in Asia. In the next section, we attempt to answer the question "What factors are important to the firm in its choice of the host country for investment?" The factors identified constitute the relevant subset of the "economic environment for investment" in a country for the purposes of this chapter. These factors will obviously depend on the type of FDI. We identify three possible types, i.e. natural resource-seeking, market-seeking and export-oriented FDI, but the discussion focuses

on the latter two. In the section after that the existing "economic environment for investment" in Asia is described. The discussion is organised by country groups, based on factors such as size, present stage of economic development and similarities in the investment environment. Finally, in the last section expected developments in the medium term in the investment environment in developing Asia are discussed by region. Also estimates of the FDI flows to Asia and their sectoral composition are presented by region for the year 2001.

Table 1. Capital Flows to Developing Countries and Asia, 1990-95
(\$ billion)

Category	1990	1991	1992	1993	1994	1995
All Developing Countries						
Net Resource Flows	101.9	127.0	155.3	207.3	207.4	231.4
Investment	28.8	42.5	60.7	113.9	115.0	112.3
Foreign Direct Investment (net)	25.0	35.0	46.6	68.3	80.1	90.3
Portfolio Equity Flows	3.7	7.6	14.1	45.6	34.9	22.0
Debt	43.8	47.0	62.7	64.1	59.9	86.2
Official Creditors	28.5	28.0	23.1	23.6	16.1	31.4
Private	15.3	19.0	39.6	40.4	43.8	54.8
Grants	29.4	37.5	31.9	29.4	32.5	32.9
FDI as % of Net Resource Flows	24.5	27.5	30.0	32.9	38.6	39.0
Developing Asia						
Net Resource Flows	38.2	45.5	62.7	83.3	99.1	120.8
Investment	13.8	15.4	27.8	58.8	63.1	69.4
FDI (net)	11.4	14.3	22.3	38.7	44.3	55.7
FDI Asia excluding P.R.C.	7.9	10.0	11.1	11.2	10.5	17.7
Portfolio Equity Flows	2.4	1.1	5.5	20.1	18.8	13.7
Debt	19.7	24.5	30.0	19.9	30.5	45.6
Official Creditors	10.7	11.6	10.3	11.2	8.9	10.9
Private	9.0	12.9	19.8	8.7	21.6	34.7
Grants	4.8	5.5	4.9	4.5	5.5	5.8

Source: World Bank (1996c).

What Investors Look for in a Host Country

Decisions to invest abroad usually have two sets of components. One depends upon firm/industry-specific factors and the other on the host-country factors. The former are largely responsible for the decision to undertake the investment and the latter influence the destination of the investment. This section is mostly concerned with factors that influence a firm's choice of country/region after it has made a decision

to invest. Firms invest outside their home country for one of three reasons: to exploit a natural resource available in the host country, to get access to the host country's protected market², or to maintain international competitiveness in the face of rising cost of labour and other non-tradeables in the home country. We refer to these three types of investments as natural-resource seeking, market-seeking and export-oriented FDI. Natural resource-seeking FDI, which consists of investment in areas such as mining, oil and gas extraction, etc., is probably the earliest type of foreign investment. However, since natural endowment and not economic environment is the primary determinant of such investments, in this chapter we focus on the other two types.

Market-seeking FDI has changed significantly in recent years. Since World War II it had been largely confined to the manufacturing sector³, but due to the recent trends in most developing countries towards greater openness of the economy and privatisation of infrastructure, sectors such as power, telecommunications and financial services are attracting increasing amounts of foreign investment. Also because of the import-substitution industrialisation policies formerly followed by most developing countries, until recently FDI in the manufacturing sector generally served to leapfrog tariff barriers, with very little, or even negative, value added in the host country. However, import liberalisation and the electronics revolution, and the consequent development of machinery and processes which make smaller production runs possible without incurring significant cost penalties, have given rise to a more efficient FDI in industries catering primarily to the host country's market.

Export-oriented FDI is of relatively recent origin. The "product life cycle" theory of FDI, which postulates that as economic growth leads to higher wages in a country, labour-intensive industries will relocate to countries at a lower level of economic development, is most applicable to export-oriented FDI. However, the mere availability of cheap labour is insufficient to attract such investments. Factors such as location, infrastructure endowment and the policy environment are equally important. Export-oriented FDI is believed to be a major factor in developing Asia's economic success, and, thus it is the type of investment that developing countries most want.

There is a general agreement that macroeconomic and political stability, competitive exchange rates, relatively low-cost labour and good infrastructure are important in attracting FDI. However, opinions vary greatly on investment incentives. Guisinger and McNulty (1996) surveyed executives of a number of US transnational corporations (TNCs) to discover what were some of the key factors effecting a firm's decision to invest in a particular country. They found that currency transferability and convertibility, which are good proxies for openness and sound macroeconomic fundamentals, were the most important, followed by political stability. Some of the other factors, in order of importance, were national treatment of foreigners, macroeconomic stability and a large domestic market. From this survey, at least, it appears that investment incentive schemes do not have a significant influence on the choice of the host country.

However, most governments still believe that they need to provide incentives to attract FDI of the type they want. The package of incentives and policies used to attract and direct investment may be referred to as the country's investment regime. In Asia two types of investment regimes are emerging. The most familiar is the export-incentive regime. In this, incentives are geared primarily towards attracting export-oriented investment. Such regimes are generally limited to smaller countries where domestic market considerations are less important. However, when the host country has a large population like China, India or Indonesia, both investor and host country strategies change. In such cases, the investment regime is a combination of incentives and conditions that encourage the development of export industries as well as import-substitution industries which the host country considers to be important. We call this the mixed incentive regime. The strategy is to achieve rapid growth in output and employment through export-oriented industries, which generate foreign exchange and are usually low skilled and labour intensive, and at the same time acquire technologically sophisticated industries and expertise so as to reduce the country's dependence on foreign investment for sustaining future growth. This strategy is based on the recognition that independent technological development requires financial and skilled human resource investments beyond the developing country's resources and therefore imports and transfers of foreign technology have to serve as substitutes for local development. Mixed incentive regimes use access to their domestic markets as a bargaining chip for pushing foreign firms towards greater value added in the host country and transfer of technology. This can be a powerful tool in the case of countries such as China, India and Indonesia.

Table 2 explores the impact of government interventions to promote and direct industrial investment. The first round impact of interventions are divided into effects of trade, exchange rate and price policies, investment incentives and other industrial policy instruments on export-oriented and import-substitution industry. In the past, trade and exchange rate policies were widely used by developing countries to promote import-substitution industries (ISIs). While protection (tariffs and non-tariff barriers) may encourage ISIs, it leads to an overvalued currency and since the output of one industry is often the input of another, the overall impact on export-oriented industry (EOI) is negative, as shown in Table 2. Governments can compensate for that by export subsidies, duty exemptions for imported inputs and restrictions on export of raw materials. The first method is not permissible under WTO rules and the last approach would have adverse implications for the raw material producing sectors of the economy. In view of the shortcomings of import-substitution industrialisation strategies, developing Asian countries are moving away from using trade and exchange rate policies to promote industry, instead liberalising import policies and maintaining realistic exchange rates. To the extent that some protection for ISIs is provided by tariffs, attempts are made to insulate EOIs through import duty exemptions or schemes such as bonded factory warehouses and free trade zones.

Table 2. **Impact of Government Interventions on Investment**

	First Round Impact on	
	Export-Oriented industry	Import industry
I.A. Trade/Price Interventions (through outputs)		
A. Trade Policy		
1. Tariffs/NTBs (on Competing Imports)	+	+
2. Subsidies (on Exports)	+	n.a.
B. Exchange Rate Policy		
3. Overvalued Currency Price Policy	-	-
C. Price Policy		
4. Price Ceilings/Controls on Output	n.a.	-
I.B. Trade/Price Interventions (through inputs)		
A. Trade Policy		
1. Tariffs/NTBs (on Imported Inputs)	-	-
2. Taxes/Restrictions (on Exports of Inputs)	+	+
3. Import Duty Exemptions/Drawbacks	+	+
B. Exchange Rate Policy		
4. Overvalued Currency	0	+
C. Price Policy		
5a. Price Ceilings/Controls on inputs	+	+
5b. Subsidised Public Unity Inputs	+	+
5c. Minimum Wages	-	-
II. Incentives Targeted at Investment Cost		
1. Land/Buildings		
a. Subsidy on Price/Rent	+	+
b. Exemption/Rebate from Land Tax	+	+
2. Capital		
a. Income Tax Holiday/Reduction and Accelerated Depreciation Allowances	+	+
b. Interest Rates Subsidies	+	+
III. Other Industrial Policy Instruments		
1. Free Trade Zones/Export Processing Zone	+	+
2. Industrial Estates	+	+
3. Grants for R & D	+	+
4. Labour Training Grants/Subsidies	+	+
5. Government Procurement Preferences	n.a.	+
6. Guarantees against Domestic Competition	n.a.	+
7. Countertrade/Foreign Exchange Balancing/Minimum Export Requirements	n.a.	-
8. Limits on Royalties	-	-
9. Limits on Ownership	-	-
10. Domestic Content Requirements	-	-
11. Restrictions on use of Expatriates	-	-

Key: -: Negative impact, +: Positive impact, 0: No impact, n.a.: Not applicable

Source: Authors' estimates.

Another popular set of measures has been the use of tax holidays, subsidies on factory buildings and land development, low interest rates, etc., to reduce investment costs. However, most Asian countries are replacing such measures for a general lowering of income tax rates and providing better infrastructure because of a need for fiscal discipline, growing evidence that tax incentives have little impact on investment decisions and an ongoing process towards financial liberalisation.

Among the remaining industrial policy instruments, many have objectives other than investment promotion. For example, in Table 2, items III.7 and 8 are measures to reduce the pressure on the balance of payments⁴ and II.9 to 11 are to promote local entrepreneurs, industrial linkages, managerial and technical skills and transfer of technology. Thus sectoral policy instruments available to governments to attract FDI, particularly the export-oriented variety, are now quite limited and consist largely of measures to compensate for distortions arising from government policies, e.g., import duty drawback schemes and FTZs/EPZs (I.B.3 and III.1), and market failures, e.g. grants and subsidies for research and development and skill development (III.3 and 4). Therefore, ensuring political and macroeconomic stability and the availability of infrastructure are increasingly seen as the key contributions of the government in attracting FDI. Other industrial policy measures mostly serve to channel FDI to maximise its contribution to a broad based industrial development of the country.

To sum up, the factors that affect the host country's decisions for attracting investment are political and macroeconomic stability, availability of infrastructure, natural resource endowment, economic policies relating to industry, trade and finance, wage costs, the investment incentive regime and the institutional framework such as the legal system, labour laws, etc. Investment flows are also influenced by factors like size (for example, China and India will attract substantial FDI just because they have a huge potential domestic market) and location (e.g. East and Southeast Asia have profited from their regional location because firms in Japan and the NIEs have found it easy to move their light, labour-intensive production to Malaysia, Thailand, Indonesia and the coastal provinces of China). Since political and macroeconomic stability, availability of infrastructure and natural resource endowment are outside the scope of this chapter, the discussion of the economic environment for investment in Asia in the next section will focus on the remaining factors listed above.

Investment Environment in Asia

The Asian region is often discussed as a single entity or block, probably because of its sustained rapid growth since the mid-1960s, the many common characteristics of its fast growing economies, such as export-oriented policies, high savings and investment rates, relative price stability and, since the mid-1980s, large inflows of FDI, and the continuous growth, beginning with Japan in the 1950s, spreading to the NIEs (i.e., Hong Kong, Korea, Singapore and Chinese Taipei) in the 1960s, to China, Indonesia, Malaysia, and Thailand in the 1980s, and to the Philippines, Viet Nam and

India in the 1990s. This expanding circle has given rise to "flying geese" as a metaphor for the pattern of Asian development in which, as one group of countries moves up the ladder of industrial development another group replaces it at the bottom. In economic literature, this process is referred to as the "product cycle" theory of development in which, as economic growth results in higher wages and other costs of production in one country, industries which are no longer competitive move to a country at a lower level of development and are replaced by more sophisticated industries moving from a country higher on the ladder. For example, industries such as textiles, garments, footwear, and simple consumer electronics moved from Japan to the NIEs, and then as the level of development in the NIEs increased, in turn, these industries moved from the NIEs to Malaysia, Thailand, Indonesia and China, while the next set of industries such as semiconductors, automobiles, metals, and chemicals moved from Japan (and other developed countries) to the NIEs.

However, this view of Asia is a gross simplification, as Asia is composed of a large number of countries with great differences in size and endowments, approaches to development and economic record. While it is true that in recent years there has been some convergence of economic performance and policies, significant differences in income levels, growth performance and economic environments still remain (see Table 3). Therefore, it is more appropriate to describe the different environments for investment in Asia. Consequently, we have divided developing Asia into three groups. Group I consists of Indonesia, Malaysia and Thailand, which fit the Asian development model well, and much of the discussion about this group is applicable to future developments in other Southeast Asian countries such as the Philippines and Viet Nam. China, which merits a separate discussion in view of its size and importance as a FDI recipient, is referred to as Group II. Finally, Asia's other giant, India, also because of its size and economic potential is Group III⁵.

These three groups also reflect to a large extent the various stages of development in Asia. Bradford (1987) identified Malaysia, Thailand and Indonesia as the "next tier NIEs" almost 10 years ago and they have continued to fulfill these expectations. However, there are some important differences between the three countries. Malaysia is the most advanced and is classified as an "upper middle income" country by the World Bank. Labour shortages and increasing wage rates have reduced Malaysia's attractiveness for labour-intensive industries, but better infrastructure and more highly skilled workers have encouraged the entry of technologically sophisticated and capital intensive industries. Thailand is in transition from a simple, labour-intensive export-oriented industrial base to a more complex one, but better infrastructure, particularly in the transport sector, will be needed if it is to emulate Malaysia's success. Indonesia is different, in that it is a big country spread out over an archipelago with a large and diverse population. Also, it is at an earlier stage of industrial development than both Malaysia and Thailand, and to attract substantial FDI in the appropriate industries, Indonesia must improve its international competitiveness by increasing domestic competition, investment in physical infrastructure and the quality of its education system, while maintaining macroeconomic stability.

Table 3. Selected Economic Indicators for Developing Asia

	Size ^a	GNP ^b (\$ billion)	Income		GDP Growth Rate (%) ^c (1990-95)	Trade	
	Population (millions)		Per Capita Nominal ^d (\$)	PPP ^e (\$)		Growth Rate in Exports (%) ^e (1990-95)	Openness ^e (XGS plus MGS)/GNP (%) ^e (%) ^e
	1994	1994	1994	1994			1994
A. Southeast Asia							
Malaysia	20	67	3 520	8 610	8.8	19.5	202
Thailand	59	142	2 210	6 870	8.9	18.8	90
Indonesia	191	168	880	3 690	7.9	11.8	61
Philippines	69	66	960	2 800	2.3	14.4	79
Viet Nam	73	16	190		7.2	26.1	72
B. People's Republic of China	1 192	521	530	2 510	10.5	19.9	47
C. South Asia							
India	901	289	310	1 290	4.8	11.8	29
Pakistan	127	52	440	2 210	4.8	10.9	43
Bangladesh	115	26	230	1 350	4.5	15.4	35
Total (A+B+C)	2 744	1 347					59
Total (A+B+C) % of world	49	5					

a. ADB (1995).

b. World Bank (1996c).

c. ADB (1996a).

d. World Bank (1996b).

e. XGS = Exports of goods and services; MGS = Imports of goods and services

China has almost caught up with the Group I countries after 25 years of rapid economic growth, however, as a "transition" economy, its economic environment is significantly different from theirs. Because of its weak financial and tax system, China has had difficulty in maintaining a balance between growth and price stability, resulting in a stop-go cycle of growth. Some of the issues China will have to address if it is to sustain its rapid transformation are: reform of the large loss-making state enterprises, development of a legal system and a regulatory framework for private enterprise, the growing disparity between the coastal provinces and rest of the country, a huge floating population of workers, and financing its massive infrastructure investment requirements.

In terms of economic indicators such as investment, savings, economic growth, trade share and employment generation, India is significantly behind the countries in the other two groups. In 1991, India began a reform programme that includes trade liberalisation and opening up the economy for FDI, especially for private infrastructure development. However, the economic environment is quite different from the rest of Asia, for the legal, financial and other institutions pertaining to private enterprise are more developed than in most of the region, while the trade and investment regimes

are still more restrictive than in other regional countries. The major challenges facing India are further deregulation and trade liberalisation, reduction of the fiscal imbalance and subsidies, and mobilisation of resources for improving its grossly inadequate infrastructure.

Tables 4 to 6 provide a comparative summary of some of the elements that define the economic environment for investment in the countries in the three groups. There are considerable differences in effective tax rates and wages. While the nominal corporate tax rate is more or less the same in all countries except India, the effective tax rates are the lowest in China and Malaysia, and the highest in India (Table 4). Tax holidays reduce the effective tax rates for eligible enterprises substantially in India and Thailand. Wages are the lowest in China and Indonesia (comparative data for India was not available), and surprisingly, despite its much lower per capita income, higher in Thailand than Malaysia (Table 5). There are no major differences in other costs, except that construction costs are significantly higher in Indonesia. While on paper there are many measures to promote FDI and export-oriented industries, the actual differences between countries are not very great (Table 6). Most countries have some income tax concessions (except Indonesia); reduction or exemption from import duties for exporters; few if any restrictions on repatriation of profits and dividends; bonded, export processing or free trade zones to attract export oriented FDI; and provisions for up to 100 per cent foreign ownership (with some restrictions in all countries). However, there may be significant differences in the investment environment because promotion measures and economic policies are implemented with varying degrees of effectiveness. Other important elements in the investment environment are the size of the market, quality of the labour force, availability of infrastructure, degree of openness of the economy, and institutional arrangements. Some of these issues are discussed next.

Indonesia, Malaysia, and Thailand

Malaysia has the smallest population and the highest per capita income of the countries in this region. It was one of the first in developing Asia to pursue a dynamic policy for attracting FDI, including promotion activities in developed countries and establishment of free trade zones (FTZs) for foreign investors, which provided good infrastructure, minimum government interference, tax holidays and duty-free imports of raw materials and machinery. Malaysia has also been able to maintain political

Table 4. Income Tax Rates in Selected Countries
(percentages)

Countries	Corporate Tax Rate	Effective Rate without Tax Holidays		Effective Rate with Tax Holidays	
		Manufacturing	Services	Manufacturing	Services
China	33	12.9	20.8	n.a.	16.1
India	55*	52.8	46.6	20.7	21.1
Indonesia	30	n.a.	n.a.	n.a.	n.a.
Malaysia	32	18.3	14.7	n.a.	11.5
Thailand	30	28.5	28.9	8.6	8.2

* 46 per cent for domestic companies.

Source: Pirnia (1995)

Table 5. Labour and Other Costs

	Average Wage 1994 (US\$/day)		Port Costs (US\$ per TEU)	Power (US cents/KWH)	Factory Construction Cost (US\$/m ²)
	Skilled	Unskilled	(1992)	(1994)	(1994)
Indonesia	6	2-3	109	4-8	200-300
Malaysia	13	5-8	114	3-6	125-170
Thailand	16	9	107	4-12	95-200
China	4-10	2-5	n.d.	5	180

Source: Lall and Rao (forthcoming)

and macroeconomic stability and currency convertibility. It is not surprising, therefore, that Malaysia, with a population of about 20 million, has been the largest recipient of FDI in developing Asia after China, with inflows averaging just under \$5 billion per annum in the last five years (see Table 7). Since the early 1990s Malaysia has become increasingly selective in the FDI which it encourages. Tax holidays and other fiscal incentives have been greatly reduced and are only available for high technology industries and less developed areas of the country. FDI in labour-intensive industries is being actively discouraged, and the government is promoting subregional co-operation (in the form of growth triangles) and outward investment as a means of relocating such industries to neighbouring countries. Malaysia is now concentrating on attracting FDI in technology-intensive and more sophisticated industries, promoting Kuala Lumpur as a financial centre and establishing the country as a regional centre of excellence in education by getting reputable foreign universities to set up "offshore" campuses or joint venture universities in the country. Also massive investments in upgrading of infrastructure are being undertaken and the national goal is to achieve developed country status by the year 2020.

Malaysia is probably the closest to what is thought to be the Asian development model: an open economy, export-driven industrialisation largely based on FDI, close co-operation between the private sector and the government, and sound macroeconomic policies resulting in price stability and a high savings rate. Malaysia's present economic environment represents what other Southeast Asian economies

Table 6: Promoting FDI and Export Oriented Industries

	China	India	Indonesia	Malaysia	Thailand
Contact Agency	<ul style="list-style-type: none"> Ministry of Foreign Economic Relations and Trade (MOFERT) 	<ul style="list-style-type: none"> Foreign Investment Promotion Board (FIPB) 	<ul style="list-style-type: none"> Capital Investment Co-ordinating Board (BKPM) 	<ul style="list-style-type: none"> Malaysian Industrial Development Authority (MIDA) 	<ul style="list-style-type: none"> Board of Investment (BOI)
Tax Holiday/ Concessions	<ul style="list-style-type: none"> 2 years plus 50 % reduction for 3 years. Reduced income tax rate of 15 per cent in SEZ,ETDZ. Local income tax reduced to 10% for activities in SEZ. For export-oriented production a 50 % reduction in income tax each year exported >70 per cent of output. For technology enterprises a 50% reduction in income tax for a three year period duty free imports of inputs for export industries. duty free import of investment goods in SEZs. 	<ul style="list-style-type: none"> 5 years for export oriented unit and infrastructure project companies. Reduced income tax for economic development areas. Refund of income taxes paid on export earnings. Eight year, 30% tax exemption for 100% export firms. Tariff reduction to 15% on import of capital goods used in export production. Access to tax free capital goods for 100% export firms Duty drawback scheme which allows direct and indirect exporters access to raw materials and intermediate goods free of import duties. 	<ul style="list-style-type: none"> None Trade zones with privileges that include exemption from import duty, import surcharge, excise, income tax. Drawback of import duty and VAT for export manufacturers. Exemption from import duties on capital goods and raw materials for two years production. 	<ul style="list-style-type: none"> 5 years for 85 % of income for pioneer industries. Potential pioneer status (income tax is paid on only 30 per cent of income for 5 years). Full exemption from import duty on raw materials or components used for export production. Or if produced in a promoted zones for domestic or export market. Partial import duty relief for goods produced for the domestic market. Full drawback of import duty and sales tax is allowed on parts, components or packaging materials used in the manufacture of goods exported. 	<ul style="list-style-type: none"> 3-8 years depending upon zone. Exemption or 50 per cent reduction of import duties and business taxes on imported machinery. Reduction of import duties and business taxes of up to 90 per cent on imported raw materials and components.

Table 6 (continued, end)

	China	India	Indonesia	Malaysia	Thailand
Profits Repatriation	<ul style="list-style-type: none"> Foreign exchange retention for exporters. 	<ul style="list-style-type: none"> Foreign Exchange retention for exporters 	<ul style="list-style-type: none"> No restrictions. 	<ul style="list-style-type: none"> No restrictions. 	<ul style="list-style-type: none"> No restrictions.
Guarantees/ Protection/ Legal System	<ul style="list-style-type: none"> Unclear legal procedures. Political authority and enforcement of regulations not fully tested. Intellectual/design and patent protection lack formal legal guarantees. 	<ul style="list-style-type: none"> Internationally recognised legal system provides investor protection for contract, land rights, dispute arbitration, etc. 	<ul style="list-style-type: none"> Unclear legal rights, weak judicial system. Bilateral agreements with a number of countries plus MIGA signatory protecting investments against political risks. 	<ul style="list-style-type: none"> Established legal system provides investors protection and fair arbitration disputes. Bilateral protection against nationalisation, expropriation: free transfer of profits and capital. 	
Promotional activities	<ul style="list-style-type: none"> Special economic zones (SEZ)/ Open coastal areas, etc. Economic and technological development zones (ETDZ), in 14 coastal cities-old urban districts. 	<ul style="list-style-type: none"> Export Processing Zones Automatic approval of foreign ownership to 51% of equity in 34 priority areas. Fast approval for investments entailing 100% foreign ownership of firms committed to 100% exports. 	<ul style="list-style-type: none"> Bonded zones. Production activities located in tax free zones are given additional incentives. 	<ul style="list-style-type: none"> Free trade zones. Pioneer status given to priority investment areas. MIDA active and effective. 	<ul style="list-style-type: none"> Industrial estates. Additional incentives for investment in outlying areas. Additional incentives for export firms. BOI active and effective.
Foreign Ownership	<ul style="list-style-type: none"> Can be up to 100% in non-restricted areas. 	<ul style="list-style-type: none"> Can be up to 100%, but very restricted. 	<ul style="list-style-type: none"> Can be 100% for 15 years. 	<ul style="list-style-type: none"> Can be 100%. 	<ul style="list-style-type: none"> Can be 100%, up to 5 years.

Source: China - Price Waterhouse (1993) Interim Provisions on Guiding the Direction of Foreign Investment (promulgated jointly by the State Planning Commission, the State Economic and Trade Commission and the Ministry of Foreign Trade and Economic Co-operation on June 27, 1995) unofficial translation, Clifford Chance, World Bank (1993), (1995), *Business China* (various issues) India -World Bank (1993), *Business China* (various). Indonesia - Lall and Rao (forthcoming), Government of Indonesia (1994), World Bank (1993). Malaysia - MIDA (1993,1992), Lall (1994), UNCTAD (1995a). Thailand - UNCTAD (1995b), Yan and Shilling (1995).

may look like in the future. However, Malaysia is also relatively small, and larger countries such as Indonesia, with their much bigger domestic markets, are likely to have more diverse and complex investment regimes

Table 7. Net FDI in Selected Countries, 1990-95
(FDI in \$ billions, GDP in per cent)

	1990		1991		1992		1993		1994		1995	
	FDI	GDP	FDI	GDP	FDI	GDP	FDI	GDP	FDI	GDP	FDI	GDP
China	3.5	0.9	4.4	1.2	11.1	2.7	27.5	6.4	33.8	6.5	38.0	5.7
India	0.2		0.1		0.2		0.3	0.1	0.6	0.2	1.3	0.4
Indonesia	1.1	1.0	1.5	1.2	1.8	1.3	2.0	1.3	2.1	1.3	4.5	2.4
Malaysia	2.3	5.7	4.0	9.0	5.1	9.4	5.0	8.3	4.3	6.5	5.8	7.9
Thailand	2.4	2.9	2.0	2.1	2.1	1.9	1.7	1.4	0.6	0.5	2.3	1.5

Source: World Bank (1996c).

Thailand's economy has also performed remarkably well, the growth having been export led with manufacturing as the leading sector. Thailand was one of the primary beneficiaries of the industrial restructuring that took place in Asia following the major currency realignments in the mid-1980s, when the loss of competitiveness in labour-intensive industry in Japan and the NIEs resulted in massive relocation of industries such as textiles, garments, footwear and consumer electronics to other countries in the region.

To promote foreign investment, the government set up a Board of Investment, removed subsidies and marketing restrictions on a wide range of products, simplified investment procedures, reduced tariffs on imports and virtually eliminated exchange controls. To reduce concentration of industry in Bangkok, the country was divided into three zones with little or no incentives being provided to investors establishing industries in Zone 1, i.e., Bangkok and its immediate environs. Incentives, such as reductions in import duties on machinery and raw materials and corporate income tax were provided for industries locating in Zones 2 and 3. However, the outer areas, especially Zone 3, do not have adequate infrastructure to be attractive to foreign investors.

Thailand today has an open economy with few restrictions or government interventions. The investment regime is transparent and the procedures and incentives administered by the Board of Investment are simple and straightforward. In 1993 and 1994 FDI inflows showed a downward trend, largely because of congestion in Bangkok, delays in implementation of some large infrastructure projects, and declining attraction as a location for labour-intensive industries. However, while FDI in traditional areas such as textiles, garments and footwear declined, inflows into technologically more advanced areas such as automobiles and electronics continued to increase. The reversal in the downward trend in FDI in 1995 may indicate that

increases in more sophisticated production are finally outpacing the slowdown in lower skilled, labour-intensive industries. Also, with its rapidly growing internal market, central location in Asia and liberal trade and exchange regimes, Thailand is fast emerging as a production centre for the Japanese and US automobile industry. It is possible that, just as Malaysia emerged as a regional export base for the electronics and electrical industry in the first half of the 1990s, Thailand could develop into the regional base for automobiles and components industry in the second half of the decade.

The third country in Group I is Indonesia, which is the fourth most populous country in the world and one of the most richly endowed in natural resources. Indonesia is considered to be another example of the "Asian development model," and is included, along with Malaysia and Thailand, in the category of the new NIEs. However, Indonesia's economy is not as open as Malaysia's or Thailand's. While substantive import liberalisation has taken place and the average tariff is now down to about 14 per cent, a significant proportion of manufacturing production remains protected. In the domestic market, barriers to competition, such as investment licensing and complicated procedures for importing capital goods, bringing in expatriate personnel, and permits are necessary for businesses, acquiring land and other matters. Competition is also restricted by cartels, price controls, entry and exit controls, public sector dominance and ad hoc interventions by the government in favour of specific firms or industries. The sectors in which such restrictions are common include cement, glass, plywood, paper, automobiles, steel, fertilizer, sugar, and flour and rice milling. The domestic economy is also dominated by about 200 conglomerates which control an estimated 40 per cent of GDP. Moreover, there is a high degree of concentration within the conglomerates, with about 14 groups accounting for more than half of the conglomerates' sales.

Nonetheless, Indonesia has been an important recipient of FDI in the region and FDI inflows more than doubled in 1995 to \$4.5 billion and FDI approvals increased to a record \$4 billion. However, because of the factors mentioned, the pattern of FDI in Indonesia is quite different from that in Malaysia and Thailand. About two-thirds of the FDI is in industry, with mining, tourism, real estate development and infrastructure making up the balance. Investment in manufacturing is mainly concentrated in large capital-intensive projects in chemical, including petroleum, paper and basic metals and metal goods industries, which accounted for almost three-fourths of the total cumulative FDI in the manufacturing sector as of December 1995.⁶ Investment in export-oriented, labour-intensive industries such as textiles, garments, footwear, and consumer electronics accounted for about 15 per cent of the cumulative investment, with textiles making up the bulk of the total. In recent years, the share of labour-intensive, export industries has fallen, with FDI approvals for textiles declining from about 14 per cent of the total in 1991 to less than 2 per cent in 1995.

China

China is the largest country in the world in terms of both population and area. Net FDI flows in 1995 are estimated at \$38 billion, which is almost one-quarter of the total FDI to the developing world. With real growth averaging over 10 per cent a year for the last decade and a half, the economy has grown fivefold since 1980 and seems likely to continue on a strong growth path into the next century. China clearly dominates developing Asia in terms of FDI, however, if FDI is seen as a percentage of GDP rather than an absolute number, the proportion in Malaysia is much higher (Table 7). This highlights an important point, that is, although current investment flows into China are large, given its size they are not excessive and China can continue to absorb such flows for a long time.

Unlike the countries in Group I, China is evolving from a command economy to a market economy. The pace and sequencing of economic liberalisation has made the transition successful so far. Agricultural reforms started the process in the late 1970s and the reform process continued with the establishment of four special economic zones (SEZs) in 1980 (Shenzen, Zhuhai, Xiamen and Shantou). The areas were chosen in the provinces of Guandong and Fujian because of their proximity to Hong Kong, Chinese Taipei and Macao. All enterprises, i.e. both foreign-funded and domestic, in SEZs were taxed at a concessional rate of 15 per cent and allowed to import building materials, office and production equipment, vehicles, etc. free of import duties. In addition, imports of inputs for production of exports were permitted free of import duties and licensing restrictions.

Hong Kong and Chinese Taipei consequently became the major investors in China and a key to the success of the SEZs. By the late 1980s more than half of China's exports to the rest of the world were handled by Hong Kong, and 70 per cent of the cumulative value of \$100 billion in FDI commitments to China between 1985 and 1994 were from Hong Kong, being directed toward export-oriented joint ventures largely in Guandong (World Bank 1994, *Global Finance*, November 1995). Guandong today accounts for about 40 per cent of China's exports and 10 per cent of its GDP (*Business China* 1996).

The dominance of Hong Kong in China's FDI and trade is due to several factors:

1. A significant amount of the investment from Hong Kong to China is actually from China itself, referred to as "roundtripping" in the literature, and it is estimated that it could account for as much as 25 per cent of the total FDI flows into China;
2. Although direct foreign investment has been permitted since 1980 in the SEZs, factors such as language, culture, and the need to identify joint venture partners have made Hong Kong the logical base for foreigners interested in investing in China; and

3. China's major focus has been on strengthening economic relationships with, as well as encouraging investment by, overseas Chinese and most of them, including those from Chinese Taipei, have found Hong Kong to be a convenient base.

In the mid-1980s about 70 cities and counties were declared open coastal areas (OCAs) where FDI was encouraged by offering foreign enterprises basically the same concessions as available in the SEZs, except that the reduced corporate income tax was somewhat higher at 24 per cent. In 1992, the concessions available in OCAs were extended to 23 open border cities, cities on the Yangtze River and inland provincial capitals. These measures have helped to disperse FDI more widely, e.g., between 1979 and 1985 the SEZs accounted for over 90 per cent of the \$4 billion invested in China but by 1993 the SEZs and 14 open cities accounted for less than half of all foreign equity projects. (*China Statistical Yearbook*, 1987-1994). Until 1992, FDI was concentrated in power and real estate development, i.e., hotels, tourism related activities and office buildings, but since then investment in the manufacturing sector has increased substantially.

There have been liberal and rapid approvals in the promoted areas because of weak central control, but China's FDI policy regime is complex and the rules and regulations lack transparency. China is much more restrictive than most countries in terms of sectors closed to foreign investment, and in investment screening, performance, local content and trade balancing requirements. Also, weak legal protection against expropriation and inadequate dispute settlement in China is an impediment to FDI.

Infrastructure bottlenecks in China, as in all of developing Asia (with the possible exception of Malaysia), are both a major disincentive and an opportunity for FDI. However, FDI in infrastructure development is constrained because of the lack of a comprehensive, realistic and transparent investment framework. For example, China received substantial private investment in the power sector until the government decided in early 1995 to reduce the fixed rate of return to 12 per cent a year, subsequently increased to 15 per cent, and since then no large power projects have been initiated.

India

The New Industrial Policy was initiated in July 1991 and a gradual process of economic reform covering investment deregulation, promotion of the private sector and trade liberalisation, has continued since then. The sectors in which only public investment was formerly permitted which have been opened to private investment include: mining, coal, hydrocarbons, power, air transport, ports, roads, telecommunications and banking. In addition, automobiles and textile production are no longer subject to licensing, the ready-to-wear garment industry, previously reserved for the small-scale sector, has been opened to large enterprises, and automatic approval of foreign majority ownership is allowed in a number of industries, while for the rest

the approval process has been liberalised. As a result, the Foreign Investment Promotion Board's rejection rate fell from 40 to 50 per cent prior to 1991 to under 10 per cent in 1993, while about 30 per cent of approvals were through the automatic route.

The telecommunications sector has been opened up for the private provision of basic services, as well as value added services, and concessions for a number of regions in the country have been awarded to private operators, mostly joint ventures. The government is promoting foreign investment in the power sector by providing sovereign guarantees, a guaranteed rate of return on equity, and a five-year tax exemption for power projects in backward areas. Several power projects involving multinational corporations and joint ventures sponsored by non-resident Indians are underway or planned. It seems probable that most of the additional investment in power generation will come from the private sector.

Trade reforms since 1991 have considerably eased import licensing requirements and, as a result, the proportion of the manufacturing sector protected by import restrictions has been reduced from 90 per cent to 50 per cent. Import tariffs have also been gradually lowered, with the maximum tariff rate being reduced to 50 per cent from 400 per cent in the pre-reform period. As a result, the trade-weighted average tariff has declined to 27 per cent from 87 per cent in 1990. The rupee has been made convertible on the trade account and the real effective exchange rate has depreciated by 30 per cent since 1990, making exports much more attractive than before. However, India remains a relatively protected market and, as a result, there is a need for the government to screen and restrict investment aimed at the domestic market, which unfortunately neutralises India's most important attraction for FDI. The government has provided a number of concessions to export-oriented FDI, but labour market rigidities, relatively high wages in the organised sector, and inadequate and poor quality infrastructure have prevented any significant inflows into the export sector.

Although moving cautiously with its market liberalisation, India is committed to the process, and the reforms have begun to generate increasing FDI flows. FDI has more or less doubled every year since 1992 to an estimated \$1.3 billion in 1995. However, investment is largely concentrated in infrastructure, particularly power and telecommunications; and petroleum refining, petrochemicals and automobiles in the manufacturing sector.

Future Trends in the Investment Environment and FDI in Asia

The key external factors likely to affect the investment environment and FDI flows in Asian countries are the trend in global FDI, the pace of trade liberalisation at home and China's impact on the "product cycle" pattern of Asian industrialisation. There can be different estimates of these developments, and our view is presented here. First, FDI flows to developing countries will continue to increase for the rest of the 1990s, and Asia will maintain its position as the major recipient of FDI. Second,

tariff and non-tariff barriers will recede fairly quickly in developing Asian countries over the next decade and the main uncertainty is the pace of liberalisation in the more highly protected countries such as China and India. The primary concern in these countries is that if they open up their internal markets too quickly their inefficient industries, especially the state enterprises, will be overwhelmed. However, we assume that significant import liberalisation will take place in these countries as well. Third, we believe there is an unfounded fear that China, with its large potential market, high growth rate, huge demand for investment funds and seemingly inexhaustible supply of cheap labour, may crowd out FDI from other countries in the region and overwhelm labour-intensive exports of countries that are just beginning the process of outward oriented growth. The reasons for this view are: (i) investors will prefer to disperse FDI among as many countries as possible to reduce risk; (ii) out of the three types of FDI discussed earlier, export-oriented FDI is the only one where labour costs are important in the choice of the host country, and export-oriented FDI is likely to be only a small proportion of the total FDI coming into Asia; and (iii) in any case, the labour costs in China are likely to rise fairly quickly as the market-oriented reforms reduce, and ultimately eliminate, implicit subsidies in public housing, education and health care. It is against this background that we discuss in this section the likely trends in the economic environment and FDI flows in different countries/regions.

Southeast Asia

Southeast Asian countries, except Indonesia, are likely to continue to follow the "flying geese" or "product cycle" pattern of development with Malaysia and Thailand in the forefront, the Philippines and Vietnam in the middle and Cambodia, Laos and Myanmar bringing up the rear. While the economic environment for investment in Malaysia and Thailand should become even more open and neutral over time, their environment today is a good example of what it will be like in the future for other countries in this group.

FDI flows are likely to stabilize at the present high levels in Malaysia, grow slowly in Thailand, and increase rapidly in the Philippines and Viet Nam. Malaysia does not lack capital for its infrastructure investments and is fast becoming an important source of FDI in the region. Malaysia's FDI is primarily in the areas of its strengths, such as agribusiness, particularly palm oil, tourism (hotels, resorts, etc.) and infrastructure. However, Malaysia also remains a very attractive destination for FDI, particularly in electronics, and should easily maintain the current levels of inflow. In 1995, Thailand saw a dramatic reversal in the stagnating/declining trend of FDI observed during the past five years, and its emergence as a regional centre for the automobile industry, and possibly other high value engineering industries, should result in a steady increase in inflows from the level reached in 1995. Political and macroeconomic stability, trade liberalisation, deregulation, and the elimination of the power shortages in recent years have put the Philippines on a high growth path fuelled by FDI. Growth and FDI flows are likely to accelerate for the rest of the decade, as the Philippines catches up with its neighbours and begins to achieve its real economic potential. Viet Nam, under its market-oriented economic

reforms, has liberalised trade, provided protection for property and ownership rights and incentives for FDI, which have resulted in an explosive growth in GDP, exports and FDI since 1992. This trend is likely to continue at least for the rest of the 1990s. Myanmar has the potential for following the same path as Viet Nam, but any significant economic developments there must await the resolution of its long-standing political problems.

The pattern of development in Indonesia, however, is likely to differ from the rest of Southeast Asia. The reason is that its size, and the potentially huge internal market associated with it, encourages the pursuit of what we described as a balanced growth strategy. Thus, there is a strong possibility of continuing separation between enterprises producing primarily for export and those producing for the domestic market, with the economic environment for the former moving towards that in other Southeast Asian countries, while for the latter, continuing to be restrictive, non-competitive and high cost. However, the resulting dual industrial structure is likely to make it difficult to sustain the high growth rates observed in the past, and that could generate pressures to reduce and ultimately eliminate barriers separating the export and the domestic markets. Until that happens, FDI in Indonesia will continue to be concentrated in infrastructure, chemicals (including petroleum), real estate development, particularly tourism-related, and natural resource based sectors. FDI in the manufacturing sector, while less than what it could be, will be substantial. It will be divided about equally, with half going to export-oriented industries, both labour-intensive ones in FTZs and capital-intensive, natural resource based sectors elsewhere, while the other half will be oriented towards consumer durables, consumer electronics, automobiles, food processing, and petrochemicals for the domestic market. Given Indonesia's rich natural resource endowment, abundant labour, large domestic market and huge infrastructure requirements, there is considerable scope for continued growth of FDI over the medium term.

China

The most important issue for China in the near future is how well Hong Kong will be assimilated into the Chinese economy after its handover in June 1997. Currently, Hong Kong is probably the most open economy in the world, the bulk of FDI into China is either from Hong Kong or channelled through it, and Hong Kong is the conduit for a major portion of China's trade. Thus a smooth and successful transition could lead to a further opening up of China and the resulting synergy would help sustain its current high rates of growth in GDP, exports and FDI. Since the start of the economic reforms in 1979, China has had a pragmatic approach towards economic issues, with the highest priority being attached to economic development, and there is every reason to expect that this will continue in the future. Therefore, our projections are based on the assumption that the return of Hong Kong to China will have a positive impact on both economies.

While FDI in the export sector will continue to expand due to the abundance of low wage labour in China and marketing capabilities and connections of the trading houses in Hong Kong, the majority of the investment in China will be for infrastructure and production for the domestic market. China not only has a huge and rapidly growing domestic market, but also a well-developed engineering industry and a large, well-educated and skilled labour force. As incomes rise, the domestic market for consumer durables should grow explosively and a substantial part of FDI will be targeted at this market. As fiscal incentives to foreign investors are reduced, access to the domestic market will be the main bargaining chip for China to achieve its goals of promoting certain industries, acquiring sophisticated technology and developing regions which thus far have been left out of the industrialisation process. While the investment environment for export-oriented industries may become more open, transparent and similar to other countries in Asia, FDI targeted at the domestic market will be faced with a complex and difficult environment, where the conditions of access will be largely a matter of negotiation.

The other area that is likely to receive huge amounts of FDI in China is infrastructure, particularly power and telecommunications. China has immense needs for investment in infrastructure to remain internationally competitive, and it will be seeking FDI for a major portion of this investment. The one thing that is retarding FDI in infrastructure in China is the absence of a comprehensive and transparent policy framework for private investment. While the lack of a framework has not, thus far, adversely affect investment in manufacturing and real estate development, the risks and size of investments involved in infrastructure projects give critical importance to the policy framework. It is assumed that such a framework will be in place soon, and investment in infrastructure will accelerate.

South Asia

Infrastructure, particularly power, hydrocarbons and telecommunications are likely to be the area of concentration for FDI in India. Private sector participation in these areas has been given the highest priority by the government. Power generation and distribution are open to private sector investment, but a lack of a comprehensive policy, and decisions on issues such as tariffs, subsidies and payment of dues by state authorities, are inhibiting investment despite widespread interest. Incentives for oil and gas exploration, along with the move towards privatisation, should make the hydrocarbon sector extremely attractive to foreign investors. Guidelines, regulations and modalities for private investment in telecommunications, ports, railways and roads are being developed. Most major TNCs in telecommunications have shown great interest in investing in India, and a number of projects are already underway in this sector. While these areas should absorb the bulk of the FDI in India in the next decade, there is considerable potential for FDI in the tourism sector, such as hotels, resorts, etc., but this sector is still virtually closed to foreign investment. However, this could

change because growth in tourism has the potential of providing India with large foreign exchange earnings, and balance of payments considerations may be an inducement to opening the sector to FDI.

In manufacturing, the potentially important industries for FDI are automobiles and components, white goods and components, consumer electronics, chemicals, and food processing. Some of these could also emerge as major export industries, however, because of a significant anti-export bias in the trade regime and labour market rigidities, initially FDI in the manufacturing sector will be largely restricted to production for the domestic market.

Over the longer term the composition of FDI in manufacturing will depend upon the pace of market liberalisation. Although India has abundant labour, wages in the organised sector are relatively high because of its labour laws and powerful unions. However, India has some unique advantages, besides its size, which could help attract FDI to the manufacturing sector. These include: (i) English is a working language, which can involve considerable saving of time and money for foreign investors since neither written or oral instructions, have to be translated, technical materials can be easily adapted and used, and managers from the parent company can quickly begin to work locally; (ii) The legal system, although slow, is well established with a tradition for fairness; (iii) There is a strong engineering base, and although machinery and equipment may be obsolete, the basic engineering infrastructure to adapt and use new technologies already exists; and (iv) There is a large reservoir of educated, skilled human resources, and since labour laws and unions do not extend to professionals, salaries of engineers, managers and technical staff are relatively low.

Perhaps some of these factors have enabled India to carve out a market niche in the software industry⁷, despite the country's inward orientation and poor infrastructure. India's software industry has been growing at over 40 per cent a year. Export earnings from software exceeded a billion dollars in 1995, despite the fact that most firms have had to construct their own export infrastructure, such as dedicated satellite links.

Given their size, comparisons between China and India are inevitable. When China began its "open door" policy in 1980, FDI responded slowly at first (less than 1 per cent of GDP in 1990) and then rapidly to today's high levels. A similar pattern seems likely to occur in India. Since 1991, when India initiated a process of liberalisation, FDI has grown from an insignificant amount to 0.4 per cent of GDP in 1995. This trend is expected to continue, with the ratio of FDI to GDP approaching 1 per cent in 1996 and 3 per cent to 4 per cent of GDP by the end of the decade.

Pakistan has many of the same advantages as India, i.e., the widespread use of English, an established Western-based legal system, a potentially large internal market, an outmoded but substantial engineering industry and abundant labour with good mechanical and industrial skills. It also has similar drawbacks, such as a highly protective trade regime, a large fiscal imbalance, inadequate and low quality infrastructure, poor enforcement of intellectual property rights, etc. Thus, most of the conclusions for India are also valid for Pakistan.

Pakistan opened its economy to FDI almost completely in 1991, and has been successful in attracting substantial inflows, particularly in infrastructure. It is also pursuing an ambitious programme of privatisation of public utilities, and that too has attracted considerable FDI. Investment flows to Pakistan are estimated to be about 1.2 per cent of GDP in 1995. The country's infrastructure investment needs are immense, and given its aggressive privatisation policy and a well thought out policy framework for FDI in the power sector, it should be able to attract large amounts in this sector. The major uncertainty for FDI will be Pakistan's poor record of political and macroeconomic stability.

Estimated FDI in 2001

To put the discussion in a perspective, it would be extremely useful to have some estimates of future FDI flows to Asia. Therefore, a simple exercise is undertaken to get an idea of the magnitudes involved. The two variables we used are GDP growth rates and projected FDI/GDP ratios. For the former, forecasts of the Asian Development Bank (1996 a and b), the World Bank (1996) and Project Link (United Nations, 1996) were used to derive the baseline GDP growth rate estimates for the period 1996 to 2001 (see Table 8). The high scenario assumes 1 percentage point higher growth rate for all the regions. Estimating the FDI/GDP ratio five years hence is much more difficult. We used the change in the ratio between 1990 and 1995 and the preceding discussion in this section on the likely developments in the investment environment in the different regions to make an estimate of the baseline FDI/GDP ratio in 2001. Some of the key underlying assumptions are: (i) a 20 per cent reduction in the FDI/GDP ratio for China because of the elimination of "roundtripping" after the takeover of Hong Kong in 1997; (ii) FDI flows to India will closely follow the Chinese experience of the 1990 to 1995 period; (iii) while investment in Malaysia and Thailand will be more or less stable, FDI flows to Indonesia, Philippines and Viet Nam will increase rapidly for the next five years, and the increase in the FDI/GDP ratio for Southeast Asia will be about half that in the 1990 to 1995 period. The high scenario assumes that the FDI/GDP ratio would be 1 percentage point higher than the baseline ratio.

Based on the above assumptions, it is estimated that FDI flows to Asia in the year 2001 will be \$101 to \$134 billion (Table 9). This represents about a doubling of FDI in five years, which seems rather low compared to the fivefold increase between 1990 and 1995. However, the huge increase in the last five years was partly because of explosive growth in China, which cannot be sustained. For Asia excluding China, FDI in 2001 will be three to four times the 1995 level, which is substantially more than the increase of 2.25 times in the 1990 to 1995 period. The most rapid growth will take place in South Asia, where FDI will increase from the current level of about \$2 billion to about \$25 billion in 2001.

We also attempted to distribute the investment into three categories, i.e., export-oriented industry, domestic-market-oriented industry and infrastructure. Since such a distribution for current inflows is not available, these numbers are merely educated guesses, based on the discussion of regional trends earlier in this section. Our conclusion is that in South Asia, infrastructure will be the most important sector for FDI, accounting for 60 per cent of the total, and export-oriented FDI will make up a relatively small proportion, about 10 per cent of the total (see Table 10). Southeast Asia will be the only region in which export-oriented investment will dominate, but even there infrastructure and domestic-market-oriented industry will account for half of the total FDI. In China, the distribution between the three categories is likely to be more or less the same, with export-oriented FDI being concentrated in the coastal provinces. An interesting conclusion emerging from this exercise is that less than a third of the FDI flows to Asia in 2001 are likely to go into export industries, i.e. contrary to popular fears, FDI flows from the OECD countries to Asia are likely to generate substantially greater opportunities for exports from OECD countries to Asia than competition from Asian exports in OECD countries.

Table 8. **Estimated GDP Growth Rate, 1996-2001**
(average annual percentage growth)

Country/Region	Various Forecasts	Assumed Baseline Growth Rate	Assumed High Growth Rate
China		8.5	9.5
ADB ¹	9.0		
Project Link ²	8.3		
IBRD ³	8.0-9.0		
South Asia		6.0	7.0
ADB ¹	6.0		
IBRD ³	5.4		
India			
ADB ¹	6.6		
Project Link ²	6.6		
Southeast Asia		7.5	8.5
ADB ¹	7.7		
Indonesia			
ADB ¹	8.0		
Project Link ²	7.5		
Malaysia			
ADB ¹	8.0		
Project Link ²	8.2		
Thailand			
ADB ¹	8.2		
Project Link ²	8.0		
Asia		7.2	8.2
ADB ¹	7.2		
IBRD ³	7.2		

¹ 1996-98

² 1996-2000

³ 1996-2005

⁴ 1996-2001

Sources: ADB (1996a); ADB (1996b); World Bank (1996a); United Nations (joint project of University of Pennsylvania, United Nations, and University of Toronto).

Table 9. Estimating FDI in Developing Asia in the Year 2001

Country/Region	FDI	FDI/GDP (%)		GDP Growth Rate (%) 1990 to 1995	Growth Rate 1996 to 2001		FDI/GDP Ratio in 2001		FDI in 2001 (\$ billion)	
		1990	1995		Low	High	Low	High	Low	High
China	38.0	1.0	5.7	10.5	8.5	9.5	4.5	5.5	49	63
Southeast Asia	15.5	1.4	2.7a	7.5b	7.5	8.5	3.5	4.5	31	42
South Asia	2.2	0.1	0.4	4.8c	6.0	7.0	3.0	4.0	21	29
Developing Asia	55.7	0.9	3.3	7.9	7.2	8.2	4.2	5.4	101	134

- a. FDI to Indonesia, Malaysia and Thailand was \$12.6 billion or 2.9 per cent of the GDP.
 b. Growth was 8.4 per cent if Philippines is excluded.
 c. Growth was 5.4 per cent in the year 1991 is excluded for India.

Source: World Bank (1996c)

Table 10. Distribution of FDI by Sector in the Year 2001

Country/Region	Export Market		Domestic Market			
	%	\$ billion	Infrastructure %	\$ billion	Others %	\$ billion
China	30	15-19	40	20-25	30	15-19
Southeast Asia	50	16-21	30	9-13	20	6-8
South Asia	10	2-3	60	13-17	30	6-10
Developing Asia	32	33-43	41	42-55	27	27-37

Source: Authors' estimates.

Notes

1. The opinions expressed in this chapter are those of the authors and do not necessarily reflect those of the Asian Development Bank.
2. It could also be to get access to a protected market in a third country to which the host country has preferential access by not being subject to textile quotas or having membership in a trade bloc.
3. In the 19th and early 20th centuries, foreign investment in infrastructure, particularly railroads and canals, was important.
4. As countries move towards realistic exchange rates the popularity of such measures is also declining.
5. Most of the conclusions for India are also applicable to South Asia in general and Pakistan in particular.
6. Approvals for the four capital-intensive industries increased from 66 per cent of the total FDI approved in 1991 to 89 per cent in 1995. The bulk of these approvals were for petroleum refining, petrochemicals and paper, which undoubtedly generate exports but are a part of "natural resource seeking" FDI.
7. Indian schools turn out over 20 000 computer science engineers a year and it is estimated that the cost of an Indian software engineer is about one-fifth of an American equivalent.

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